



Research Articles

HOTEL CAP RATES

HOW MUCH LOWER CAN THEY GET?

Capitalisation rates have become a very practical and quick way for hotel investors to assess their various investment opportunities. We support this valuation methodology but insist on the importance of calculating cap rates on a fair and consistent basis to maximise the benefit of their use.

Hotel cap rates have been progressively declining. This translates into hotel valuations having gone up significantly. A favourable economic environment, solid RevPAR growth and the remarkable interest in the hotel sector from the investment community are just some of the reasons that would explain the descent in cap rates.

But where to from here? We have asked ourselves whether we are likely to see cap rates going much lower. In our view, these are likely to stay at or around current levels. There are enough reasons to believe that hotel cap rates will not increase or decrease significantly in the short to medium term. We believe that the freefall that these have experienced over the last few years is not likely to continue. But it is also true that the sector's dynamics have changed and that most of the reasons that led to such yield compression have definitely not gone away. Contradictory as it may sound, it seems that this change is here to stay.

Cristina Badenes

Research

T: +34 93 484 15 00

F: +34 93 484 15 81

E: cbadenes@meridiacapital.com



Executive summary

Calculating cap rates on a consistent basis is important

Cap rates are increasingly becoming hotel investors' preferred valuation methodology. They can be quickly calculated and provide investors with a rough measure with which to assess if an investment is worth it. However, in this report we insist on the importance of being aware of their limitations. Knowing what income is taken for their calculation or what period of time this income covers is key to maximising the benefit that cap rates can provide us. When using cap rates for valuation purposes, making sure that these have been calculated on a consistent basis is clearly relevant.

Several variables influence cap rates

We have also gone through what we believe are some of the most relevant variables that determine cap rates: location, property type, market dynamics in terms of supply and demand, timing within the cycle and cost of capital. We have examined each of these aspects and have shown how much they can influence the performance of cap rates.

Over the last few years, hotel cap rates have declined significantly

Globally, cap rates have progressively declined in every sub-sector within the real estate industry. Hotels have been no exception to this and valuations have increased. Solid GDP growth, low interest rates (despite the increasing trend), high loan to value ratios, excellent operating performance of hotel companies, increasing number of buyers, high interest in the sector from new entrants, an extremely liquid market and the lower returns being offered by other real estate asset classes largely explain the drop in hotel cap rates.

We do not think there is much room for further reductions

But are we likely to see cap rates going much lower than this? We doubt it. Rising interest rates, more moderate RevPAR growth, the deceleration seen in various real estate markets globally and the recently failed or unsuccessful IPOs of several real estate groups have led us to believe that there is not much room left for further reductions.

Cap rates should stabilise

After the decline of the last few years, we believe that cap rates are likely to stabilise at a lower level than that seen in prior hotel cycles.

Using cap rates for valuation purposes

A commonly used methodology

There are several methodologies for valuing real estate. The income capitalisation approach is perhaps the most commonly used nowadays. It is a simple and quick valuation technique that is increasingly being used by investors in our sector.

Definition

What is a cap rate and how is it calculated?

This methodology is based on the premise that an asset is worth the returns that it will be able to generate in the future (i.e. the value of a property is equal to the present value of future cash flows).

According to the Appraisal Institute, the capitalisation rate or cap rate is a method used to convert an estimate of a single year's income expectancy into an indication of value in one direct step, by dividing the income estimate by an appropriate rate. The relationship between these variables would be as follows:



$$V = I / C$$

I = Income

C = Cap rate

V = Value

Income

In order for this valuation methodology to result useful, it is important that we take a consistent definition of what "income" means. There are two aspects to consider:

What income do we use as the basis for our calculation?

EBITDA is generally the profit measure taken

The most commonly used income is EBITDA (earnings before interest, tax, depreciation and amortisation), which effectively is a measure of profit that obviates the different financing structures, different tax regimes and different accounting policies, thus facilitating comparability.

For consistency reasons, we should make sure that the calculation of EBITDA is always done on the same basis

Investors in the real estate sector tend to show interest in the implied cap rates derived from a transaction in order to assess whether the transaction has been done at a high or low price. However, care should be taken as cap rates are not always consistently calculated. The calculation of EBITDA is not always done on the same basis. This discrepancy involves mostly fixed charges. We have found that cap rates resulting from transactions are based on an EBITDA figure that some times includes aspects like management fees, whilst some times it does not. The same applies to other measures, like the replacement reserve (although these fixed charges tend to be, generally, deducted before capitalisation). This means that investors comparing the different cap rates achieved in various hotel transactions are not always comparing figures calculated on the same basis, which can clearly be misleading.

What period of time does this income cover?

The time period linked to the EBITDA used in the calculation should also be taken into consideration

Another aspect that we generally find is that investors tend to talk about the achieved cap rate in a specific transaction without considering the time period linked to the profits used in the calculation. Some times the EBITDA taken is based on past performance, whilst others it is based on current figures or on future estimates. Clearly, what period of time we consider will affect the resulting cap rate. As profits tend to increase year over year, cap rates based on historic data tend to be lower than those calculated using estimated future profits.

