



THE WEBSITE FOR SENIOR FINANCE EXECUTIVES

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## **Give and take**

As property emerges as a liquid asset class, CFOs have many more—and more complex—choices about how to manage it.

By **Eila Rana**

Some of the most eye-catching deals at the start of 2007 have been about property—the record \$40 billion (€31 billion) private equity takeover in the US of Equity Office Properties Trust, a real estate investment trust (REIT); Swiss Re's record £600m (€900m) sale-and-leaseback of the landmark "Gherkin" office tower in London's financial district; even the takeover of Liverpool Football Club by US financiers George Gillett and Tom Hicks.

A focus on property, both direct and indirect, is a growing feature of takeover deals, and of corporate finance generally. Why? Because real estate has, after a long process, become a truly global, tradable asset class. The market for REITs, or securitised pools of property assets, is the main reason. REITs really took off in the US in the 1990s, some 30 years after they were introduced there—the market is now worth around \$350 billion and growing fast. And REITs have exploded in the past few years in other markets, notably Australia, Hong Kong, Japan and France.

This year, REIT markets have been created by new laws in the UK and Germany—the latter, in particular, has enormous potential as Europe's largest property market. According to Baker & McKenzie, a law firm, the 65 largest quoted German companies alone hold real estate reserves of about €80 billion. And German REITs "create an incentive for selling any real estate deemed unnecessary for operation of the business by introducing tax privileges for the disclosure of hidden reserves," according to a Baker & McKenzie briefing on the new law.

In the UK, nine property companies converted as soon as the law took effect on January 1st this year, creating a market worth £37 billion, or about 9% of the global REITs market. That could double if other listed property companies choose to convert.

This explosion of liquidity is expanding the potential investor base for property. In anticipation of these markets, several European firms have already been unlocking capital through sale-and-leasebacks. But the development of a liquid property market is putting pressure on those that have been slow to move. J Sainsbury, a £17 billion UK supermarket chain, looks set to be the target of a record European private equity buyout after CVC, KKR and Blackstone confirmed a bidding interest in February. As Jaime Vazquez, food retail analyst at JPMorgan, observed, "The approach to the company merely represents an attempt to arbitrage away the gap between the company's valuation and the value it would have as, separately, a property asset and an operating company."

The benefits to companies when they hive off their property are manifold. Michael Lindsay, a corporate finance partner at KPMG, says that it frees up capital for investment; it has tax benefits as lease costs are offset as an expense; it often improves the balance sheet as property has been held at below cost; and it transfers property value risk to a third party while leaving the seller with operational control. Lindsay adds, however, that a big issue for sellers is to get a grip on "the degree of operational flexibility you require and are prepared to pay for."

This is something that early adopters have been grappling with—none more so than the hotel sector, where some of the biggest chains have been adding contractual wrinkles to sale-and-leasebacks aimed at addressing their market's particular set of circumstances.

### **The tough questions**

When Jacques Stern, CFO of Accor, a €7.6 billion French hotel group, first spoke to potential real estate investors in 2005, he knew it was going to be a tough sell. He wanted to pitch a new concept for the hotel sector—a sale-and-variable leaseback, which would require no minimum guaranteed rental payment. Stern concedes, "It was hard to convince them not to have a minimum."

That's understandable, as Accor's proposal effectively pulled the property owner's safety net away, says Arthur de Haast, CEO of Jones Lang LaSalle Hotels, a property advisory firm. If a hotel had zero income one month, so did the property owner.

However, he adds that the minimum guarantee rarely comes into play. A hotel would have to do catastrophically badly to hit that safety net.

As for Stern, he was trying to crack a problem facing most companies that have gone down the sale-and-leaseback route—it may reduce capital intensity, but not earnings volatility. Sale-and-variable leasebacks address that, up to a point—they give the property owner a fixed percentage of revenue but there is still a minimum guaranteed payment.

In 2005, Accor decided to sell just over 200 hotels, mostly in France, under a sale-and-variable leaseback arrangement.

“We selected assets that were midscale and economy hotels, far less volatile [than our upscale hotels in terms of earnings] and far more profitable from a ROCE standpoint,” says Stern.

Accor entered into an agreement with Foncière des Murs (a consortium of property group Foncière des Regions and the life insurance arms of Credit Agricole, Credit Mutuel and Generali) for a phased purchase of 128 hotels from its portfolio of Mercure, Novotel and Ibis brands for €1.03 billion. Under the agreement, Accor pays rent at 14% of revenue for 12 years, with an option to renew four times—a total of 60 years. In March 2006, 76 properties were sold for €583m under similar terms. Stern intends to roll this model out to other markets and is looking for partners in the UK, Germany and the Netherlands to sell a portfolio of 120 hotels.

Stern notes that one of the key objectives in selecting a partner was the consortium’s agreement to expand the three main hotel brands. The move was part of a wider strategy to release the value of Accor’s real estate to invest in growing the business—an industry-wide trend that de Haast describes as “going asset light.”

## **A twist**

Accor plans to sell €1.5 billion of property across its various segments by 2008, although for its upscale Sofitel hotels, Stern is using a different tack: sale-and-manage-back.

