# Private Equity Hotel Investments

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**Abstract**

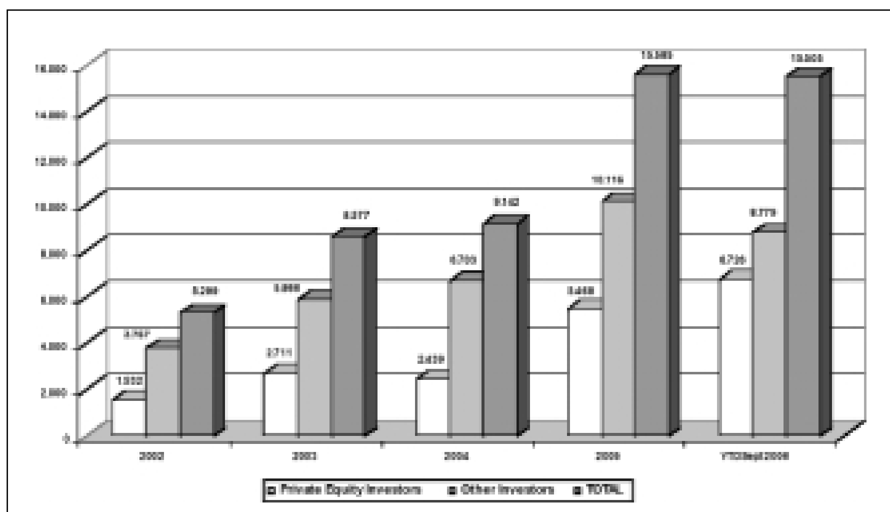
*The significance of private equity as a form of financing and investing has led to growing interest in the real estate economy over the past few years. Anglo-American investors in particular are currently engaged in large-scale real estate transactions and have now become the most important group of investors in the European hotel real estate market. However, for private equity funds, the high risk of investing in complex tourism and specialized real estate such as hotels is always coupled with an expectation of returns well above the market average. Yet actually achieving above market returns is not always accomplished. This paper therefore deals with the question of why some real estate private equity investors succeed in getting returns above the total market average even in the overall bear Western European market environment while others fail to do so. It shows that one formula for success includes deliberately exploiting market imperfections und overcoming inefficient information policies.*

*Key words: hotel investments – hotel real estate – private equity – real estate economics – principal-agent-theory*

## 1 Introduction

Real estate private equity funds are investing like never before in the European hotel real estate market. The hotel sector has continued with the strongest growth achieved in the Western European countries. In absolute terms during the first nine months of 2006, European hotel real estate transactions totalled some 15.5 billion Euros, significantly exceeding 2005's year-to-date September level. Similar to 2005, purchasing activity was dominated by private equity investors accounting for 43% of total transactional activity year-to-date September 2006 (Jones Lang LaSalle Hotels 2006, p. 2). Hence, one can assume that international private equity funds, as competitive and growth-oriented hotel investors, will persist the trend depicted in figure 1 and will continue to increase their activities in the European hotel investment market in the near future.

*Figure 1: Hotel investment volume in Europe 2002–2006 (Euro Million)*




*Source: Jones Lang LaSalle Hotels 2006, p. 2.*

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At the same time the local hotel landscape, as the mainstay of tourism, is experiencing predatory competition and a concentration process to an extent never seen before. Accordingly, the traditional hotel investor groups, primarily international hotel chains and open-ended real estate funds, are becoming increasingly restrained. On the other hand, private equity groups – especially in the Western European hotel business which is subject to competitive pressure and which has historically almost always lacked equity and debt capital – see extensive opportunities to act anti-cyclically and to invest in a property class that they are familiar with in terms of their home markets (Jones Lang LaSalle Hotels 2004, p. 20).

In this context the principle objective of private equity hotel investors is the identification and acquisition of under performing hotel properties or portfolios with the goal of turning them into more profitable assets. During an envisaged holding period of 5 to 8 years maximum, private equity funds implement value added measures and investments that increase the cash flow of the acquired hotels. As a general rule these measures include:

- Investments in fixtures, furniture & equipment (redevelopment),
- Transfer of hotel operation to an international hotel company via a management contract (professional management),
- Integration into an international sales and marketing network provided by the contracted hotel company (branding),
- Integration into an efficient international reservation system provided by the contracted hotel company (performance management),
- Active hotel asset management (financial controlling).

The investment exit is most likely to take place as a sale of the redeveloped hotels as a single asset or a portfolio transaction to other international investors, who are seeking mature and stable, yet attractive hotel cash flows.

But since the high investment risk on the part of international private equity investors is always associated with the expectation of above-average returns (risk-yield structure), the high internal rate of return (IRR) of this relatively new class from mainly Anglo-American market players is already being described as immoral in some continental European countries. However, this paper does not aim to comment on the merits of such socio-political discussions. Rather, with solid scientific facts it will deal with the theoretical issue of why some hotel real estate private equity investors are able to achieve IRRs of 20% p.a. and more from hotel investments, while others fail. Thus the US based private equity fund Blackstone bought the London Savoy Hotel Group in 1998 for 520 million pounds and sold it for 750 million pounds after a holding period of six years, while the US investor Lone Star even until today is not successful in selling his 17 hotels purchased at the beginning of the decade, located in Germany and Switzerland.

