Aalto University
School of Engineering

Investing in Hotel Properties in the Nordics

Master's Thesis, Department of Real Estate, Planning and Geoinformatics, School of Engineering, Aalto University

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Abstract of master's thesis

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Abstract

Property investors' interest in hotel properties has increased during the past decade in the Nordics. Today a wide pool of investors has begun to consider hotel properties as a viable addition to their existing property portfolios and as an alternative to the traditional commercial property assets. Earlier hotel properties have been regarded as risky and illiquid assets. The financing possibilities in the market for such investments were limited. Furthermore, the lack of sufficient understanding of hotel operating business decreased the investors' interest in hotel properties as the successfulness of the business may affect the investors' profit. However, the current property investment market situation has increased property investors' interest into hotels.

The scientific literature suggests that hotel properties are risky and volatile investment targets. The research has thus far been mainly focused on the United States of America.

The aim of this thesis was to find out what makes hotel properties a worthy investment target in the Nordics. The focus was especially on what types of risks and benefits are related to hotel properties as individual investments and as a part of a portfolio. Some importance was also given to the characteristics of hotel properties as they differ from those of other commercial property assets.

The study comprised of a literature review and thematic interviews. A total of 13 real estate experts were interviewed in Finland, Sweden and Norway. The purpose of the interviews was to fully understand how investors perceive the risks and benefits of hotel property investments and how they consider the market to evolve.

This study has been conducted from a new point of view and it brings new aspects to the existing scientific literature. The results of this thesis suggest that hotel properties can be considered noteworthy and viable investment targets for multiple investor groups in the Nordics. However, investors must have some special knowhow on the hotel business to make profitable hotel property investments. Successful hotel property investments require understanding of the risks and benefits of hotel properties, and knowledge of the lodging and hotel market.

Keywords Hotel property investments, risks and benefits, Nordics

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Diplomityön tiivistelmä

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Tiivistelmä

Kiinteistösijoittajien kiinnostus hotellikohteisiin Pohjoismaissa on herännyt viimeisen vuosikymmenen aikana. Nykyisin sijoittajat pitävät hotellikiinteistöjä varteenotettavina vaihtoehtoina perinteisille liikekiinteistöille. Sijoittajien näkökulmasta hotellit tasapainottavat jo olemassa olevia kiinteistöportfolioita.

Aiemmin sijoittajat pitivät hotellikiinteistöjä riskipitoisina ja epälikvideinä sijoituskohteina. Myös rahoitusmahdollisuudet olivat rajalliset. Toinen keskeinen syy vähäiselle kiinnostukselle liittyi hotelliliiketoiminnan luonteeseen; kiinteistösijoittajan tulee ymmärtää hotelliliiketoiminnan periaatteet, koska hotellitoiminnan menestyminen voi vaikuttaa sijoittajan tuottoihin. Nykyinen kiinteistömarkkinatilanne mahdollistaa kannattavat hotellikiinteistösijoitukset ja lisää sijoittajien kiinnostusta hotellikiinteistöihin. Myös kasvava matkailu innostaa sijoittamaan hotellikiinteistöihin.

Kirjallisuudessa hotellikiinteistösijoitukset mielletään edelleen riskipitoisiksi ja volatiileiksi sijoituskohteiksi. Nykyinen tieteellinen tutkimus keskittyy erityisesti Yhdysvaltoihin.

Diplomityön tavoitteena oli selvittää sijoittajan näkökulmasta, miksi hotellikiinteistöt ovat varteenotettavia sijoituskohteita Pohjoismaissa. Työ keskittyy erityisesti siihen, millaisia riskejä ja hyötyjä yksittäisiin hotellikiinteistöihin ja portfolioihin liittyy.

Tutkimus toteutettiin kirjallisuuskatsauksena ja haastattelututkimuksena Suomessa, Ruotsissa ja Norjassa. Haastateltavia kiinteistöalan asiantuntijoita, jotka ovat erikoistuneet kiinteistösijoittamiseen tai -neuvonantoon oli 13. Haastatteluiden tarkoituksena oli selvittää, miten kiinteistösijoittajat näkevät hotellikohteisiin liittyvät riskit ja hyödyt sekä miten he uskovat hotellikiinteistösijoitusmarkkinan kehittyvän.