The trailing 12 months is perhaps the preferred time frame to take

The three most common periods of time considered are the previous financial year, the trailing 12 months ending at the time of the transaction and the following financial year. For instance, if the acquisition of a hotel that has its financial year to December took place in June 2007, we would find that some investors base their cap rate calculation in the cash flow generated from January to December 2006. Others would consider the period from May 2006 to May 2007, whilst others would take January to December 2007. Depending on the

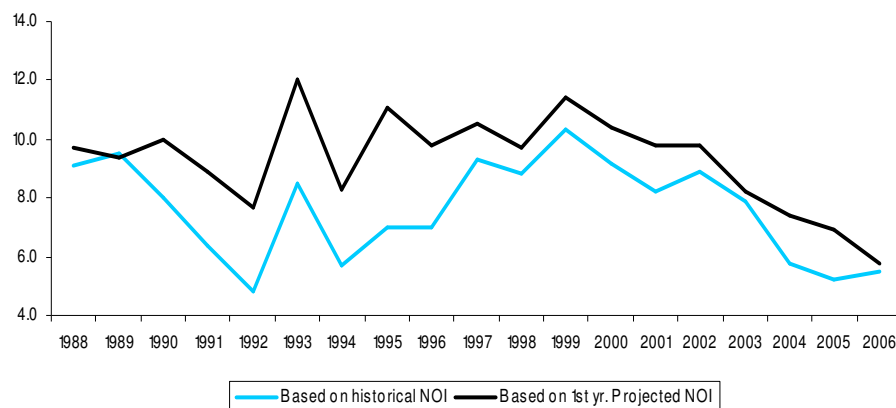


time period considered the resulting figures would, of course, be different. The trailing 12 months is perhaps the preferred time frame for stable hotels. In any case, whichever period we decide to take, when comparing cap rates we should make sure that we are comparing figures calculated on the same grounds.

The differential between cap rates based on historic and projected profits averaged 170bp between 1988 and 2006

The following chart shows the trend in cap rates for a select set of full service hotels in the US from 1988 to 2006. A set of data has been calculated using the historic net operating profit, whilst the other has been calculated taking the first year projected profit. On average, the differential between these two sets of data for the whole period was 170bp, although this differential narrowed over the last few years. The line reflecting cap rates based on historic profits is below the one reflecting forecast income, as an improvement in operating performance is usually assumed. The two lines cross or almost cross in 1989 and 2003 (two rather difficult years for the industry), which shows that investors' expectations of increasing profits were low. This was also the case in 2006, which reflects a moderation of expectations of further profit improvements (perhaps quite conservatively).

Chart 1: Derived and projected derived cap rates for select set of full service hotels (in %)



Source: HVS International.

It should also be noticed that the stage that a hotel is going through will also be relevant for valuation purposes. Using the cash flow from a stabilised year would be most appropriate. Taking what we believe is a reasonable cap rate to value a hotel based on market data but applying it to the estimated EBITDA in the first year of operations could clearly give us a misleading result. The different stages in the cycle of a hotel (initial growth, maturity and decline) should therefore be considered.

In practical terms, full comparability of results is not always feasible

It must be said that taking the right data for comparison purposes is not always possible. Theoretically, this is what should be done. In practical terms, however, this is not always viable. The information available on the different market transactions tends to be limited and, depending on the source that we use, inaccurate. Also, the price paid by the acquirer is not always disclosed, which turns arriving at a cap



rate figure into an impossible exercise. The numbers published on the various hotel transactions may not always be totally precise or calculated on a comparable basis, but will in most cases provide us with a good reference. That said, it is important that we are aware that inaccuracies or inconsistencies may exist.

Cap rate

Cap rates tell us how much a property yields

What we are doing when calculating a cap rate is dividing the annual income generated by the property being appraised by the price paid. Looking at it this way, the cap rate tells us how much that property is yielding.

In a way, this would be very similar to the inverse of the earnings multiple used to value quoted companies. The stock market uses Enterprise Value/EBITDA (EV/EBITDA) as the reference valuation multiple for hotel companies.

When we try to arrive at the value of a property using cap rates, we divide the estimated profit (in cash terms) by the cap rate. Effectively, the cap rate is the weighted cost of the invested capital (both debt and equity). We would be valuing an asset as a perpetuity cash flow.

What determines cap rates?

Several variables influence cap rates

Hotel cap rates may vary according to different variables. When valuing a hotel, aspects like which type of hotel it is or its location can clearly make a difference. Here are some of the variables that should be taken into consideration:

- Location
- Property type
- Supply vs. demand
- Timing within the cycle
- Cost of capital

Location

This variable is one of the most important ones. It divides itself into different sub-variables:

Geographical market

A hotel's location will clearly be relevant

Cap rates used can vary depending on a hotel's geographical location. The cap rate used to value a hotel in a mature and stable market will generally be lower than that used to value a hotel in an emerging and riskier market (albeit offering higher growth potential).

