A Case for Limited Service Hotel Investment

Admiral Investment Limited
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Executive Summary

This white paper analyses the limited service hotels as an investment alternative for institutional investors. Limited service hotels focus on a satisfactory room experience but offer less amenities. This serves a wide clientele, from causal travellers to small-and-medium-enterprise employees. Industry data, including the growth of the low cost carrier market, suggest that this clientele has grown in the last two decades and is expected to grow by another 50% in the next five years. Investors should consider this asset class because it is seen as a lower risk alternative to full service hotels. While limited service hotels can serve as a constituent investment in a core or core-plus portfolio, limited service hotels also offer several strategies for value add investments.

This is the first instalment of a series of articles. Future articles will consider the financial details of a limited service hotel. The second article will focus on the hotel supply and demand in Asia Pacific and the cost structure of limited service hotels.

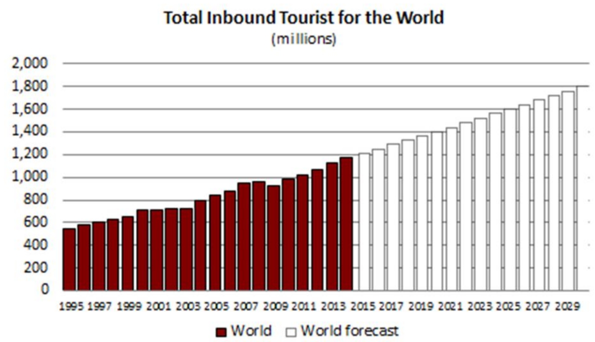
Information about this white paper series is available at http://investlsh.blogspot.com/

Contents

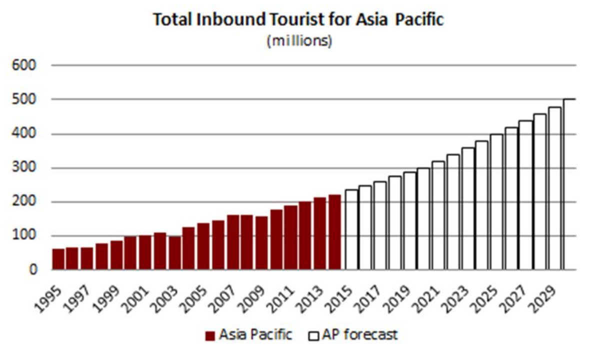
Hotels as an investment class

Limited service hotels (LSH) have expanded its footprint to all major regions in the world over the last twenty years. Starting from a notion that the room experience is key to a significant group of travellers, limited service hotels have stripped out many traditional amenities that characterized full service hotels (FSH). This allows for a better investment product, characterized by lower investment outlay and operational cost.

The first reason for the LSH expansion is the general development of the traveller's market. The number of travellers from all markets has expanded significantly. According the UN World Tourist Organization, the number of total inbound tourists globally has grown from less than 600 million in1995 to 1,200 million in 2014, while the number for Asia Pacific has grown from 60 million in 1995 to 210 million in 2014. Continued growth is expected. The UN World Tourist Organization expects the number of total global inbound tourists to grow to 1,800 million in 2030.



Source: UN World Development Indicators, UN World Tourist Organization



Source: UN World Development Indicators, UN World Tourist Organization

Having the ability to outsource hotel operations allows institutional investors and REITs to treat hotels as commercial real estate. LSHs hold particular appeal, as the limited amenities profile lowers investment outlays and operating costs. On top of generating higher investment yield and IRRs, the lower operating costs also protects LSH during downcycles, as the breakeven occupancy rate is much lower.

This white paper will be published in a series of two instalments. In this article, we will discuss the investment nature of LSHs. In the next one, we will analyse the financial characteristics of hotel investment.

What are Limited Service Hotels?

Originally, a LSH was defined as a hotel without restaurant and banquet facilities, which are part of the defining characteristics of a full service hotel (FSH). More generally, a FSH provides both basic amenities, such as food and beverage, and more advanced ones such as pool and gym.