Tutkimus täydentää ja tuo uutta tietoa aiempaan tieteelliseen kirjallisuuteen. Diplomityön keskeinen havainto on, että Pohjoismaissa hotellikiinteistösijoitukset soveltuvat eri sijoittajaryhmille. Hotellikiinteistösijoitukset edellyttävät kuitenkin erityistä osaamista. Sijoittajan tulee ymmärtää, millaisia riskejä ja hyötyjä hotellikiinteistöihin liittyy ja miten ne eroavat muista kiinteistösijoituskohteista. Hotellimarkkinan ja hotellien liiketoiminnan ymmärtäminen mahdollistavat onnistuneen ja tuottoisan sijoituksen.

Avainsanat Hotellikiinteistösijoitukset, riskit ja hyödyt, Pohjoismaat

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Stockholm, 6th May 2015

Annina Salakka

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Definitions

Hotel Occupancy Rate
The hotel occupancy rate describes the number of rooms occupied in proportion to the number of rooms available for occupation during a given period of time (Jafari 2002, p. 417; Tang 2011, p. 1).

$$Occupancy\ rate = (Rooms\ sold) / (Rooms\ available)$$

Hotel Operator
In this thesis hotel operator means an external entity that lends its brand and service concept to a hotel. A hotel operator is responsible for the daily operations of a hotel and it may be considered as an intermediary between the property owner and the hotel guests.

Private Equity Investment
Private equity investors make investments directly into private companies or conduct buyout of public companies resulting in a delisting of public equity. Such investments are typically made in potentially high-growth companies in order to further develop and grow their operations. Private equity investment enables the companies to access not only capital but also other resources including advisory. (Leong et al. 2008, p. 6; Investopedia 2015b.) In hotel industry this could for example mean investments in hotel operating businesses.

Private Equity Real Estate Investment
Private equity real estate investments mean equity capital invested directly primarily in properties via private equity real estate funds. Such funds do not aim at owning the assets to perpetuity but to exit them realising a capital gain and generating an internal rate of return for the fund and its investors. This is partially received through active fund management that is typical for these types of investments. (Leong et al. 2008, p. 5).

Real Estate Fund
Real estate fund is a professionally managed portfolio of diversified real estate holdings. It may be either a closed-ended fund with an initial capital collection period, fixed amount of capital and a pre-determined holding period or an open-ended fund that is open to new investments and exits throughout the holding period. (Investopedia 2015a.)

Rent-paying Ability
Rent-paying ability of an entity describes how much rent it could pay while still maintaining a profitable business. The rent-paying ability is calculated by decreasing all items of expenditure from the turnover. (Asplund 1992, p. 4).

In this thesis the rent-paying ability of a hotel is perceived in a similar way. It is noted that the rent-paying ability of a hotel may vary throughout the lease agreement period according to the changes in the hotel operator's expenditures. In general, the rent-paying ability of a hotel operator should be equal to the turnover percentages in case the hotel property is leased to the operator with a turnover based agreement.

Revenue Per Available Room, RevPAR

Revenue per available room, RevPAR, is a performance metric in the hotel industry that describes the financial performance of a hotel during a certain period of time. It is calculated by dividing the revenue of the rooms by the number of available rooms. (Slattery 2002, p. 146-147.)

$$RevPAR = (Rooms\ Revenue)/(Available\ Rooms)$$

Turnover

Turnover comprises sales profits form the actual activity of an entity that is legally obligated to keep books, after deduction of granted subsidies, value added tax and other taxes based directly on sales volume. (The Accounting Act 1336/1996, Chapter 1, Section 4; *Finnish: Kirjanpitolaki 1336/1996*; Tilastokeskus 2015b).

1 Introduction

1.1 Background

Recent market activities indicate that hotels have become worthy investment opportunities for several investor groups in the Nordics. During my time at DTZ Finland Oy, I also noticed an increasing demand for challenging consultancy services regarding hotel properties as there was an increased amount of players interested in investing in hotel properties as well as more parties asking for further information and advice.