To answer this central issue, this paper is based on various methodological approaches. In a first step the conceptual and theoretical framework will be produced on a foundation extended by real estate economics as a functional portion of general management (Crommen 2001, p. 4). Furthermore, the second section gives an overview of the recent literature and documents on hotel real estate private equity investment. After the review and evaluation of the available literature this part also encompasses the contextual and real estate related delineation of the term private equity.

The focus of the paper is the third section that deals with one of the main actual value driver. On the basis of agency-theoretical considerations, the thesis will be deduced that successful private equity funds achieve high hotel investment returns by overcoming inefficient information policies and specifically by deliberately exploiting market imperfections. Based on a practical illustrative case study, it will be demonstrated that this is mainly achieved by working together with local operative partners and related incentive-compatible participation models as well. The paper concludes with a summary of the results and implications for tourism scientific research and practice.

## 2 Real estate economics as a conceptual and theoretical framework

The rapid increase in real estate investments by internationally operating private equity funds has lead to the interest in institutions and activities that are fundamentally attributed to the real estate sector shifting to the entire spectrum of economic and socio-political discussions. However, an intensification of the scientific interest in the subject of hotel real estate private equity investments does correlate with the recent increased public importance. This applies to both: international general management and tourism literature.

It can thus be stated that the practical hotel business is currently reacting considerably faster to the identified environmental developments than tourism scientific research. It could be said regarding the entire real estate private equity field that theory based models and defining approaches are lagging considerably behind. Proof of this deficit is evidenced first and foremost in the fundamental lack of papers and documents regarding hotel real estate related subjects and issues even in relevant compendiums, guides and text books. Publications in scientific journals are likewise scares. Articles that deal with the subject of real estate private equity only can be found in the daily or specialized press. As a general rule they often refer to the success of investments in undervalued real estate (discount deal), situations where a relatively large percentage of debt capital is used for real estate financing to utilize the leverage effect during sale or increasing the efficiency of real estate administration (Rottke/Holzmann 2003, Rottke/Holzmann 2004, Haacke 2005).

### 2.1 Term and particularities of real estate private equity and hotel real estate

Even the general term private equity and the specific term real estate private equity have thus far been interpreted quite differently and sometimes confusingly in literature across disciplines (Nathusius 2001, p. 55). This fundamental issue of differentiation as well is largely founded in the fact that the term being defined is not the result of a theoretical construct but stems from a necessity in the practical real estate business.

Accordingly, the term private equity is used in many different ways in international scientific literature. Especially confusing is the multitude of terms and various definitions used in the USA and Europe (Fenn/Liang/Prowse 1995, p.2; Kraft 2001, p. 31, Nathusius 2001, p. 53f.). The private equity concepts described in the cited literature are not specifically targeted to real estate or real estate companies. Based on the historic chronology, the real estate field ap-

pears to have simply adopted the structures of the private equity company concept. But the taking up of such structures is not accomplished without further adaptation since depending on the investment object – a company on one side or a real estate property on the other – large structural differences exist.

As follows, the term private equity is defined in a way that encompasses the particularities of the real estate asset classes: Real estate private equity is a type of financing in which external investors provide capital resources for short to medium-term investments in all typological and geographical real estate markets via generally unregulated fund solutions, usually with a high proportion of debt capital. If required, active asset management support is provided. Investment categories can be established and development properties or real estate portfolios, non-performing real estate loans and real estate companies. To realize the above-average high return on equity, which is calculated on the basis of the internal return on net worth, it is clear right from the outset that the real estate must be sold.[1]

Traditional investment categories in the real estate sector are commercial, residential, industrial and specialized real estate. Office and retail properties are covered by commercial real estate, while specialized real estate also includes hotels. As opposed to most other real estate categories, hotels investments have some very special features and are thus much more complex. Hotels are handed over as turnkey projects, have a pre-opening phase and generally achieve stable results only after a start-up period of two to four years.

Apart from the real estate aspect of a hotel there is always also a management aspect (Elze 1995, p. 14). Consequently, the value of the property is very dependent on the skills of the hotel operator. In this point, hotels also differ from commercial, residential and industrial real estate where the value results solely from the amount of rent that can be charged. The cash flows resulting from this are generally independent of the entrepreneurial success of the tenants. While the market value of commercial, residential and industrial real estate can be determined from the average market rents and the size of the area to be rented, there is no uniform price level for hotel properties in the same location.