Cap rates in Europe tend to be lower compared with the Americas or Asia

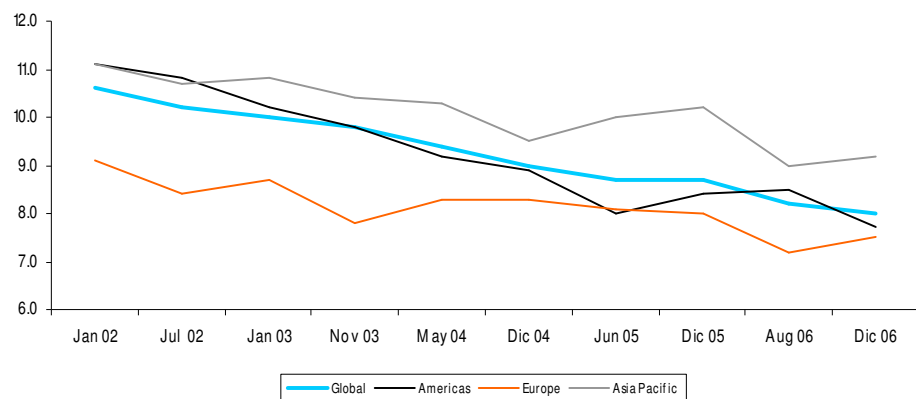
Cap rates in Europe have traditionally been lower than in other markets. Hotel assets in Europe have generally achieved higher prices per room than in other places (even when compared with the US). This is due to the fact that traditionally it has been more difficult to acquire quality assets in Europe given the higher restrictions on the land and the higher number of protected buildings.

The chart below, based on the data provided by several Hotel Investor Sentiment Surveys (by Jones Lang LaSalle Hotels), shows the



performance of cap rates in the Americas, Europe and Asia from 2002 to 2006. The trend itself is quite similar, although a gap exists between them. The blue line reflects the performance of cap rates globally, showing a pronounced drop since 2002.

Chart 2: Average cap rates (in %)



Source: Jones Lang LaSalle Hotels' HISS and Meridia Capital.

Over the last few years, no single market has seen an overall rise in cap rates

We have also looked at the performance of each area individually, taking the cap rates in the most relevant markets within each area. This data is shown in the tables below. We have also compared the performance of cap rates vs. the previous period for each area. Again, in most cases the data shows falling cap rates (negative growth rates are shown in red). There are some exceptions to this, depending on the area and the periods being considered. Comparing the data in December 2006 with that of January 2002, it is interesting to see that no one single market has seen a rise in hotel cap rates. The growth figures are all negative.



Table 1: Global – Average cap rate (initial yield) for new acquisition

In %	Jan 02	Jul 02	Jan 03	Nov 03	May 04	Dic 04	Jun 05	Dic 05	Aug 06	Dic 06	Jul 02 vs. Jan 02	Jan 03 vs. Jul 02	Nov 03 vs. Jan 03	May 04 vs. Nov 03	Dic 04 vs. May 04	Jun 05 vs. Dic 04	Dic 05 vs. Jun 05	Aug 06 vs. Dic 05	Dic 06 vs. Aug 06	Dic 06 vs. Jan 02
	GLOBAL	10.6	10.2	10.0	9.8	9.4	9.0	8.7	8.7	8.2	8.0	-0.4	-0.2	-0.2	-0.4	-0.4	-0.3	0.0	-0.5	-0.2

Source: Jones Lang LaSalle Hotels' HISS and Meridia Capital.

Table 2: Americas – Average cap rate (initial yield) for new acquisition

In %	Jan 02	Jul 02	Jan 03	Nov 03	May 04	Dic 04	Jun 05	Dic 05	Aug 06	Dic 06	Jul 02 vs. Jan 02	Jan 03 vs. Jul 02	Nov 03 vs. Jan 03	May 04 vs. Nov 03	Dic 04 vs. May 04	Jun 05 vs. Dic 04	Dic 05 vs. Jun 05	Aug 06 vs. Dic 05	Dic 06 vs. Aug 06	Dic 06 vs. Jan 02
	AMERICAS	11.1	10.8	10.2	9.8	9.2	8.9	8.0	8.4	8.5	7.7	-0.3	-0.6	-0.4	-0.6	-0.3	-0.9	0.4	0.1	-0.8
<u>US:</u>																				
Boston	10.7	10.2	9.8	9.5	9.1	8.5	8.1	7.5	7.7	7.6	-0.5	-0.4	-0.3	-0.4	-0.6	-0.4	-0.6	0.2	-0.1	-3.1
Chicago	11.1	10.5	9.9	9.5	9.4	8.7	8.4	7.8	8.0	7.6	-0.6	-0.6	-0.4	-0.1	-0.7	-0.3	-0.6	0.2	-0.4	-3.5
Miami	11.1	10.5	10.7	9.6	8.8	8.8	8.2	7.9	8.6	7.7	-0.6	0.2	-1.1	-0.8	0.0	-0.6	-0.3	0.7	-0.9	-3.4
New York	10.5	9.8	9.3	9.1	8.5	7.9	7.3	6.5	7.2	6.4	-0.7	-0.5	-0.2	-0.6	-0.6	-0.6	-0.8	0.7	-0.8	-4.1
San Francisco	10.6	10.5	9.6	9.5	9.5	8.2	7.9	7.1	7.6	6.9	-0.1	-0.9	-0.1	0.0	-1.3	-0.3	-0.8	0.5	-0.7	-3.7
Washington D.C.	10.8	10.3	9.7	9.4	8.8	8.6	7.8	7.2	7.5	7.2	-0.5	-0.6	-0.3	-0.6	-0.2	-0.8	-0.6	0.3	-0.3	-3.6
<u>Caribbean</u>	12.5	12.0	10.7	10.6	8.9	10.0	9.3	9.1	10.4	9.2	-0.5	-1.3	-0.1	-1.7	1.1	-0.7	-0.2	1.3	-1.2	-3.3
<u>LatAm:</u>																				
Buenos Aires	13.1	12.0	11.3	10.8	9.4	9.5	9.6	9.9	10.9	8.8	-1.1	-0.7	-0.5	-1.4	0.1	0.1	0.3	1.0	-2.1	-4.3
Mexico City	12.5	12.0	10.1	12.1	9.7	10.3	9.2	9.5	10.4	8.4	-0.5	-1.9	2.0	-2.4	0.6	-1.1	0.3	0.9	-2.0	-4.1
Rio de Janeiro	12.2	12.2	10.5	10.8	9.4	9.5	9.8	9.9	10.7	8.8	0.0	-1.7	0.3	-1.4	0.1	0.3	0.1	0.8	-1.9	-3.4
Sao Paulo	12.2	12.5	10.7	10.8	9.4	9.3	9.8	9.8	10.7	8.8	0.3	-1.8	0.1	-1.4	-0.1	0.5	0.0	0.9	-1.9	-3.4