As noted when investigating the latest changes in the hotel and hotel real estate market, private equity investors have pounced on the opportunity to invest in hotel operating businesses. On the other hand institutional and private property investors have started to consider hotel properties as a tempting addition to their existing property portfolios and as an alternative to the traditional commercial property asset classes. In some cases, hotel properties can also be considered as substitutes to other commercial properties as there is currently a lack of core investment targets in the market. (CapMan 29th January 2014; Kauppalehti Optio 20/2014 11th December 2014, p. 48; PricewaterhouseCoopers 2015, p. 25; Places & Spaces, The Real Estate Magazine of Union Investment 1/2015, p. 19.)

Today, hotel property investors seem to have an increasing interest in already existing hotel properties as well as in new production and conversion projects. In practice the demand of hotel properties reflects to the market as increased activity; both in terms of transaction and construction volumes. We have seen a number of hotel property transactions in the Nordics within the last couple of years which can also be seen as a rising amount of needed investment analyses. (Barthel et al. 2015, p. 12, 14; Waldthausen et al. 2014, p. 9-10; Grilo 2013, p. 10.)

Several advisors in the real estate market have noted the recent trends in the hotel property market. JLL forecasts that the global hotel real estate transaction volume will continue to increase by 15 percent in 2015 (JLL Hotels & Hospitality Group 2015, p. 12). In 2014 a 10 percent growth was recorded over the year before. Their study suggests that in 2015 the transaction volume in Europe, Middle East and Africa (EMEA) will be mostly driven by single-asset transactions whereas portfolio deals are anticipated in just a few countries in Europe (JLL Hotels & Hospitality Group 2015, p. 6). The forecast of the PricewaterhouseCoopers supports JLL’s view as they mention that the deal activity and the transaction volume is expected to be strong despite the decreasing deal size. They consider that the transaction volume will be mainly driven by large central European cities but note that there is also interest in the Nordics. (PricewaterhouseCoopers 2015, p. 25.)

Hotel properties have traditionally not been regarded as an asset class that would provide investment possibilities to a wide range of investors including private and institutional investors. Hotel properties are not like other commercial property assets as investment opportunities; they have unique features when looking at operational schemes and provided services as well as property level characteristics (Bohdanowicz 2006, p. v, 1; Nuutinen 2003, p. 51; Talja 1999, p. 36). These features can be considered to cause some of the reasons why hotel properties have been perceived as difficult investment targets. The lack of understanding of the hotel business, the uncertainty and the volatility of the received level of return, the illiquid nature of hotel properties, and the limited funding possibilities are examples of such hindrances that have kept investors from investing in hotel properties (Larkin et al. 2007, p. 24; Hess et al. 2001, p. 58; Nuutinen 2003, p. 51; Liu et al 2011, p. 4; Rushmore et al. 2001, p. 323).

Historically some institutional investors have avoided hotel properties (Larkin et al. 2007, p. 24) whereas private equity real estate funds and other hotel property investment companies have dominated the market (Bader et al. 2008, p. 183). This, however, is no longer the case as for instance numerous Finnish institutional investors are currently investing in hotel properties (Kauppalehti 22nd October 2014, p. 4). On a wider perspective, it should be noted that hotel properties have become more mainstream assets during the past decade and some fund managers have begun to consider hotel properties as core components of successful real estate portfolios (Larkin et al. 2007, p. 24, 28; EuroProperty 23rd July 2012, p. 10).

Despite having a larger pool of investors interested in hotel properties, the current economic downturn could slow down investors' enthusiasm towards hotel property investments. However, no such trend can be perceived in the hotel property investment market. One reason for this could be that investors rely on the increasing tourism worldwide, and hence, are willing to invest in hotel properties even in the current economic situation (Kauppalehti 22nd October 2014, p. 4). Tourism is a growing industry in Finland although it is overshadowed by other industries in the media (Kauppalehti Optio 20/2014 11th December 2014, p. 48). Tourism is expected to remain a growing market also on a global scale and to continue its stable increase. The annual report of the World Tourism Organization, UNWTO (2014, p. 10-11), reports that tourism achieved a milestone of one billion people travelling the world in a year in 2012 and since then the world wide travel has continued to increase. It is expected that the number of tourists will be increasing by 3.3 percent per year reaching 1.8 billion in 2030 (UNWTO 11th October 2011).