Approximately 98 percent of the hotel contracts world wide are management and franchise contracts (Baurmann 2000) by which the hotel owner carries the majority of the risk because the cash flow generated from owning the hotel goes to the landlord whereas the hotel operator or franchisor only receives a fix and incentive management or a franchise fee. In addition, there are a multitude of hybrid contracts in the hotel industry by which the owner – in contrast to the customarily fixed rental contracts in other real estate categories – continues to carry part of the risk/reward potential of the hotel investment.

On top is a five-star hotel not automatically more expensive than a three-star hotel in the same location although guests generally have to pay much more for the extra comfort. This is because each hotel is different in regard to its furnishings and positioning in the market and competition. Because of these special features no comparable and transparent transaction business exists in the hotel real estate sector.

## 2.2 Real estate economics as a scientific interdiscipline

Expanding on the aforementioned issue of differentiation, further analyses and review of the available literature explains why a broad discussion about the epistemic and scientific methodological fundamentals and principles of real estate economics and its relationship to other disciplines – such as tourism – has still not taken place. Such disregard for conceptual and theoretical consideration over time is highly unsatisfactory to the players on the international real estate investment markets since even the hotel sector, like other branches of tourism, cannot forgo a scientific base for real decision making processes.

In this regard, real estate economics represents an innovative field for tourism research that merits the increased interest of hotel real estate. Within general management studies, real estate economics is a comparatively young field too (Crommen 2001). The central goal of this scientific discipline is the "explanation and representation of real decisions of economic subjects relating to real estate" (Schulte/Schäfers 2000, p. 108). This objective highlights the focus on decision oriented business studies approaches. The goal is to put concrete recommendations to solve real estate specific issues in the hands of decision makers.

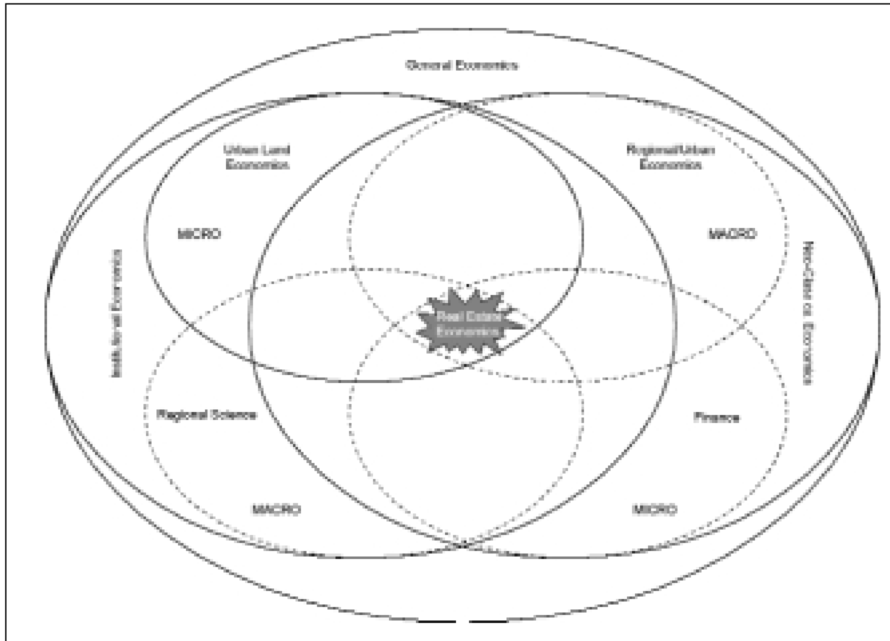
An additional aspect of real estate economics that corresponds to a basic understanding of tourism research is its intended interdisciplinary nature (Graaskamp 1991b; Grissom/Liu 1994; Schulte/Schäfers 2001). Building on the fundamentals of general management studies, the exchange of ideas within real estate economics is not only focused on science and business, but also knowledge of other scientific disciplines, such as law, design and architecture. In accordance, real estate economics is not limited to companies in the real estate industry but applies to the real estate related decisions of all active institutions (Schäfers 1997). The hotel real estate specific decisions of private and institutional investors during market transactions should be at the forefront of the subsequent performance without allowing the interactions with other institutions, such as public authorities, to be forgotten.

In contrast to the overall, less desirable assessment of conditions regarding the theoretical analysis in European literature, interdisciplinary scientific analysis of real estate related questions possesses a comparatively long tradition in the USA.[2] But even the discussion there was not borne of a meta-theoretical consensus that could have expressed the collective identity in a scientific perspective and the delineation between this research field and other disciplines of science.[3]

However, in the period following, a few fundamental approaches have come out of US literature, which may have certain validity. The interdisciplinary approach put forth by Grasskamp (1991a, p. 53) is in accordance with the opinions expressed in this article. Following this train of logic, real estate is an object created by people, bound through a psychological, social and political context. Graaskamp emphasizes a multi- or interdisciplinary approach to solving real estate industry problems (Graaskamp 1991b, p. 49).