David Parry, a director in Ernst & Young’s Real Estate Finance practice, says that while European companies have been experimenting with sale-and-manage-back arrangements since the early 2000s, they are still considered to be relatively new. “They have happened almost exclusively in the hotel sector. Other sectors may be doing them but those deals have not been widely shouted about,” he says.

Under these arrangements, responsibility for managing the property and employing staff lies with the owner. For a basic fee, based on a percentage of revenue, the hotel operator brings in a general manager and runs the business using its own brand. The operator also receives an incentive fee, based on a percentage of profit or Ebitda.

It's an approach similar to that employed by €6 billion Hilton Hotels of the US. After buying Hilton International of the UK in 2006 for £3.3 billion, reuniting the brand for the first time in 40 years, Hilton sold two of its major properties—the Hilton London Metropole and the Hilton Birmingham Metropole—to Tonstate, a local real estate company, for £417m. Under the terms of the agreement, the hotel operator will retain a 30-year management contract on both properties while Tonstate has agreed to invest in renovation programmes for the hotels.

The divestments were the latest in a property-sales programme that has delivered more than \$2 billion for Hilton Hotels since early 2005. "The hotel transaction market continues to be vibrant, with a high level of market interest and enthusiasm being shown for quality hotel assets," explains Robert La Forgia, CFO of Hilton Hotels. "Consistent with our strategy to grow the managed and franchised business and reduce hotel ownership, we intend to place further hotels on the market. For example, we have recently listed 11 properties across Europe and announced we are evaluating alternatives for the Scandic brand [Hilton's Nordic hotel chain]."

La Forgia intends to use proceeds from the property sales to pay off some of the \$7 billion of debt taken on to acquire Hilton International, bringing its debt-to-Ebitda ratio down from 4 to 3.5.

Also, he says, "We were looking to move our business model from real estate ownership to generating fees from managing and franchising to third parties." The motivation is simple: "Fee-based [hotel] businesses generally attract a higher valuation on Wall Street because they are less susceptible to the typical 'cyclicality' in the business than when you actually own the operation. We wanted to become less volatile, less cyclical," La Forgia says.

## **Occupancy risk**

But what about the risk of the owners' interests changing, of them looking to sell or redevelop? Long-term management contracts with renewal options deal with the possibility to some extent. La Forgia says that buyers' financing agreements contain a cross default provision "such that if they're in default under the management

agreement, it would create a default situation under their financing arrangement. That's what we use to mitigate risk."

A more pressing concern, he says, is ensuring the buyer is committed to continued investment in the properties "because it's our brand name that they're carrying on top of the hotel." Hilton guarantees this commitment by getting the buyer to establish a capital expenditure reserve, which is maintained on an annual basis, at between 4% and 6% of revenue.

Sale-and-manage-back has become especially attractive to operators of upscale hotels, which tend to suffer from low ROCE, due to high fixed costs, and high earnings volatility because of their exposure to the international traveller market.

Accor's Stern says that after the September 2001 terrorist attacks in New York, Sofitel took, on average, a 15% hit on revenue, which led to a drop in profits of more than 30%.

Accor has already sold eight Sofitel hotels in the US for a total of \$625m to a joint venture between GEM Realty Capital and Whitehall Street Real Estate Fund. The group has a 25-year contract to manage the properties under the Sofitel brand with two options to renew for ten years. Accor has retained a 25% stake in the joint venture to benefit from the properties' long-term appreciation. It plans to dispose of 14 Sofitel hotels in Europe under a similar agreement this year.

The joint venture model is set to become increasingly prominent in emerging markets. Accor recently signed a joint-venture agreement with Emmar Properties, a Dubai-based real estate firm, to build 100 of its budget Formule 1 hotels in India over the next ten years.

"What we are looking for in a joint venture is a local partner to speed up development," says Stern. In a separate joint venture to develop Ibis in India with India-based travel firm InterGlobe Enterprises, Accor has taken a 40% stake in the real estate and holds the management contract.

In November 2006, Hilton Hotels announced a similar project in partnership with Delhi-based real estate developer DLF. The joint venture, in which Hilton has a 26% stake, will own and develop 75 hotels and serviced apartments in India over the next seven years. The properties will be managed by Hilton Hotels and operate under a range of its brands.

“Joint ventures are fairly common, especially in new markets such as India and China,” says de Haast of Jones Lang LaSalle. “What’s perhaps new in the last few years is that operators are trying to do this with a strategic investor to roll out a number of hotels. Historically it tends to be done asset by asset, on a one-off basis.”

Strategic joint ventures and variable leasebacks with no minimum guarantee are signs that surging liquidity is being matched by a growing array of options for operating companies.

Andrew Midas, managing director of real estate adviser Midas Corporate Consulting, says this leads to a new challenge for companies: “It’s all about risk transfer. How should a company be managing property when property isn’t its business?” Crucially, which real estate management strategy is right for its business strategy?

Stern believes he’s cracked this problem. “Eighteen months ago, we were at €35 per share and today we are at €64—this is not so bad,” he says. “It’s not the only element ...but the real estate strategy is an important part of the restructuring of Accor.”

**Eila Rana**

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