In addition to the increasing number of tourists, there are other reasons why today's market conditions provide a suitable investment climate for investors to focus on hotel properties in the Nordics. Firstly, long lease agreements with hotel operators and current low interest rate level may enable investors to receive high enough returns from their hotel property investments. Secondly, the availability of debt financing has improved and the conditions are better than some time ago, although not all banks are willing to finance hotel property investments today. The funding possibilities can be considered to facilitate hotel property investments even further. (Waldthausen et al. 2014, p. 2-3; Places & Spaces, The Real Estate Magazine of Union Investment 1/2015, p. 23.) Thirdly, it should also be noted that the performance of hotel properties can also be considered more stable than that of other commercial property sectors, and according to data collected by Investment Property Databank Ltd, hotels strongly outperformed the other asset classes during the last recession (EuroProperty 23rd July 2012, p. 10).

Yet another reason for the increased demand for hotel property investments in the current economic downturn could be that new construction can be done more cost efficiently at the moment than during a construction boom. It seems that the investors' demand of hotel properties has reflected to the market also in the sense that several new projects are being planned in the Nordics, especially in the capital city areas. It should, however, be noted that not all these projects will be realized. The current construction activities can also be explained by the fact that when the economy starts to grow again, the new capacity should be up and running in order to create benefits for the owners. (Kauppalehti 22nd October 2014, p. 4-5; Talouselämä 3/2014 24th January 2014, p. 18.) For these reasons it has become common that investors enter into contractual commitments and partnerships with property developers at an early stage of a hotel construction process (Places & Spaces, The Real Estate Magazine of Union Investment 1/2015, p. 19).

1.2 Research Aim and Research Questions

As indicated in the background, hotel property investments have become more desirable investment targets during the past years in the Nordics, and hence, it is necessary to investigate the main drivers behind the investors' current interest in such investment opportunities.

The main purpose of this thesis is to investigate whether hotel properties are nowadays viable investment targets in the Nordics. Additionally, it is studied how investors perceive the pros and cons of hotel property investments. Moreover, this research tries to gain a better understanding of the investors' viewpoints with regard to hotel property investments and to some extent illustrate the thinking behind hotel property investment decisions.

In order to attain the goal of the research, the following questions have been used to guide the research:

1. What makes hotel properties a worthy investment target in the Nordic countries?
    a. What are the risks and benefits of individual hotel real estate investments?
    b. What are the risks and benefits on a portfolio level?
2. What are the current trends in the Nordic hotel property market?

The aim of the first research question is to figure out how investors perceive hotel property investments. The two supporting research questions attempt to deepen the awareness of the characteristic features of hotel property investments and to investigate what types of risks and benefits are related to such investment targets. Additionally, these two questions seek to clarify some perceptions of investors with regard to hotel properties that have hindered some investors from investing in hotel properties.

The second research question makes an effort to get a general insight of the Nordic hotel property investment market, and further to get a better view on how the market has evolved. It also aims at giving a wider picture of the current hotel property investment trends in the Nordics.

The results of this study will be most beneficial for real estate investors. More broadly, other operators in the real estate field and in the hotel operating business can benefit from this research. The main advantages of this study include the increasing understanding of the pros and cons of hotel properties. As hotel properties have traditionally been regarded as highly risky and difficult investment targets due to the lack of understanding the characteristic features of hotel properties (Hennessey 2009, p. 75-76; Rushmore et al. 2001, p. 364; Larkin et al. 2007, p. 24), this thesis tries to provide some further explanations on the unclear matters. Additionally, this research illustrates the current aspects of the Nordic hotel property market that has not thus far been widely studied.