As indicated in figure 2, real estate economics as an interdiscipline is at the center of the analysis. This opinion is shared by other American experts (Wendt, cited by Grissom/Liu 1994, p. 67ff.) and is the basis of this paper since it simultaneously succeeds at integrating real estate related issues in general tourism studies and, in this specific instance, as applied to hotel investments specifically in the (tourism) science debate.

*Figure 2: Real estate economics as a scientific interdiscipline*




*Source: Grissom/Liu 1994, p. 68*

## 3 Agency-theoretical analyses of real estate private equity hotel investments

The features and particularities that were mentioned in the second section support the classification of hotels as specialized real estate. It became clear that a lot of information must be generated and answers to the most varied issues are required to invest in hotels and get high returns: is the owner even interested in selling; how is the hotel's location developing; is renovation necessary; how does the quality of the current hotel owner rate; under which form of contractual agreement is the hotel currently run; what is the owner's financial situation; what role do the banks play; is there a succession agreement?

Only after extensive answers are found to such exemplary questions a potential hotel investor can judge whether a potential financial engagement meets IRRs above the total market average or not. On the other hand, inefficient information policies and an asymmetrical distribution of information among the interacting transaction partners lead to market imperfections and much higher costs, as investment-relevant information cannot be offered free (Coase 1991, p. 18ff.).

Some Anglo-American private equity funds improve the value-adding potential of their hotel investments by consciously exploiting or overcoming the market imperfections and inefficient information policies that result from the non-existence of the usual business transaction and the lack of comparison opportunities. This is because the availability of an adequate number of suitable comparative prices, comparison factors, price indices and conversion coefficients is not guaranteed in the hotel real estate sector.[4] Assuming that the traditional price mechanisms on the hotel investment markets also have no effect and that not all existing and transaction-relevant information can be mapped, investment opportunities exist that promise above-average IRRs if some market players recognize the promising investment chances sooner than the market because they have better access to the relevant information (Robert/Yoon 2004).

For this reason, most Anglo-American real estate private investors integrate local cooperation partners as information intermediaries. According to a study by Lietz/Dewey/Chan from 2003, 76% invested with the assistance of local operative partners in the respective target countries (Lietz/Dewey/Chan 2003, p. 15). A notable example for successful hotel investments is the cooperation between Blackstone and the Event hotel group in the German-speaking markets. In cooperation with Event, Blackstone has already bought 9 Accor hotels from the Dr. Peters Group and 14 hotel properties of the east German Interhotel-Group as portfolio deals as well as the Munich Marriott Hotel, the Hotel Nikko Dusseldorf and the Grand Hotel Esplanade Berlin as single asset transactions.

### 3.1 Agency theory and information asymmetry

The agency theory offers a suitable analysis framework as a sub-area of new institutional economics for this additional generation of added value through access to success-critical information, since, as opposed to the neoclassical theory, it does not assume complete and efficient markets.[5] The principal agent theory deals with delegation relationships in which an economic subject, the agent, is commissioned in the interest of a different economic subject, the principal, to make decisions and take action (Coase 1991). The resulting interrelationships between the decision makers participating in a hotel transaction is the focus of the following observations which will, in turn, concentrate on the cooperation between real estate private equity funds as principals and their operative partners in the target country as agents.

In addition to the heterogeneity of hotel properties and the resulting lack of transparency in the hotel investment markets, this segment is also characterized by a private and confidential atmosphere during hotel transactions. Markets with little transparency are especially characterized by a low level of high-quality information. However, handling this information is important for the different results of neo-classicism and new institutional economics, as the latter does not assume that complete information is available, which still is the situation in the hotel real estate sector. For example, how could an Anglo-American real estate private equity investor based in New York or London obtains direct access to all the success-critical information related to a potential hotel transaction in Berlin, Vienna or Zurich? The term information can be understood in various ways and is thus classified in the pairs of terms listed in Figure 3.

According to this classification, a symmetrical distribution of information always exists when the market players are equally informed about all the relevant facts (Feess 1997, p. 388). As a result, there is no exclusive or private information that is available to just one player (Rieck 1993, p. 110). However, such conditions for sym-

*Figure 3: Classifying information statuses*

| Assumed information | Description | Opposites |
|---|---|---|
| Complete information | Every player knows what type of opponent they are dealing with. Everyone knows the information status, options for action and how much the others have paid. The players do not know certain charcteristics of the other players. | Incomplete information |
| Perfect information | Each player can always observe the actions of the other players; in other words, all information areas are a single element, all previous moves of the other players are known. | Imperfect information |
| Symmetrical information | All players have the same information. There is no private informaion. | Asymmetrical information |
| Private information | Private information is information that is available to only one player. | Public information |

*Source: Based on Rieck 1993, p. 110.*

metrical information are found very rarely in the transaction relationships of hotel investments, as some of those involved in the business deal usually have exclusive and private information. For example, on the seller side this could include no successor regulation for the hotel operation, finance problems for the necessary maintenance investments, disagreements among the community of heirs or on the buyer side emotional reasons.