This brand position stems from the recognition that, for some travellers, the key requirement is a satisfactory room experience and few of the other amenities. Indeed, traditional LSHs may be a budget option, where the hotel stripped out as much cost as possible to deliver a low cost option to travellers. At the lowest end of the spectrum, the low-cost LSHs can be seen as just one step above budget choices such as motels and guest houses. However, the bare-bone option now constitutes merely one sub-type of LSHs. More robust LSHs distinguish themselves from more budget choices by maintaining a higher standard for rooms and essential services.

Clayton Christensen defines a disruptive innovation as a new service or product that "were technologically straightforward, consisting of off-the-shelf components put together in a product architecture that was often simpler than prior approaches. They offered less of what customers in established markets wanted and so could rarely be initially employed there. They offered a different package of attributes valued only in emerging markets remote from, and unimportant to, the mainstream."[1]

Personal computer is one of best examples of a disruptive innovation. The original personal computers were too primitive for the existing mainframe computer users, and it served only a smaller, non-mainstream market. Eventually, however, the smaller market allowed

[1] Christensen, Clayton M. (1997), *The innovator's dilemma: when new technologies cause great firms to fail*, Boston, Massachusetts, USA: Harvard Business School Press.

personal computers to continually develop, and as they became more powerful, personal computers served an increasingly larger clientele. Today, most computers are personal computers, and large computer clusters are only used for specific applications.

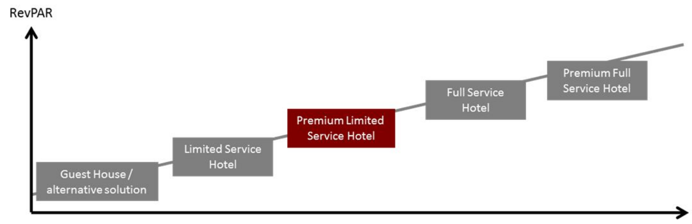
LSH was born from a simpler notion that, among services given by FSHs, the room experience is the key. Since its founding, LSH operators have been innovative in satisfying other requirements through other designs, some of which are covered in this white paper. While we do not think that LSH can replace FSHs, the more premium LSHs have the potential to increase their market share by competing with 4-star FSHs.

The sector, however, diversified as travellers grew to accept the format. More sophisticated travellers, although cost-conscious, may have higher expectations of room experience. Thus, some LSHs started to cater to these investors by offering fuller room experience with high-end décor and staff presentation. Some LSHs also recognize that some amenities are essential. Thus, they also offer basic amenities, often using innovative strategies. Some of these innovations are discussed below in a later section.

Hotel brands now form a spectrum of brand positions, with some significant overlap between the most premier offering of a category and the most mass-market offering of the next. In particular, premium LSHs actively compete with other 3-star hotels, and in some selected markets, they serve as a complementary or back up product to 4-star, FSHs.

The below table is a summary of brand positions of various hotel types. It ranges from guest houses and [traditional] LSHs that offer a basic room with no amenities, to the premium LSHs that have a full-service level room and some basic amenities. The FSHs, moreover, offer a full package of room, basic amenities and other amenities.

Brand matrix of hotel brands



Source: Admiral Investment Limited

The brand positions not only differentiate the hotel types to the travellers, but they also change the investment and operational characteristics of each type.

Single versus multi-brand management companies

Modern hotel management companies typically own multiple brands across a spectrum. The motivation is usually to allow the company to cross sell its products, but this format may or may not be suitable for all hotel types. For example, hotel brands fare differently at different points of an economic cycle, with LSHs performing better during uncertain time.

Moreover, the different business models of FSHs and LSHs give rise to different focus. Whereas FSHs aim to provide the best delivered service, LSHs aim to provide the best cost-adjusted service. FSH is necessarily a more labour-intensive option, given the level of amenities it offers.

The resulting culture and skills between the two groups are different, and as a result, most companies tend to have a dominant brand. Since hotel owners and investors have the liberty work with any brand, it is to their advantage to work mostly with the dominant brands of any particular company.

Brand position of various hotel types

	Guest House	Limited Service Hotel	Premium Limited Service Hotel	Full Service Hotel	Premium Full Service Hotel
Room Experience	Basic	Basic	Full	Full	Full
Basic Amenities (Basic F&B, Meeting Space)	None	None	Innovative	Traditional	Traditional
Other Amenities (Banquet, Pool, Gym)	None	None	None	Traditional	Traditional

Source: Admiral Investment Limited

Who stays at limited service hotels?