1.3 Scope of the Research

In this thesis the hotel property investments are presented from the real estate investor’s point of view. This thesis focuses solely on hotel real estate investments. Hence all other lodging establishments such as spa hotels, motels, hostels and varying forms of bed & breakfast and other small lodging establishments are not studied.

The main focus of this thesis is on hotel investments made by real estate funds and institutional investors. To further outline the research, only non-listed real estate funds are studied, and hence, investments made by real estate investment trusts, REITs, are not covered in the study. Real estate investment trusts have been outlined from the research due to the country specific legislation and the special attributes of REITs that differ from those of other real estate funds. Moreover, private equity funds investing mainly in hotel operating businesses are not included. Furthermore, hotel operating businesses are not included in this research. Although hotel operating businesses are not included in the scope of the study, they are briefly discussed to pinpoint the characteristics of hotel properties and to understand the income stream of the property investor.

Moreover, some geographical limitations are made as the focus is on the Nordic countries, i.e. in Finland, Sweden and Norway. Denmark was not included in the study as no interviews were obtained. The hotel market of the three countries under survey can be considered to have some similarities, and therefore, such scope was seen justified.

1.4 Research Methodology

Research designs are means to narrow decisions from broad perspective to detailed methods. Research designs can be classified into three types: qualitative, quantitative and mixed methods. Qualitative and quantitative designs have traditionally been considered as opposite methods. However, according to Creswell (2009, p. 3-5), they should be considered as different ends of a continuum as a research tends to be more qualitative than quantitative or vice versa. Mixed methods, which combine features of both qualitative and quantitative methods, can be seen to locate in the middle of this continuum. (Creswell 2009, p. 3-5.)

Quantitative research design is usually used to test theories by studying the relationships among variables. The outline of the final report of a quantitative research is fixed and it consists of an introduction, literature and theory, methods, results and discussion. The research hypotheses are typically formed into closed-ended questions. Qualitative research designs on the other hand are generally used in social sciences to analyse the impact of individuals or groups to a social or human problem. When it comes to the outline of the final report of a qualitative research, the structure is flexible. The research questions are open-ended as the researches are executed as interviews. (Creswell 2009, p. 3-5.) Mixed methods combine attributes of both quantitative and qualitative designs. It has been developed to enhance the overall strength of the research and what is more, it enables researchers to study more complex issues than what is possible by using only quantitative or qualitative method. (Creswell 2009, p. 3-5, 203-205.)

The aim of this thesis is to study why hotels are a noteworthy investment target by interviewing actors in the real estate market. In these thematic interviews, mainly open-ended questions are being used. Thus, the nature of this thesis is qualitative.

There are several possible ways to carry out a qualitative research. According to Creswell (2009, p. 13), there are five alternative methods to conduct a qualitative research. Ethnography is a method which is used to study a cultural group of people in a natural setting during a certain period of time whereas grounded theory is used to derive a theory of a process by comparing data of multiple groups to find similarities and differences. In a case study a researcher studies processes, events or activities. Narrative method on the other hand studies the lives of individuals by collecting stories about their lives. Phenomenological research focuses on identifying human experiences about a phenomenon. (Creswell 2009, p. 13.)

Marshall and Rossman (2011, p. 68-69) point out that researchers aim at exploring, explaining and describing a phenomenon through qualitative research. They identify four alternative methods to conduct a qualitative research. Exploratory method investigates a little-understood phenomenon whereas explanatory method tries to explain the patterns related to the phenomenon that is being investigated. Descriptive method documents and describes the phenomenon in question, and emancipatory method creates opportunities to engage in social actions. (Marshall et al. 2011, p. 68-69.)

Two of the above mentioned qualitative research methods could be recognized in this thesis. According to Creswell (2009, p. 13), patterns and relationships of meanings are created by studying a small number of subjects. In this study, a rather limited number of people are interviewed in order to understand and describe the reasoning behind investment decisions. Therefore, in addition to the phenomenological research method presented by Creswell, this study has also features of the explanatory method introduced by Marshall and Rossman. The explanatory method focuses on attitudes and motives behind a certain phenomenon. (Marshall et al. 2011, p. 69.)