Therefore, because of the special features of the focus on hotel investments, on which this paper is based, it is more practical to define information in terms of its asymmetry (Feess 1997, p. 583). The economic subjects taking part in a hotel real estate transaction are generally confronted with an asymmetrical distribution of information due to the non-existence of a relevant market, as there is a considerable lack of transparency in the hotel industry due to the character of the real estate in combination with a high level of private and exclusive information. An asymmetrical distribution of information exists always when the market players involved in the hotel transaction are informed differently about the relevant facts (Feess 1997, p. 388).

For the cooperation between the private equity investor as principal and the operative partner as agent it is strategically relevant that there must ultimately be an information deficit for the principle. In addition, agents usually do not provide private equity funds with all the information that would be necessary for both sides to structure and implement the transaction to an equally positive extent (Cieleback 2003, p. 10). The agent's discretionary leeway resulting from this situation – which he can use to his own advantage because of his actions cannot be observed – is the result of this asymmetric distribution of information (Herzig/Watrin/Ruppert, 1997, p. 764, Jost 2001a, p. 21). Consequently, the agent's possible actions due to the information asymmetry also affect the asset situation of the principal (Herzig/Watrin/Ruppert 1997, p. 765).

### 3.2 Incentive-compatible participation models to overcome discretionary behaviour

Delegation relationships between real estate private equity funds as customers and operative partners in the target countries as contractors are characterized by information asymmetries both within the scope of the above agency-theory considerations and also in hotel business. Agents are in a position to make discretionary decisions that do not have a positive influence on the welfare of the principals but especially on their own interests (Feldmann 1999, p. 132).

To exclude such behaviour on the part of the agent, real estate private equity funds as principals very consciously make use of incentive-compatible participation models in their contracts and dealings with their operative partners. This means that one criticism of the agency theory that is frequently mentioned in literature – that its models and incentive contracts are seldom used in practice – can quite clearly be disputed in regard to the majority of hotel real estate private equity transactions.

As the agent's work cannot be observed by the principal in case of an asymmetrical distribution of information, the investor will always choose to work in a way that maximizes his individual benefits when the contract has been signed. In case of wholly fixed remuneration the work and payment would be independent of each other so that the agent would always choose the path of least resistance. Consequently, with a wholly fixed fee a private equity fund as principal would give no incentive whatsoever for the agent's adequate commitment. This is also why in a typical principal-agent relationship; this type of remuneration is not considered in regard to real estate transactions in the hotel sector.

Accordingly, in practice those involved in this type of business generally make use of an incentive-compatible remuneration structure. To ensure that both parties' interests are identical, the principal can control and monitor the results in the form of performance-related payment schemes. This method is also known as output-oriented. In this case, costs are incurred especially for the variable salary to be paid to the agent – the risk bonus – in the event of exit (Prendergast 2000, p. 27). However, to ensure that a participation and remuneration model such as this is effective, three preconditions have to be fulfilled (Spremann 1988, p. 615f.):

- The remuneration must be dependent on variables that are within the agent's sphere of influence and that he can also realistically achieve.
- The reward should only be dependent on variables that both parties can observe without any dissent – for example, in hotel industry an output variable such as overall performance.
- The agent must understand how his actions affect the reward, which means he must know the interconnections, in other words, the participation model, the production function and the probability distribution of the environmental conditions. If this knowledge is not available, the agency theory talks of ignorance.

These kind of incentive-compatible participation models have become very popular in the hotel business during the

last years. The majority of these models generally comprise a base salary and a bonus which is aligned proportionally to the result of a specific key performance indicator, usually a hurdle rate and initially corresponds to a linear remuneration form. In addition, non-linear remuneration structures are used in the hotel practice. The aim of these is to improve cooperation between principal and agent so that the local partner increases his level of activity to participate over-proportionally in a high profit. This profit sharing model also satisfies private equity groups, since in the case of a high IRR after exit they are quite willing to spend additional costs to balance out the interests (Prendergast 1996, p. 9). The subsequently presented simplified and illustrative case study for a hotel real estate private equity investment will integrate the thesis deduced in this paper so far in a practical technique.

### 3.3 Illustrative case study

An American real estate private equity investor works exclusively with a local partner regarding hotel investments in Germany. Through an existing network, the local agent learned in 2002 that the owner of a hotel centrally located in a major city in southern Germany would like to sell due to his age and lack of someone to take over the business. Since the hotel has been family owned for almost more than 100 years, the sale should be conducted discreetly without the involvement of a hotel broker as a single asset deal. The financial investor is responsible for real estate transfer tax amounting to 3.5% and notary and legal fees amounting to 1.25%. The local partner receives a one-time acquisition fee amounting to 1% of the purchase price. However, he is required to invest directly in the hotel. In addition, both parties agree that the agent has to meet an additional commitment of at least a 5% of the total equity.