The brand proposition of modern LSHs is to provide a good rooming experience in a cost-effective manner. It is, however, not the cost-minimization proposition. This is a crucial distinction from 2-star hotels and even lower cost options.

The first group of LSH clientele are the cost conscious tourists, who require a level of room experience that truly budget option cannot fulfil. For example, a room that is too small or have budget versions of bathrooms or beds may not satisfy the needs of these travellers. This group often includes travellers that stay at FSHs when traveling on business, and thus, their room experience will be directly compared to that of FSHs.

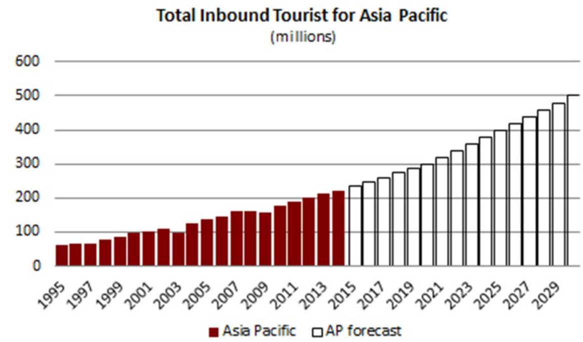
Business travellers, especially those working for small and medium enterprises and start-ups, may favour LSHs for its cost. This group, however, still requires a comfortable room where they can perform light duty work tasks, making LSHs its natural choice. The premium LSHs, offering breakfast and basic F&B, serve this clientele particularly well.

Because the premium LSHs aim to complement FSHs, the premium LSH also serves as an overflow of the higher value proposition. For example, when traveling on a short notice, business travellers may not be able to secure a room at a FSH. A LSH, especially one that is a sister brand to a familiar FSH brand, may become the choice.

Just as low cost air-carriers gradually entered competition with full service carriers, premium LSH could broaden its appeal in a similar way in the long run. The path of least resistance may be by serving the small and medium enterprises as they grow in size.

Growth of the Asia Pacific traveller's market

Asia Pacific hotels have seen demand grown substantially in the last two decades. In 1995, the number of total inbound tourists for Asia Pacific was 60 million, and by 2014, the number has reached 210 million. As the region continued to develop, the UN World Tourist Organization expects inbound tourists to grow to 300 million by 2020 and 500 million by 2050 from travelers both within and outside of Asia.



Source: UN World Development Indicators, UN World Tourist Organization

In many gateway cities, including Hong Kong, Singapore, Tokyo and others, hotel occupancy has remained above 85%, and in some cases above 90%, in the years since the Global Financial Crisis. As 85% is typically seen as full occupancy for hotels, the currently observed high occupancy has led to double digit RevPAR[2] growth for many markets in the last five years. With traveller arrivals expected to increase by another 50% in the next five years, we believe that many gateway markets remain undersupplied, even factoring in the current pipeline.

In our next article, we will discuss, in further detail, the supply and demand of the hotel markets in Asia Pacific.

Low cost carrier suggests development room for LSH

Perhaps we can draw a parallel with the Low Cost Carrier (LCC) development. In Asia, the first LCC started its operation in 2003, with less than 20 million seats. By 2014, however, the total capacity has increased to 170 million seats, representing an 8.5 times jump in capacity. The LCC network has also expanded to incorporate most major Asia Pacific cities.

Since Asia had about 200 million inbound arrivals in 2014, the 170 million seat capacity of LCCs roughly serves between 20 to 30% of the overall market. This level of development represents that the LCC market has diversified to serve an increasingly large segment of the overall market.

At a conceptual level, LCC share some similarities with LSH. Both recognize that a simpler business plan without amenities can create savings that can be passed to customers while retaining focus in the core activity.