Source: Jones Lang LaSalle Hotels' HISS and Meridia Capital.

Average cap rate for Americas as a region is calculated based on a larger number of cities and areas than shown above.



Table 3: Europe – Average cap rate (initial yield) for new acquisition

In %	Jan 02	Jul 02	Jan 03	Nov 03	May 04	Dic 04	Jun 05	Dic 05	Aug 06	Dic 06	Jul 02 vs. Jan 02	Jan 03 vs. Jul 02	Nov 03 vs. Jan 03	May 04 vs. Nov 03	Dic 04 vs. May 04	Jun 05 vs. Dic 04	Dic 05 vs. Jun 05	Aug 06 vs. Dic 05	Dic 06 vs. Aug 06	Dic 06 vs. Jan 02
	EUROPE	9.1	8.4	8.7	7.8	8.3	8.3	8.1	8.0	7.2	7.5	-0.7	0.3	-0.9	0.5	0.0	-0.2	-0.1	-0.8	0.3
<u>Austria:</u>																				
Vienna	n.a.	n.a.	n.a.	n.a.	8.4	7.3	7.2	7.6	6.7	7.4	n.a.	n.a.	n.a.	n.a.	-1.1	-0.1	0.4	-0.9	0.7	-0.9
<u>Benelux:</u>																				
Amsterdam	9.2	8.2	7.9	7.5	7.3	7.5	10.3	7.9	7.2	7.0	-1.0	-0.4	-0.4	-0.2	0.2	2.8	-2.4	-0.7	-0.2	-2.2
Brussels	9.6	8.6	8.7	9.0	8.8	7.2	7.3	7.7	7.1	7.1	-1.0	0.1	0.4	-0.2	-1.6	0.1	0.4	-0.6	0.0	-2.5
<u>Eastern Europe:</u>																				
Budapest	10.7	9.7	11.5	10.9	10.5	10.0	8.7	9.0	7.3	8.6	-1.0	1.8	-0.6	-0.5	-0.4	-1.3	0.3	-1.7	1.3	-2.1
Moscow	n.a.	n.a.	n.a.	n.a.	14.7	13.2	10.6	10.9	8.8	8.6	n.a.	n.a.	n.a.	n.a.	-1.5	-2.6	0.3	-2.1	-0.2	-6.1
Prague	10.6	9.8	10.8	8.8	10.0	8.3	8.5	9.0	7.3	8.3	-0.8	0.9	-2.0	1.2	-1.7	0.2	0.5	-1.7	1.0	-2.3
<u>France:</u>																				
Paris	8.7	8.0	8.9	7.5	7.4	6.6	6.5	7.0	6.9	6.3	-0.7	0.9	-1.4	-0.2	-0.8	-0.1	0.5	-0.1	-0.6	-2.4
<u>Germany:</u>																				
Berlin	8.3	8.4	7.3	7.8	8.5	7.4	7.5	7.9	7.1	7.1	0.1	-1.1	0.5	0.7	-1.1	0.1	0.4	-0.8	0.0	-1.2
Frankfurt	8.3	8.1	7.6	7.4	7.6	7.3	7.2	8.0	6.9	7.0	-0.2	-0.6	-0.1	0.1	-0.3	-0.1	0.8	-1.1	0.1	-1.3
Munich	8.5	8.0	7.4	7.9	7.9	7.1	7.6	7.4	6.9	6.9	-0.5	-0.6	0.5	0.0	-0.8	0.5	-0.2	-0.5	0.0	-1.6
<u>Italy:</u>																				
Milan	8.4	7.9	8.2	7.5	7.5	7.1	10.6	7.7	7.3	7.2	-0.5	0.3	-0.7	0.0	-0.4	3.5	-2.9	-0.4	-0.1	-1.2
Rome	8.6	7.9	7.8	7.4	7.4	7.2	7.2	7.5	7.4	7.0	-0.7	-0.1	-0.4	0.0	-0.2	0.0	0.3	-0.1	-0.4	-1.6
<u>Nordic region:</u>																				
Copenhagen	n.a.	n.a.	n.a.	n.a.	11.5	8.0	7.7	8.0	6.7	7.1	n.a.	n.a.	n.a.	n.a.	-3.5	-0.3	0.3	-1.3	0.4	-4.4
Stockholm	9.2	8.5	9.5	9.1	9.1	7.8	7.7	8.2	6.7	7.5	-0.7	1.0	-0.4	0.0	-1.3	-0.1	0.5	-1.5	0.8	-1.7
<u>Spain:</u>																				
Barcelona	9.5	8.1	9.5	8.8	8.6	8.3	7.3	7.3	7.3	6.9	-1.4	1.4	-0.8	-0.2	-0.3	-1.0	0.0	0.0	-0.4	-2.6
Madrid	9.5	8.2	9.5	8.5	8.5	9.7	9.6	10.8	6.9	7.8	-1.3	1.3	-0.9	0.0	1.2	-0.1	1.2	-3.9	0.9	-1.7
<u>UK + Ireland:</u>																				
Dublin	n.a.	n.a.	n.a.	n.a.	9.3	10.8	7.9	7.7	7.0	7.0	n.a.	n.a.	n.a.	n.a.	1.6	-2.9	-0.2	-0.7	0.0	-2.3
London	8.8	8.3	9.1	8.6	8.4	7.4	6.6	6.6	7.2	5.8	-0.5	0.8	-0.5	-0.2	-0.9	-0.8	0.0	0.6	-1.4	-3.0