The historic property will be run within the scope of a management contract (residual term of 15 years) by a global hotel chain and has 250 rooms, food and beverage areas as well as a conference and fitness area. The city is a business and leisure destination with a strong international reputation and old heritage. It attracts tourists from North America and Asia. The sales trend was markedly affected by the September 11th attacks. For this reason, the agent informs the principal that the desire to sell is particularly strong on the hotel owner's side.

At this point, the real estate private equity investor from the US was allowed to look at the hotel's historic operating figures during the exclusive pre due diligence period along with his local partner. As a result, it was determined that the hotel was still able to charge a net room price of 125 Euro with an average occupancy of 65% during 2001. This is equivalent to a RevPAR (Revenue per Available Room) of 87.75 Euro. The numbers for 2002 were sharply declining and were already clearly under budget.

The business plan prepared by principal and agent according to the Uniform System of Account of the Lodging Industry[6] outlined that the hotel should be purchased at the end of 2002 based on poor earnings. Following the hotel acquisition, the private equity fund had to invest Euro 5 millions in new room types and public areas to increase the quality and standards of the hotel in order to reposition it as the first class hotel in town again. Due to the high noise levels during renovations while the hotel remained open, 2003 saw a slight improvement in occupancy but without an improvement in the average room price. Since the hotel was also located at the soccer world championship, the business plan assumed a steady improvement in annual net operating profit up until 2006 inclusive. Accordingly, the exit was planned for the end of 2006. The hotel was purchased for 13 times the net operating profit and resold four years later for the same multiple.

To achieve the maximum leverage of equity, financing of 70% debt capital was acquired through a renowned real estate bank thanks to the investors' creditworthiness. The credit of Euro 25.42 million was carried with a foreign capital rate of 4.5%. Since the bank had been involved in the financing of a number of the private equity investor's real estate transactions with foreign financiers and had an established business relationship, a capital repayment-free phase of five years was added.

The cooperation agreement between principal and agent outlined that first the private equity investor and then the operational partners receive a preferential interest rate of 15%. Furthermore, the operative partners receive an above average profit participation of 20%-preferred return as an incentive after Hurdle Rate. The following IRR calculation depicted in figure 4 is the return on the entire hotel investment with an IRR p.a. of 24.51% based on a sale per business plan on 31.12.2006. This results in a net equity IRR for the private equity investor of 22.60%, while the strongly performance-oriented model earns a profit for the agent at exit resulting in an IRR of 101.36%.

## 4 Conclusions

This paper deals with the question of why some real estate private equity funds succeed in getting hotel IRRs above the total market average while others fail to do so. It was illustrated that a number of Anglo-American financial investors are able to generate returns of 20% p.a. and more, not just by means of their traditional value-adding strategies, but also by deliberately exploiting market imperfections in a specific manner and by overcoming inefficient information policies as one central success formula. The paper has deduced the central thesis that private equity funds are able to exclude discretionary behaviour because of implementing incentive-compatible participation models within the teamwork with well informed operative partners in their target countries.

To highlight the success potential of an incentive-compatible remuneration model, the relationship between a real estate private equity fund as principal and a operative partners as agent was recognized as important and was judged to be success-critical in terms of an asymmetric distribution of information within the scope of the principal-agent theory making a simplified hotel investment case study more plausible.

It was also shown that the partial dismissal of private equity groups as vultures, locusts or company raiders in the real estate area is unjustified. The most frequently cited criticism that Anglo-American financial investors buy up hotels or hotel companies with financial problems and then split them up plays no big part in the hotel sector, as the main focus is on investments in real estate portfolios. In regard to the European hotel industry it should also be added that real estate private equity funds often consolidate supply and demand by their involvement in inefficient market situations and, in fact, often get the hotel assets out of their financial distress.

It is critical to note that the momentary flood of liquidity and the resulting run to-