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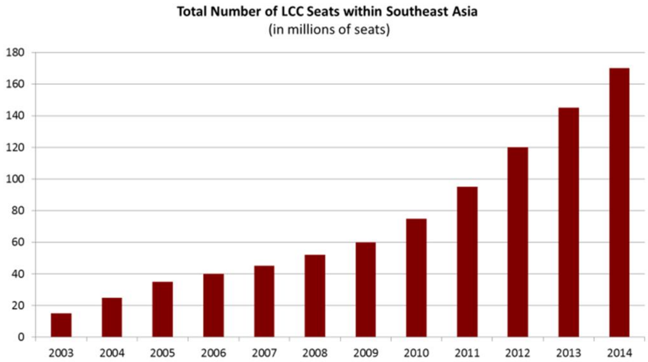
[2] Revenue Per Available Room (RevPAR) is the product of occupancy rate and average room rate. Room rates are typically managed to maximize RevPAR.

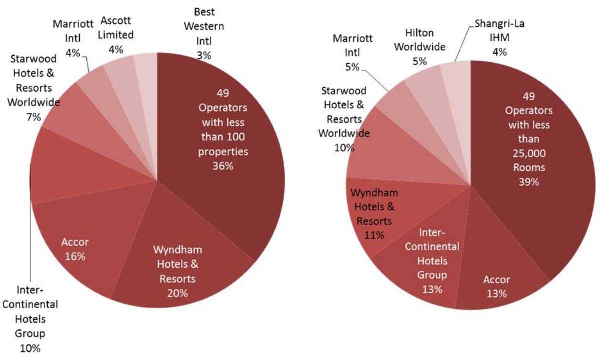
The core activity for LCC is transportation, and that for LSH is room experience. The success of the LCC suggests that Asian travellers are ready to look at the trade-off between amenities and cost.



Source: CAPA Aviation Outlook 2015

Fragmented hotel market suggests opportunities

The Asian hotel market, however, remains fragmented, with the largest competitor gaining less than 20% of market share by the number of hotels and 13% by the number of hotel rooms. More than 35% of hotels are operated by brands with less than 100 rooms, and 39% of hotel rooms are operated by brands with less than 25, 000 rooms. These numbers suggest that the hotel market remains competitive, albeit fragmented.



Source: HVS Asia-Pacific Hotel Operator Guide 2014

We believe the smaller operators present a compelling, specific investment strategy, which we will cover in more detail below. Without a size to achieve an economy of scale, the smallest operators cannot optimize revenue and effectively manage costs. Thus, renovating and rebranding these hotels can unlock value with significantly enhanced revenue and cost management programs.

Demand for branded products will also continue to grow. Travelers from outside of Asia Pacific, especially those from established markets such as the United States, Europe or Australia, may choose to stay with international brands while they stay in Asia. Loyal travelers of major brands will have to find second choices if the brands are not represented in Asia.

In addition, travelers within Asia Pacific expect to see their income continue to rise. Reviewing the development of the more established markets in other regions, this typically leads to both an upgrade of desired service level and a preference for established brands.

Value proposition for investors

The value proposition for investors to invest in LSHs comes from a lower investment outlay and a higher Gross Operation Profit (GOP) ratio. Premium LSHs, by their nature, focus on presenting a thoughtful room experience, and this is reflected from its underwriting to its operation.

Integrated underwriting

Any successful hotel incorporates revenue management, technical services and operations into its underwriting.

Revenue management, which we will further discuss below, determines the daily rate for any room, in real time. Hotel room rates are more complicated than rents in other commercial sectors for several reasons. First, hotel room rates negatively affect occupancy rates. An overcharged room rate will lower occupancy rate, and this means that revenue optimizing needs to take into account both room rates and occupancy rates. Second, hotel competition may not be limited to a single market, especially for leisure traveling. This means that room rates should also be set against a competition set that may be regional in nature. These factors mean that brands with existing operations can typically be more accurate in determining rent levels.

Hotels are also often highly regulated, needing approvals from multiple government departments to operate. This is especially relevant in renovation projects, as compared with the regulatory regimes for industrial, office, and sometimes residential assets that often may be relatively more relaxed. Underwriting of conversion projects need to account for any additional regulatory costs incurred to convert the building.

In addition, hotels are also more operationally heavy. Although operational management is now typically outsourced to the hotel brands, the hotel owners still pay for staff and other operational costs. Thus, a more efficient operational structure material affects cash flows and thus returns to investors. A LSH is likely to optimize its operations via economy of scale.