1.5 Research Methods

This thesis is conducted by using a literature review and thematic interviews as research methods. The first part of the study comprises a literature review, which serves as a preparatory phase for the research and aims at highlighting the theoretic background of the subject. Several concepts related to hotel investments are presented and discussed in the literature review. Firstly, the characteristic features of hotel properties and hotel property investments are discussed. Secondly, the focus is on risks and benefits of individual hotel property investments after which these topics are investigated on a portfolio level.

The second part of the research consists of thematic interviews and it is of qualitative nature. According to Hirsjärvi and Hurme (2011, p. 47-48), a thematic interview is a half structured interview, which covers certain themes and topics. They mention that the order and the exact form of the questions can vary between the interviewees. In this thesis the interviews were slightly modified and tailored based on the interviewer’s previous knowledge on the interviewee’s company in order to receive extensive information on the subjects dealt in the interviews and to take advantage on the interviewee’s expertise and knowhow.

1.6 Structure of the Thesis

The thesis consists of three main sections which all contribute in answering the research questions and in achieving the research aim. These three parts of the research are the preparatory section, empirical section and the discussion.

The preparatory part of the research comprises the introduction and the literature review of the thesis. The introduction discusses the topicality of the research and also the current issues related to the topic. Furthermore, the research aim and the scope of the research are introduced in this part. The research methodology and the methods are also briefly explained.

The literature review addresses the main issues and concepts related to hotel property investments. The first part of the literature review discusses the main characteristics of hotel properties as well as the characteristics of lodging markets. The second part of the literature review focuses on hotel properties as individual investments with a special focus on risks and benefits associated to them. The third part of the literature review studies hotel properties as part of a portfolio by focusing mainly on the pros and cons and briefly on the diversification possibilities of hotel property investments and also on the performance of hotel properties in a portfolio.

The empirical part of the research consists of the thematic interviews made on the subject. The answers received in the interviews are carefully analyzed to find extensive responses to the research questions. The focus is especially on the reasoning behind hotel property investments and on the risks and benefits that are associated with hotel property investments both on an individual investment but also on a portfolio level.

In the discussion part, the results of the thematic interviews are compared and reflected to what was found in the literature review. Moreover, recommendations for further research are represented in the discussion part. The key results of the research are presented in the conclusions. Finally, a short summary gives an overview of the whole thesis.

2 Literature Review

2.1 Definition of a Hotel

There are several definitions for hotels. Hotels can be defined as establishments providing accommodation, meals and other services for travellers and tourists, by night (Oxford dictionaries 2014). Phyrr et al. (1989, p. 871) characterizes hotels similarly as establishments that provide temporary lodging for the public and usually also other facilities, such as restaurants and entertainment possibilities. Jafari's (2002, p. 288) view supports these definitions as according to him, hotel is a business unit that provides accommodation to the public for a minimum period of one night and its activities are commonly supported by the provision of other related services.

Rushmore and Baum (2001, p. xiii) claim that hotels and other lodging facilities can be defined so that no distinction is made between them. They state that hotels are multistorey facilities with extensive food, beverage, and banquet services, convenient parking, efficient designs, and small public areas. (Rushmore et al. 2001, p. xiii.)

In the Finnish legislation, accommodation services and properties are defined broadly. In the Act of Accommodation and Restaurant Services, accommodation services are prescribed as professional service that offers furnished rooms or other accommodation locations on a temporary basis for clients. Lodging houses on the other hand are described as buildings, apartments or other business locations, where accommodation services are offered. (The Act of Accommodation and Restaurant Services 308/2006, Section 1; *Finnish: Laki majoitus- ja ravitsemisliiketoiminnasta 308/2006*.)

In this thesis, hotels are understood as Phyrr et al. (1989, p. 871) define them. Motels and certain other lodging facilities are not included in the research.

2.2 Characteristics of Hotels

2.2.1 Characteristics of Hotel Properties

Commercial real estates have several distinct attributes. They are heterogeneous, indestructible and immobile assets. Furthermore, certain real estate types can be characterized as a scarce asset class.