*Figure 4: IRR-calculation of the hotel investment*

| | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Available Rooms Hotel | 250 | | 250 | | 250 | | 250 | | 250 | | 250 | |
| Hotel open days per year | 365 | | 365 | | 365 | | 366 | | 365 | | 365 | |
| Available Rooms p. a. | 91.250 | | 91.250 | | 91.250 | | 91.500 | | 91.250 | | 91.250 | |
| No. Rooms Occupied | 59.313 | | 54.750 | | 56.575 | | 57.645 | | 59.313 | | 59.313 | |
| Hotel Room Occupancy (%) | 65,00 | | 60,00 | | 62,00 | | 63,00 | | 65,00 | | 65,00 | |
| Average Room Rate Hotel (_) | 135,00 | | 130,00 | | 130,00 | | 132,00 | | 135,00 | | 140,00 | |
| RevPar Hotel (_) | 87,75 | | 78,00 | | 80,60 | | 83,16 | | 87,75 | | 91,00 | |
| RevPar Growth (%) | n.a. | | -11,11 | | 3,33 | | 3,18 | | 5,52 | | 3,70 | |
| | **Euro** | **%** | **Euro** | **%** | **Euro** | **%** | **Euro** | **%** | **Euro** | **%** | **Euro** | **%** |
| **Total Revenue** | **12.752.188** | **100,0** | **11.585.100** | **100,0** | **11.971.270** | **100,0** | **12.312.972** | **100,0** | **12.847.088** | **100,0** | **13.143.650** | **100,0** |
| **Rooms** | | | | | | | | | | | | |
| Rooms Revenue | 8.007.188 | 100,0 | 7.117.500 | 100,0 | 7.354.750 | 100,0 | 7.609.140 | 100,0 | 8.007.188 | 100,0 | 8.303.750 | 100,0 |
| Department Profit | 5.605.031 | 70,0 | 4.626.375 | 65,0 | 4.927.683 | 67,0 | 5.174.215 | 68,0 | 5.605.031 | 70,0 | 6.061.738 | 73,0 |
| **Food & Beverage** | | | | | | | | | | | | |
| Total F&B Revenue | 3.855.313 | 100,0 | 3.629.925 | 100,0 | 3.750.923 | 100,0 | 3.821.864 | 100,0 | 3.932.419 | 100,0 | 3.932.419 | 100,0 |
| Department Profit | 963.828 | 25,0 | 725.985 | 20,0 | 825.203 | 22,0 | 879.029 | 23,0 | 983.105 | 25,0 | 1.101.077 | 28,0 |
| **TEL. & MOD** | | | | | | | | | | | | |
| Tel. & Mod. Revenue | 889.688 | 100,0 | 837.675 | 100,0 | 865.598 | 100,0 | 881.969 | 100,0 | 907.481 | 100,0 | 907.481 | 100,0 |
| Department Profit | 622.781 | 70,0 | 586.373 | 70,0 | 605.918 | 70,0 | 617.378 | 70,0 | 635.237 | 70,0 | 635.237 | 70,0 |
| **GOI (Gross Operating Income)** | **7.191.641** | **56,4** | **5.938.733** | **51,3** | **6.358.804** | **53,1** | **6.670.622** | **54,2** | **7.223.373** | **56,2** | **7.798.052** | **59,3** |
| Total Costs | 2.550.438 | 20,0 | 2.601.446 | 22,5 | 2.653.475 | 22,2 | 2.706.545 | 22,0 | 2.760.676 | 21,5 | 2.815.889 | 21,4 |
| **GOP (Gross Operating Profit)** | **4.641.203** | **36,4** | **3.337.286** | **28,8** | **3.705.329** | **31,0** | **3.964.077** | **32,2** | **4.462.697** | **34,7** | **4.982.163** | **37,9** |
| Property tax | 127.522 | 1,0 | 130.072 | 1,1 | 132.674 | 1,1 | 135.327 | 1,1 | 138.034 | 1,1 | 140.794 | 1,1 |
| Non property insurance/tax | 127.522 | 1,0 | 130.072 | 1,1 | 132.674 | 1,1 | 135.327 | 1,1 | 138.034 | 1,1 | 140.794 | 1,1 |
| Operator Basic Man. Fee | 382.566 | 3,0 | 347.553 | 3,0 | 359.138 | 3,0 | 369.389 | 3,0 | 385.413 | 3,0 | 394.310 | 3,0 |
| Operator Incentive Fee | 464.120 | 3,6 | 333.729 | 2,9 | 370.533 | 3,1 | 396.408 | 3,2 | 446.270 | 3,5 | 498.216 | 3,8 |
| FF&E Reserve | 510.088 | 4,0 | 463.404 | 4,0 | 478.851 | 4,0 | 492.519 | 4,0 | 513.884 | 4,0 | 525.746 | 4,0 |
| **NOP (Net Operating Profit)** | **3.029.386** | **23,8** | **1.932.456** | **16,7** | **2.231.459** | **18,6** | **2.435.107** | **19,8** | **2.841.064** | **22,1** | **3.282.302** | **25,0** |
| Debt interest | | | 0 | | 1.143.929 | | 1.143.929 | | 1.143.929 | | 1.143.929 | |
| **Free Cash Flow** | | | **0** | | **1.087.530** | | **1.291.177** | | **1.697.134** | | **2.138.372** | |
| **Equity Value** | | | **10.894.566** | | **0** | | **0** | | **0** | | **0** | |
| **IRR Valuation** | | | **-10.894.566** | | **1.087.530** | | **1.291.177** | | **1.697.134** | | **19.966.444** | |
| **Assumptions** | | | **Entry calculation (_)** | | | | | | **Exit calculation (_)** | | | |
| Net Income 2002 | | | 1.932.456 | | | | | | Net Income 2006 | | | |
| Entry Multiple | | | 13,0 | | | Yield | 0,077 | | Multiple | | | |
| Enterprise Value | | | 25.121.928 | | | | | | Enterprise Value | | | |
| (Re-)Development costs | | | 10.000.000 | | | | | | FF&E Factor | | | |
| Total Enterprise Value | | | 35.121.928 | | | | | | FF&E Reserve | | | |
| | | | | | | | | | Cumulated cash | | | |
| Transaction costs | | | 1.193.292 | | 4,75% | | | | Debt | | | |
| | | | | | | | | | Net Financial Position | | | |
| **Total Invest** | | | **36.315.220** | | | | | | Transaction costs | | | |
| **Debt** | | | **25.420.654** | | 70,0% | | | | Equity Value | | | |
| Interest rate | | | | | 4,5% | | | | | | | |
| | | | | | | | | | IRR | | | |
| **Equity** | | | **10.894.566** | | | | | | Cash multiple | | | |
| Equity Share Principal (95%) | | | 10.349.838 | | | | | | | | | |
| Equity Share Agent (5%) | | | 544.728 | | (including 1% Acquisition Fee) | | | | **Whole Equity Profit** | | | |
| **Profit Share** | | | | | | | | | | | | |
| Free Cash Flow before Hurdle Rate | | | | | 1.087.530 | | 1.291.177 | | 1.697.134 | | 19.966.444 | |
| **Total Cash Flow Private Equity Investor (Principal):** | | | | | | | | | | | | |
| Equity beginning of period (Hurdle 15%) | | | | | 10.349.838 | | 10.714.187 | | 10.910.704 | | 10.693.190 | |
| Net Cash Flow Hotel (95%) | | | | | 1.033.153 | | 1.226.619 | | 1.612.278 | | 10.693.190 | |
| Equity end of period | | | -10.349.838 | | 9.316.684 | | 9.487.568 | | 9.298.426 | | 0 | |
| Exit Promote (80%) | | | | | | | | | | | 6.968.363 | |
| **Cah Flow / IRR Principal** | | | **-10.349.838** | | **1.033.153** | | **1.226.619** | | **1.612.278** | | **17.661.553** | |
| **Total Cash Flow Cooperation Partner (Agent):** | | | | | | | | | | | | |
| Equity beginning of period (Hurdle 15%) | | | | | 544.728 | | 563.905 | | 574.248 | | 562.799 | |
| Net Cash Flow Hotel (95%) | | | | | 54.376 | | 64.559 | | 84.857 | | 562.799 | |
| Equity end of period | | | -193.509 | | 490.352 | | 499.346 | | 489.391 | | 0 | |
| Exit Promote (20%) | | | | | | | | | | | 1.742.091 | |
| **Cah Flow / IRR Agent** | | | **-193.509** | | **54.376** | | **64.559** | | **84.857** | | **2.304.890** | |