Room led design strategies

While the key of a premium LSH is to offer a satisfactory room experience, over-delivering on rooms is a sure way to under-perform financially. Larger and better equipped rooms may increase per room rent and further the positioning of the hotel away from its lower-end competitors. However, larger rooms reduce the total number of rooms in a hotel and better fit out increases the per-room investment. As such, a careful balance of room size and investment level is necessary to maximize the overall investment yield.

Thus, both owners and operators of LSHs need to place specifications on room amenity. REITs focused on LSHs, for example, may list the room size and capital expenditure per room as a key investment metrics along with more regular metrics such as required IRR and cap rates. Brands, ensuring that a standard experience is delivered, have requirements on room size and equipment.

A standard requirement, however, does not necessarily mean homogeneity. Room size requirement, for example, may differ depending on the individual market. Land price in major metropoles, such as Hong Kong and Singapore, is higher than secondary cities. Room size in premier cities, therefore, is usually smaller than room size of similarly positioned hotels in other cities. Amenities, in addition, may also be slightly localized to take advantage of local supply of construction material and to create a localized identity of the brand.

The focus on room experience, however, means that LSH can be more flexible in other areas. While the standard approach is to provide other amenities only as necessary, physical constraints may dictate otherwise. For example, a conversion project that converts another hotel into a LSH may come with amenities that are above the brand standards. A larger-than-required food and beverage space is a typical example. A LSH brand may decide to keep the restaurant if the renovation cost is too high. If the operational cost is too high, the LSH may decide to lease the restaurants out to a third-party vendor.

This flexible approach means that the design documents of a LSH typically have less moving parts, and thus, it may be easier to find suitable investment targets.

Revenue management systems

The lease structure of hotel is characterized by its short length, as travellers check in and out on a daily basis. As such, hotels are typically the first sector that responds to economic changes, and traveller demand at an individual hotel is typically quite responsive to changes in the daily rate. In addition, occupancy rates at a hotel affect revenue as much as daily rates. As such, hotels are typically managed on RevPAR.

Nowadays, RevPAR is typically managed done via sophisticated computer systems. The systems have three stages—input, algorithm, and output.

The input stage takes in real time data from various channels. The below table shows the common sales channels, and a successful revenue management systems access data from these sources in real time.

Channel Name	Channel Details
GDS	Airlines and travel agencies
Website Booking Engine	Brand website
Channel Manager	Third-party Online agents
Reservation Call Centre	24-hour hotline maintained by the brand

Source: Travelodge Asia

The algorithm is typically treated as a trade secret and most likely implemented by artificial intelligence, such as ruled-based or genetic algorithms. The key requirement of the algorithm is to make judgement on whether current room rates are too high, too low, or just right to drive the highest RevPAR. A higher than normal occupancy, for example, may suggest that demand is higher than expected and prompt the program to increase rates, and a lower than normal occupancy may cause the program to lower rates. Other special events and knowledge about the local markets may also play a role in rate settings.

The real time management of room rates allows brands to take advantage of quick and fleeting changes in demand. It also allows the brand to manage all rates from one system to maintain consistency over the entire brand.

The output of the decisions is typically also implemented in real time. The channels listed above all receive continuous decisions from the management system to update their price continuously. Decisions from these systems drive quotes sent to online agents to change throughout the day.

For investors, a key input to appointing a brand is the effectiveness and robustness of its revenue management system. While these systems are common to the larger brands, significant differences do exist. Some systems, for example, require the hotels to implement specific accounting systems. The algorithms and approach of each system may also vary, which makes reviewing the system important.

Innovations in delivering amenities

The original focus on room delivery was to reduce investment and operating cost, with the benefit shared between the investor and the customers. Dropping various amenities, such as the business center and the gym, was mainly driven by a cost concern. The value of basic amenities, however, continues to be recognized, and premium LSHs are finding innovative ways to satisfy customer demand.

For example, some limited service brands have created a common lobby area. Through smart design, the lobby can serve as the front desk and concierge; food & beverage; bar functions; lounge area; and business meeting areas. In a FSH, these functions can take several floors of space. By integrating these functions into a common area, the hotel reduces cost-adding space and its associated staff.