Source: Jones Lang LaSalle Hotels' HISS and Meridia Capital.

Data for Jan 03, Nov 03 and May 04 is the average between short and long term cap rates.

Average cap rate for Europe as a region is calculated based on a larger number of cities and areas than shown above.

n.a. = not available.

Growth rates for Vienna, Moscow, Copenhagen and Dublin shown in last column are for the period Dic 06 vs. May 04.



Table 4: Asia – Average cap rate (initial yield) for new acquisition

In %	Jan 02	Jul 02	Jan 03	Nov 03	May 04	Dic 04	Jun 05	Dic 05	Aug 06	Dic 06	Jul 02 vs. Jan 02	Jan 03 vs. Jul 02	Nov 03 vs. Jan 03	May 04 vs. Nov 03	Dic 04 vs. May 04	Jun 05 vs. Dic 04	Dic 05 vs. Jun 05	Aug 06 vs. Dic 05	Dic 06 vs. Aug 06	Dic 06 vs. Jan 02
	ASIA PACIFIC	11.1	10.7	10.8	10.4	10.3	9.5	10.0	10.2	9.0	9.2	-0.4	0.1	-0.4	-0.1	-0.8	0.5	0.2	-1.2	0.2
<u>Australia:</u>																				
Melbourne	10.5	9.8	9.4	9.2	9.1	9.0	8.8	9.2	8.2	7.9	-0.7	-0.4	-0.2	-0.1	-0.1	-0.2	0.4	-1.0	-0.3	-2.6
Sydney	9.6	9.0	8.9	8.7	8.3	8.3	8.2	8.5	7.9	7.6	-0.6	-0.1	-0.2	-0.4	0.0	-0.1	0.3	-0.6	-0.3	-2.0
<u>China:</u>																				
Beijing	12.1	11.8	11.3	9.5	9.1	9.6	9.8	10.2	9.3	9.0	-0.3	-0.5	-1.8	-0.4	0.5	0.2	0.4	-0.9	-0.3	-3.1
Hong Kong	8.8	8.3	8.9	9.6	12.8	8.8	8.1	8.9	8.3	7.6	-0.5	0.6	0.7	3.2	-4.0	-0.7	0.8	-0.6	-0.7	-1.2
Shanghai	12.5	11.8	10.8	9.4	8.9	9.9	9.8	9.8	9.1	8.9	-0.7	-1.0	-1.4	-0.5	1.0	-0.1	0.0	-0.7	-0.2	-3.6
<u>India:</u>																				
Bangalore	n.a.	n.a.	n.a.	n.a.	10.6	13.2	11.9	12.2	10.4	10.4	n.a.	n.a.	n.a.	n.a.	2.6	-1.3	0.3	-1.8	0.0	-0.2
Mumbai	11.9	11.9	13.3	12.3	11.9	9.8	11.2	11.3	9.9	9.9	0.0	1.4	-1.0	-0.4	-2.1	1.4	0.1	-1.4	0.0	-2.0
New Delhi	12.1	12.4	13.5	11.0	10.8	10.5	10.9	10.9	9.9	9.9	0.3	1.1	-2.5	-0.2	-0.3	0.4	0.0	-1.0	0.0	-2.2
<u>Japan:</u>																				
Tokyo	9.5	8.7	8.7	9.1	8.0	8.3	8.0	8.6	6.8	6.9	-0.8	0.0	0.4	-1.1	0.3	-0.3	0.6	-1.8	0.1	-2.6
<u>Singapore</u>	8.6	8.2	8.5	8.3	7.8	7.5	8.6	9.5	8.6	7.3	-0.4	0.3	-0.2	-0.5	-0.3	1.1	0.9	-0.9	-1.3	-1.3
<u>Thailand:</u>																				
Bangkok	11.2	11.0	11.3	11.4	10.4	9.2	10.3	10.3	9.6	9.8	-0.2	0.3	0.1	-1.0	-1.2	1.1	0.0	-0.7	0.2	-1.4

Source: Jones Lang LaSalle Hotels' HISS and Meridia Capital.