*Source: Own illustration*

wards real estate of all kinds is intensely reminiscent of the boom time during the new economy. Eventually the structures and concepts of private equity business were turned to the real estate sector from the new economy in the USA in the 90s. A successful exit is at the center of the entire interest though then it was in relation to companies and today it is in relation to real estate properties or portfolios. Thus, it is still the question if real estate private equity is currently an investment in a bubble which will burst in the short to mid term or not. The generation of IRRs of 20% p.a. and more ultimately only functions as long as a new buyer is found on the exit side and only a few ask about the underlying quality of the real estate in which they are investing.

On the whole, private equity funded hotel real estate investments are a new field for tourism scientific research and offer considerable leeway for more detailed theoretical and empirical investigations. From a cross-discipline aspect the few existing studies on the subject of real estate private equity especially deal with the relationship between financial and original private equity investors, such as an investing insurance companies, pension funds or foundations. Primarily, governance issues are discussed within this framework.

On the other hand, the issues that so important for overall value adding such as the relationship between real estate private equity funds and operative partners are almost non-existent in general management and tourism literature. In this respect, tourism scientific research with its interdisciplinary fundamental understanding has the task of integrating hotels as a special real estate category, which has been examined in the past only fragmentarily and whose socio-cultural and economic significance is virtually disregarded, into the current practical and theoretical real estate private equity discussion.

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## Endnotes

1) Based on Kraft 2001, p. 34, Linnemann/Ross 2002, p. 7 and Reiss/Levinson/Presant 2002, p. 41.
2) Thus academic programs specifically targeted to real estate economics were first developed in the USA in 1904/05 at the Universities of Pennsylvania and New York. In 1926, the Institute for Research in Land Economics and Public Utilities was founded at the University of Wisconsin which is considered the first independent research institute for real estate economics (Davies 1958).
3) Also based on the critique by Grissom/Liu (1994), p. 65 and Clapp/Goldberg/Myers (1994), p. 107.
4) Correspondingly the use of the direct value comparison is categorically excluded for valuing hotel real estate in literature (Frehse 2004).
5) As opposed to the new-classical theory new institutional economics doe not make the following assumptions: free transactions, free and efficient legal systems, allocation-neutral institutions, companies as economic subjects, perfect, individual ownership of goods, complete information, perfect rationality and contractual fidelity (Jost 2001b, p. 3).
6) Based on Educational Institute of the American Hotel and Motel Association (1996).