Another example of an innovation system is the computerized check in system. Some systems include a pre-check in program, where a traveller can check in via his cell phone. If enabled, the cell phone can also act as the room key. Kiosks may also be placed at the lobby to speed up checking in and out, especially if local laws require the checking of travel documents at the point of check in. These and similar strategies speed up people flow, optimizing the size of the check-in lobby and staff required.

Concept art of a unified lounge area

Source: Travelodge Asia and Admiral Limited

Cost-effective loyalty management

Different strategies are developed to manage loyalty for LSH. FSHs typically run loyalty programs that reward loyal customers with future rewards. Many LSHs opt for instant gratification, such as priority check in and instant discounts on every booking.

Computerized check-in and other forms of convenience may also improve loyalty. These systems may not work as well for customers targeted by the FSHs, but they address the most salient concerns of the customers targeted by the LSHs.

For investors, these programs reduce contingent liabilities and often increase overall revenue.

LSH offers higher risk-adjusted return than FSH

One traditional risk that has not been fully resolved is the seasonality nature of the hotel markets. Most hotel markets, save for the largest metropoles, have strong and weak seasons. For some hotel models, operational cost creates a material risk, if the strong season is not strong enough to compensate for the operational cost for the full year.

From this angle, LSHs further reduce risks with a lower investment outlay and a higher gross operating margin. Because LSHs offer only a selected few amenities, more floor area is typically used for rooms. Together with the fact that LSHs typically carry smaller rooms, the per-room floor area is typically between one third and a half lower than that for full services hotels.

This economy on amenities also reduces staff requirement. According to our analysis, the number of staff at a similar-sized LSH can be less than one-third of the staff number at a FSH. On the income statement, this typically translates to a 20 percentage point increase in GOP Margin.

A higher GOP Margin also lowers the breakeven RevPAR and breakeven occupancy of a LSH. A LSH also manages better the seasonality issue identified above, as the overall cost during off season is lower than that of a FSH. In fact, a similar sized LSH typically has a breakeven occupancy that is about 30 to 40%, versus over 60% for a FSH.

In our next article, we will provide a more detailed breakdown of these statistics.

What are the common strategies for investing in LSHs?

There are several major strategies for investing in LSH. The first is to own them as part of a diversified core or core-plus portfolio, such as including hotel REITs in a REIT program. Of the four major REIT markets in Asia Pacific, Japan, Hong Kong, and Singapore have dedicated hotel REITs, whilst Australia has some major REITs that have exposure to the hospitality sector.

Some investors may also gain exposure to hotels through their private equity programs. Opportunistic funds with a general sector mandate often include an allocation to hotels, for example. Sector specific hotel funds or investment clubs can also provide additional exposures to hotels.

Hotels are also suitable for value add opportunities, given the level of know-how necessary to run a hotel project. The following two strategies are common in achieving value-add or opportunistic risk-adjusted returns.

Conversion of home brand hotels

This is a strategy specific to some Asian cities, where the last ten years saw significant development activities. Some hotels, while located in suitable areas are run by smaller, often newly created, brands. Although some brands eventually succeed, other hotels are not optimally run.

The first major reason for a brand to not achieve optimal revenue is its sales & marketing strategy. Without a sizable portfolio, brand building will be more difficult, as sales & marketing budgets may be smaller than ideal. Global brands, on the other hand, collect sales and marketing fees from all their operations, and can run a more effective sales and marketing campaign.

The pricing power of brand also scales with its asset size. While revenue management systems can be developed with off-the-shelf components, the data and key parameters remain a trade secret. A larger network typically suggests better data, and thus, better decisions.

A brand's operation also scales with its portfolio size. Part of the advantage of a larger operation is purely financial, as will be discussed below. Beyond financial, moreover, a better portfolio typically means better training and a better staff pool. Since a traveller's experience is driven partially by his interaction with the staff, better trained staff increases satisfaction levels.

These operational hurdles mean that when a global brand takes over a weaker hotel, RevPAR can be expected to increase. This in turn leads to higher operational income and finally an uplift in asset value.