Average cap rate for Asia Pacific as a region is calculated based on a larger number of cities and areas than shown above.

n.a. = not available.

Growth rates for Bangalore shown in last column are for the period Dic 06 vs. May 04.



The Americas is the region where hotel cap rates declined the most

The Americas is the region that has seen larger declines (340bp compared with 190bp in Asia and 160bp in Europe). In the US, New York is the city where cap rates decreased the most (410bp from 2002 to 2006). In Latin America, Buenos Aires and Mexico City are the only two places of those considered that have seen a decline of more than 400bp.

In Europe, Moscow saw the largest decline

In Europe, Moscow is by far the market that registered the largest drop (around 600bp from May 2004 to December 2006). London and Paris, two key capital cities, also saw considerable declines.

In Asia it was China

In Asia, China is the country which saw the biggest descent, with Beijing and Shanghai seeing declines above 300bp in the 2002-2006 period.

Location within an area

This may also affect the cap rate. Clearly, it is not the same valuing a city centre hotel than a suburban hotel.

Property type

Again, this variable has more than one aspect to consider.

Hotels operating at the lower end of the market tend to be valued at higher cap rates

By market segment

Luxury hotels are usually valued at lower cap rates than budget hotels. The table below provides an indication of such differences. We have taken the cap rates estimated by HVS International for the different segments within the US hotel market. The differential between the lower end of the range for luxury hotels in 2006 (5%) compared with the higher end of the range for budget hotels (11%) was as much as 600bp, which is very significant.

Table 5: Hotel cap rates (2006)

Luxury segment	5.0% - 6.5%
Mid-rate segment	7.0% - 9.0%
Budget segment	8.0% - 11.0%

Source: HVS International.

Cap rates have dropped in all real estate sub-sectors

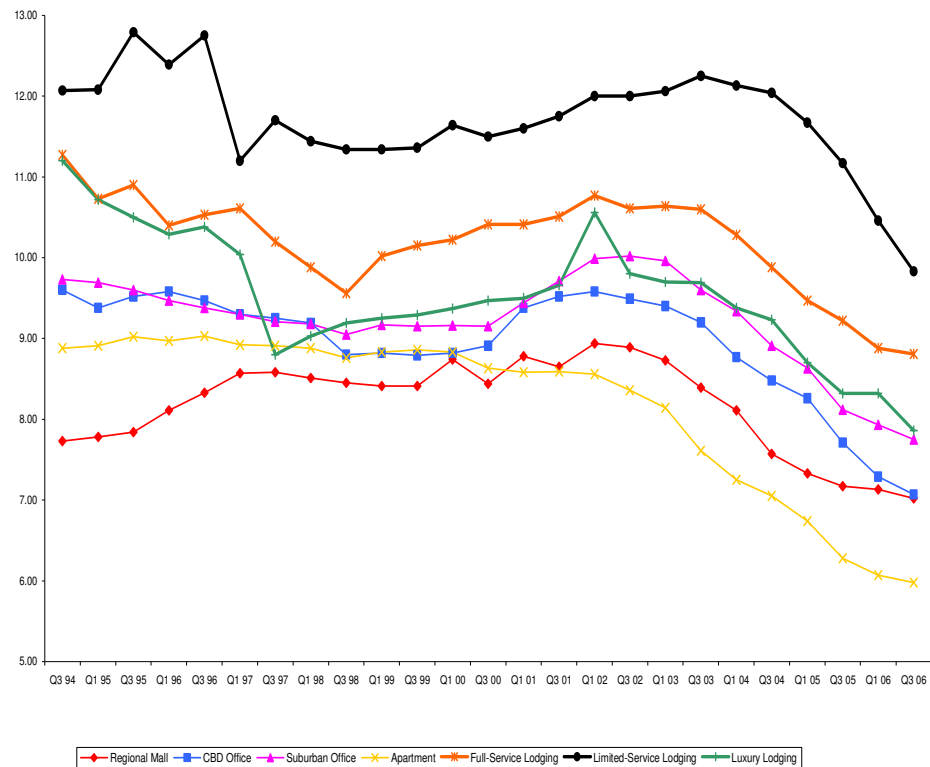
The following chart shows a comparison of cap rates for different investment alternatives within the real estate sector from 1994 to 2006. It proves that the descent in cap rates has not only affected the hotel sector but also all other sub-sectors within real estate.

Given their higher risk, hotels offer higher cap rates than other real estate assets

Generally speaking, hotels offer higher cap rates than other forms of real estate, given their higher risk. The chart shows how cap rates for limited service, full service and luxury hotels are above those of office buildings, malls or apartments. Within hotels, luxury registers the lowest cap rates, with a performance that does not differ much from that of the suburban office segment. The differential between hotel segments is perhaps less pronounced here. Luxury hotel cap rates are around 100bp lower than full service hotel cap rates. These, in turn, are 100 to 200bp lower than those for limited service hotels.



Chart 3: Cap rate comparison for different real estate alternatives (in %)



Source: Korpacz Real Estate Investor Survey and HVS International.

Urban hotel vs. resort

We have not seen data on the different cap rates for urban vs. resort hotels

We have not come across any data that illustrates the difference between cap rates for urban versus resort hotels. However, we believe that which cap rate to use would ultimately depend on the location of the hotel itself and whether the barriers to entry in that specific area are high or low.