LSH typically performs better than FSH in asset conversion because of a more flexible design mandate. A LSH typically only has specific requirements for rooms and the ground floor lobby, meaning less renovations are required to convert an existing hotel into a particular brand. A FSH typically will have a larger set of items to be converted, making the conversion more complex and costly. Granted, some prime locations will benefit more to be converted to a FSH, as the higher rent commanded by a FSH will more than compensate the higher fit-out. But LSH, with a more flexible design mandate, will see more conversion opportunities across a broader range of destination markets.

City-hubs provide economy of scale

Larger LSH brands can leverage at a city-wide level economy of scale that is not available to smaller brands or FSHs. Typically, save for the largest metropoles, cities do not have enough demand to sustain multiple hotels from a high-end FSH brand. However, LSH brands can typically deploy multiple hotels in the same city. This provides an opportunity for the LSH to consolidate operations to further save costs.

Some LSH brands have successfully built city hubs to provide services such as laundry and F&B across multiple hotels. Typically located in the suburbs, where rents are lower, city hubs can scale up and provide necessary services for thousands of rooms. This assures quality levels and lower operational costs.

These hotel assets also benefit from having more floor area that is not used for these services. Depending on the design, the hotels may further increase its room numbers or use the space to provide other amenities.

In some situations, hotels in the same city may also share its general staff, such as the general manager and the back office staff. This is especially true as automated revenue management systems are now making room rate decisions, and the general manager is usually tasked with making operational decisions. Fewer general staff further lower operational costs.

What investment vehicles are available?

For institutional investors to access LSHs, there are four major ways.

First, for investors with a full investment team, owning hotels on their own accounts may be the most appropriate. In this format, the investor retains the most control, as it has the decision power to buy, sell or renovate the asset based on its overall investment needs. It will typically retain most management power and can make managerial and operational decisions internally.

Second, for investors desiring similar levels of control but opt to minimize operational decisions, it may use a separate account and appoint a professional manager as its asset manager (which is separate from the hotel operator). As the investor typically controls the board and thus has the authority to appoint and remove managers, it maintains a level of operational control.

Third, an investor may consider a club approach when he is interested in a similar level of control without committing as much capital. By grouping with a small group of other like-minded investors, the investors as a group control the vehicle and make most high level decisions. An investment manager is typically appointed in a similar manner as the separate account approach.

Lastly, private equity funds with a hotel focus may serve the needs of investors wishing to achieve the highest level of diversification with their capital. Funds are also managed by professional investment and operating managers, reducing the needs of the investors to continually be involved in the investment and asset management of the assets.

All of the above approaches can be used to implement a hotel portfolio.

Sidebar: hotels owners, operators and the brand standard manuals

Before the 1990s, hotels were not seen as institutional grade real estate but operational businesses. A hotel's success depends on its brand, marketing strategies and operational excellence, all of which are not priorities for other types of commercial real estate. Compared with rents from other types of commercial real estate, hotel income is more volatile, as political or social events could directly impact a hotel's average daily rates and occupancy levels. The operating cost of a hotel is typically also higher than that of other commercial real estate in the same locale, because of a larger on-the-ground staff and higher cost of goods sold from a hotel's food and beverage operation. Because of these differences, a self-operated hotel is not even classified as an investment asset under the International Financial Reporting Standards (IFRS).

In 1993, the then owner-cum-operator Marriott split itself into Host Marriott and Marriott International. Host Marriott became an asset-owning entity, owning Marriott's hotel assets in North America; whilst Marriott International became the operator, owning the Marriott brand family. Under the split, the Marriott hotels are owned by the hotel owner but operated, via a management contract, by the hotel operator. The hotel operator invests in the brand image and marketing strategies and maintains service levels at the individual hotels. This frees the hotel owners from the operational details. Like the owners of any other commercial real estate, hotel owners now focus on investment strategies such as buy-and-hold, renovation and development, shifting expertise to focus on investment returns and capital management.

In essence, without having to directly manage the operation, hotel ownership has evolved into another asset class in the commercial real estate sector. Under the IFRS, hotel assets leased to a hotel operator are admissible as an investment asset, giving these hotel assets the same accounting treatment as office, malls, and other commercial real estate assets.

The hotel ownership model has continued to evolve and diversify in the 25 years since the Marriott split, with the precise relationship between the owner and the operator being the key to financial reward.