Supply vs. demand

Cap rates will also be affected by the balance between demand and supply

The balance or imbalance between demand and supply can have a major effect on cap rates. Oversupplied markets will inevitably experience pricing pressure. In today's hotel market, buyers outnumber sellers. According to Jones Lang LaSalle Hotels, the relationship between buyers and sellers of hotel assets was nearly 3:1 globally in 2006. The huge interest from private equity groups in the hotel sector has clearly changed the scene to this respect and largely explains the drop in cap rates. In Europe, this ratio reached 5:1. This is a consequence also of the fewer opportunities that exist and would explain the higher prices paid in Europe compared with other geographical areas.

Timing within the cycle

As evidence

As would be expected, the performance of cap rates is tied to the

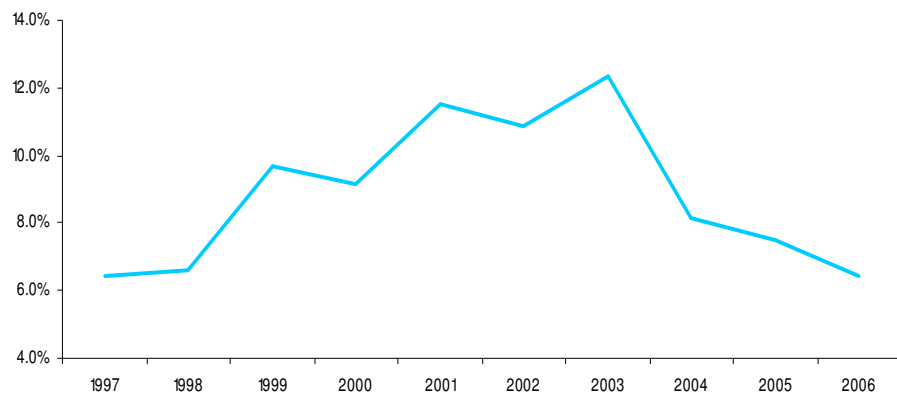


shows, where we are in the cycle is relevant

general estate of the economy. Where we are in the cycle becomes key. The hotel industry is highly cyclical and tightly linked to economic performance (the correlation between RevPAR growth and GDP growth is widely known).

The following chart shows the inverse of historic EV/EBITDA transaction multiples for European hotels. We have taken the inverse of these multiples as a good proxy of hotel cap rates in Europe. These were quite low at the end of the 90's decade (a time of economic bonanza). They then increased from 2000 to 2003 (a very weak period for both the economy and the hotel industry). From 2003 onwards, cap rates declined again, reflecting a healthy economic background and investors' growing interest for hotels.

Chart 4: Inverse of historic EV/EBITDA transaction multiples for European hotels

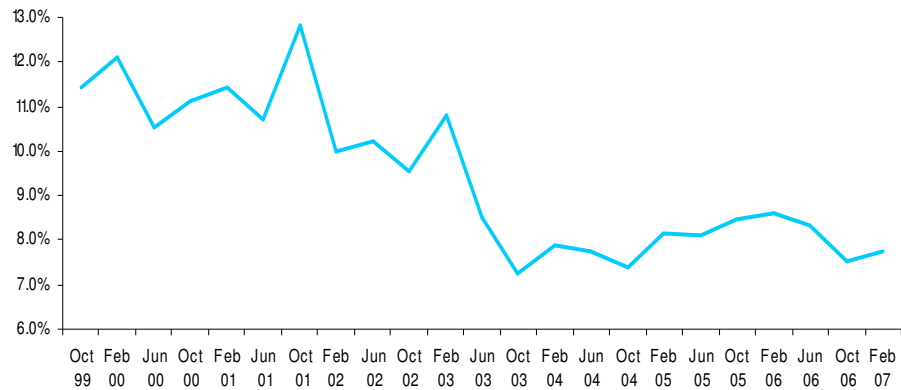


Source: UBS Investment Bank and Meridia Capital estimates.

We have also taken the inverse of historic EV/EBITDA trading multiples for a select set of US hotel stocks as a good proxy for hotel cap rates in the US. The data ranges from Q4 1999 to Q1 2007. This chart shows a slightly different trend, with cap rates progressively declining. The two most relevant exceptions to this are the peaks seen at the end of 2001 and at the beginning of 2003 - again, this showing two very difficult periods for the economy and for the hotel industry. Since then, cap rates have generally gone downwards (in a period of solid economic growth). It is interesting to see that, according to this chart, cap rates bottomed in October 2003, a time of low profitability in the industry. This, we believe, reflected investors' expectations of a significant recovery.



Chart 5: Inverse of historic EV/EBITDA trading multiples for select set of US hotel stocks



Source: Morgan Stanley Research, Company data, FactSet Reserach Systems and Meridia Capital estimates.

Note: Historic average consensus EV/EBITDA ratios for Hilton, Host, Starwood, Marriott, Sunstone and Morgans (market cap weighted).

Cost of capital

Cap rates are inevitably affected by the cost of debt and equity.

Cost of debt

Hotel cap rates came down as interest rates fell. The decline in interest rates had a multiple effect:

- Cost of financing was reduced, increasing loan to value ratios.
- Hotel demand escalated as consumption grew.
- Investment in hotels soared as a result of fewer investment alternatives (within the real estate sector and in other investment areas, such as fixed income products).