The increasingly global nature of both the owners and the operators also add an additional layer of complication. Most modern operators work with multiple owners. Some global brands have sold or master-franchised to third parties the operating rights of their brands in international markets. These developments mean that often each hotel asset can have a different set of owner and operator. The idiosyncratic nature of each deal suggests that the investment and operational plans must be communicated clearly for an investment project to execute successfully.

This is one of the reasons why modern brands typically have standard operating manuals on both investment and operation. The investment manual typically defines the necessary standard for various aspects of the hotels, including the size, layout and required fixtures in a room; the size and décor of the lobby and restaurants, and any other required amenities. This provides the hardware for a standardized experience in any of the brand's hotels. The operation manual specifies the standard procedures of different operational teams. In some cases, the manual may specify items as detailed as the dialogues to be taken between staff members and hotel guests. This ensures that the hotel experience is delivered in a standardized and uniform way.

Conclusion: Hotels serve multiple purposes in an institutional real estate portfolio

(This portion of the white paper has been syndicated as a column article to English publication in the US, Hong Kong, and Singapore. As a stand alone article, this article summarizes the white paper but does contain some repeated language)

Relative to other commercial real estate, limited service hotels in gateway cities generate stable income returns and an on-par to slightly higher risk-adjusted total return. Hotels were once seen by institutional investors as being higher risk than office or retail assets, but several factors have lowered risks that used to be inherent to hotel investments.

1. The segregation of hotel ownership and operations started in 1993 has shifted hotel operations to hotel brands. Freed from the operational burden, owners can now focus on investment strategies such as buy-and-hold, renovation, and development.
2. The Asian in-bound tourist arrivals have seen explosive growth, growing from 100 million arrivals in 2000 to more than 220 million in 2015. In airlines sector, low cost carriers (LCC) have increased their seat capacity from less than 20 million seats in 2003 to over 170 million seats in 2014. The growth in the LCC market suggests that the travellers' market has diversified and grown deeper. This provides a larger and thus more stable market for the hotel industry.
3. Revenue management systems, driven by artificial intelligence, allow hotel chains to manage occupancy, average daily rates, and RevPAR in real time. This allows a better revenue optimization than the previous model driven by fragmented, local managements.

One traditional risk that has not fully resolved is the seasonality nature of the hotel markets. Most hotel markets, saved for the largest metropoles, have strong and weak seasons. For some hotel models, operational cost creates a material risk, if the strong season is not strong enough to compensate for the operational cost for the full year.

From this angle, limited service hotels further reduce risks with a lower investment outlay and a higher gross operating margin. Because limited service hotels offer only a selected few amenities, more floor area is typically used for rooms. Together with the fact that limited service hotels typically carry smaller rooms, the per room floor area is typically between one third and a half lower for limited services hotel.

The economy on amenities also reduces the staff requirement. According to our analysis, the number of staff at a similar-sized limited service hotel can be less than one-third of the staff number at a full service hotel. On the income statement, this typically translates to a 20 percentage point increase in Gross Operating Profit Margin (GOP Margin).

A higher GOP Margin also lowers the breakeven RevPAR and breakeven occupancy of a limited service hotel. A limited service hotel also manages better the seasonality issue identified above, as the overall cost during off season is lower than that of a full service hotel. In fact, a similar-sized limited service hotel typically has a breakeven occupancy that is about 30 to 40%, versus over 60% for a full service hotel.

Hotels, in most markets that Admiral covers, yield between 100 to 300 bps higher than office or retail assets. For example, in Hong Kong, retail assets typically yield at around 3%, while hotels yield at about 5%. We have also observed similar capital value increases between general office, retail and hotel assets. On a risk-adjusted basis, hotels are on par to slightly better than other forms of commercial real estate.

We believe that hotels can be best compared to logistics assets two or three decades ago. Logistics assets saw a similar cycle, when investors were initially concerned with its long term investment value. However, once the ownership and operational models matured, logistics assets saw a one-time, secular value appreciation in multiple markets. This tightened the yield gap between logistics and office assets, and now in many markets, especially those with an active REIT market, logistics cap rates are on par with office or retail cap rates. We see hotels, more specifically limited service hotels, as having similar potential.

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