It must be said, however, that the rise in interest rates of the last few months in both the US and Europe has not had the same impact in cap rates, which have continued to remain low. This, perhaps, is partly as a result of less demanding investors, as we explain below.

Cost of equity

Cap rates also declined as a result of investors' lower return expectations. Hotels have a very significant operating leverage, given the importance of fixed costs within their business model (small changes in RevPAR can have a large effect on the bottom line). In a positive economic environment, hotels tend to be a sought after asset, given that they offer above average growth rates. Investors are now more prepared to assume the hotel sector's higher risks compared with other real estate sectors, which are considered safer (the office market, for instance). Investors conformed themselves with less (i.e. lower yields), as competition for hotel assets intensified.

Other

We have mentioned above some of what we believe are the most

The lower cost of debt and equity partly explains the decline in cap rates seen over the last few years

There are other



variables that can impact cap rates

important variables that determine cap rates. However, other variables exist that can have an effect on yields. For instance, whether the hotel being acquired is operated through a lease or a management contract will also become relevant. Leased hotels tend to be transacted at lower cap rates, as they carry a lower risk (the owner receives an income that is fixed in many cases). The income received from a hotel with a management contract is more volatile, carries higher risk and therefore should offer a higher return. Traditionally, there has been a gap between leased and managed hotels of around 200bp, although this gap has also been narrowing over the last few years and is now closer to 50-75bp.

Hotel valuations escalated for several reasons

How much lower can cap rates get?

Hotel valuations have clearly gone up over the last few years, as profitability improved and cap rates declined. This increase in hotel valuations is, as we have seen above, the result of a variety of reasons:

- Good economic environment.
- Low interest rates (despite recent increasing trend).
- Higher loan to value ratios.
- Excellent operating performance. Hotel RevPAR growth fuelled by rising demand and steady supply. Operating leverage leading to very attractive levels of profitability.
- A very competitive market, with more buyers than sellers.
- High interest in the sector from new entrants. The role of private equity and REITs.
- A very liquid market with a large number of transactions taking place.
- A flood of investors from other forms of real estate. Lack of alternatives in other real estate segments, which are offering lower returns.

We do not think we will see hotel cap rates declining *much* further...

Are we likely to see cap rates going much lower?

We doubt it. It is true that most of the reasons that have caused cap rates to fall are still applicable today, which is why we believe that cap rates will not experience a sudden and sharp increase. But that does not mean that cap rates can continue to fall *much* further. We have different reasons to believe that:

- Rising interest rates.
- The constant comments about the deceleration of growth (and whether we are nearing the top of the investment cycle).
- Investors' reaction after several US hotel stocks reported their Q1 results. The share price of various stocks suffered after the groups' management teams provided a more conservative outlook (guided the market slightly downwards, which was not well received).
- Deceleration in the real estate market in some countries. The US is perhaps the most obvious example. In Spain, for instance, this has also been the case. Real estate stocks have been hit and investors are still wondering whether we are likely



to see a hard or soft landing.

- Recently failed or unsuccessful market floatations of several property groups. This would be the case of Vector Hospitality (which was to become the first UK hotel REIT) or Realia (Spanish real estate company).

Are we then likely to see cap rates increasing to past levels?

...although we believe that they are unlikely to rise to levels seen in the past

In our view, this is unlikely too. Interestingly, terminal cap rates used to be around 100-150bp higher than going-in cap rates to reflect the age of the hotel and the need for capital expenditure. Additionally, until recently, investors were unsure whether the drop in rates was a here to stay. However, over the last couple of years hotel investors are doing deals assuming that cap rates will not revert to the levels seen a few years ago. According to HVS International, investors now assume terminal cap rates of 5% to 9% for quality hotel assets vs. the traditional 8% to 12% range. Investors no longer assume a normalisation of cap rates. Until 2005, deals were being done at very low cap rates. However, terminal cap rates were still rather high, as it was being assumed (conservatively) that these would have gone back to historical levels by the time investors had to exit their investment. Today this is no longer the case.

Final thoughts

In our view, in the short to medium term hotel cap rates will stabilise at or around current levels

Our own view is that, in the short to medium term, cap rates are likely to stay at or around current levels. For the reasons explained above, we do not foresee very abrupt movements in either direction (upwards or downwards). There are reasons to believe that cap rates will stabilise and that they will do so at lower levels than in prior cycles. In any case, what is for sure is that cap rates will continue to be used by hotel investors as one of their preferred valuation methodologies.

Cristina Badenes

Research

T: +34 93 484 15 00

F: +34 93 484 15 81

E: cbadenes@meridiacapital.com



Meridia Capital



Meridia Capital

T: +34 93 484 15 00 • F: +34 93 484 15 81 • www.meridiacapital.com

© 2007 MERIDIA CAPITAL. All rights reserved. Copying and redistribution prohibited without permission of the publisher. Meridia Capital is designed to provide factual information with respect to the subject matter covered, but its accuracy cannot be guaranteed. Under no circumstances shall any of the information provided herein be construed as a buy or sell recommendation, or investment advice of any kind. Comments are based on information from sources believed to be reliable, but accuracy and completeness cannot be guaranteed. Meridia Capital, its officers, employees, or agents may hold positions in any of the securities mentioned herein.