Firstly, real properties are heterogeneous. Each property has a unique location and use. Location is one of the most important factors of properties as the infrastructure and the neighboring area have a major impact on the value of the property. Additionally, each property has a unique shape and size and the topography of the properties varies. In addition to the location and the use of the building, the size and age of the construction as well as the tenant mix of the building affect the value of the property. (Hoesli et al. 2000, p. 19-20.)

Secondly, real estates are indestructible. However, the physical indestructability must be distinguished from the economic durability as land itself cannot be destroyed but the value of real estate is subject to changes. The buildings on the site, however, are not indestructible in physical or economic sense, but they have a long life-span in both senses. The immobility of real estate is closely linked with the heterogeneity and indestructability of real estate. Whereas the land in physical sense is not movable, some substances, such as soil, may be removed and transported from the site. (Shilling 2002, p. 8-9.)

Thirdly, a shortage of certain land type is possible. This scarcity is related only to physical space as for example buildings and other man made space can be constructed but requires time, money and effort. (Shilling 2002, p. 11.)

Hotel properties have much in common with other commercial properties, as they are heterogeneous and a scarce asset class. However, hotel real estates have some additional distinctive characteristics when compared to other commercial real estates. These features include for example small rooms with bathrooms, complicated technical features, large amount of furniture, fixtures and equipment, and fast ageing of the property.

Hotels can be considered as complex investment targets. Nuutinen (2003, p. 9, 53), Talja (1999, p. 38) and Lind (1995, p. 62) claim that there are little if any alternative uses for hotel properties. Talja (1999, p. 38) argues that this is due to the fact that the technical features of hotel properties are rather complex. Each room has a separate bathroom and nowadays also air-conditioning. Nuutinen (2003, p. 53) adds that hotel rooms are typically rather small which complicates the development process even more. These two above mentioned factors increase the cost of development, and consequently, decreases the profitability of such actions. In some cases old hotel properties have been developed into care homes or into student housing purposes (Nuutinen 2003, p. 53-54; Talja 1999, p. 43). Another consequence of the large number of bathrooms and air-conditioning is the increased amount of technical equipment needed in the property which increases the repair needs (Talja 1999, p. 38).

Furniture, fixtures and equipment are an essential part of a hotel and its operation. The condition of the so called personal property determines quality and affects on the image of the hotel. The term furniture, fixtures and equipment covers all non-real estate items such as the décor of the rooms and the public areas but also the equipment used in the kitchen premises. In order to maintain the standard of the hotel as well as the income potential, the furniture, fixtures and equipment should be replaced on a regular basis. (Rushmore et al. 2001, p. 285, 359-361; Rushmore 2001, p. 209; Lesser et al. 1993, p. 12, 21.) The useful life of the personal properties varies on the quality, durability, and on the amount of use (Lesser et al. 1993, p. 21; Rushmore 2001, p. 209), but is typically approximately eight years (Talja 1999, p. 38; Rushmore 2001, p. 418).

In addition to the previously mentioned personal property, hotel properties themselves age rather rapidly. Rushmore (2001, p. 80) states that the economic life of a hotel property is somewhere between twenty to sixty years depending on the renovations made during the life-cycle of the property. However, the life-cycle of a hotel real estate is shorter than that of another type of commercial properties (Gallagher et al. 2000, p. 136). The first two to four years of the life-cycle is the time of economic expansion when the occupancy rate of the hotel rises. The hotel reaches the stabilized maturity level between the second and fifth year of operation. (Talja 1999, p. 37; Rushmore et al. 2001, p. 320-321; Denton 2009, p. 14; Larkin et al. 2007, p. 24.) After a few stabilized years, the recession of a hotel property begins. Due to changes in architectural styles, physical deterioration and functional difficulties, hotel properties appear dated after seven to twelve years of operation (Rushmore 2001, p. 236; Rushmore et al. 2001, p. 231; Talja 1999, p. 37). This development of life-cycle and of business cycle of hotel properties is presented in the Figure 1 below.

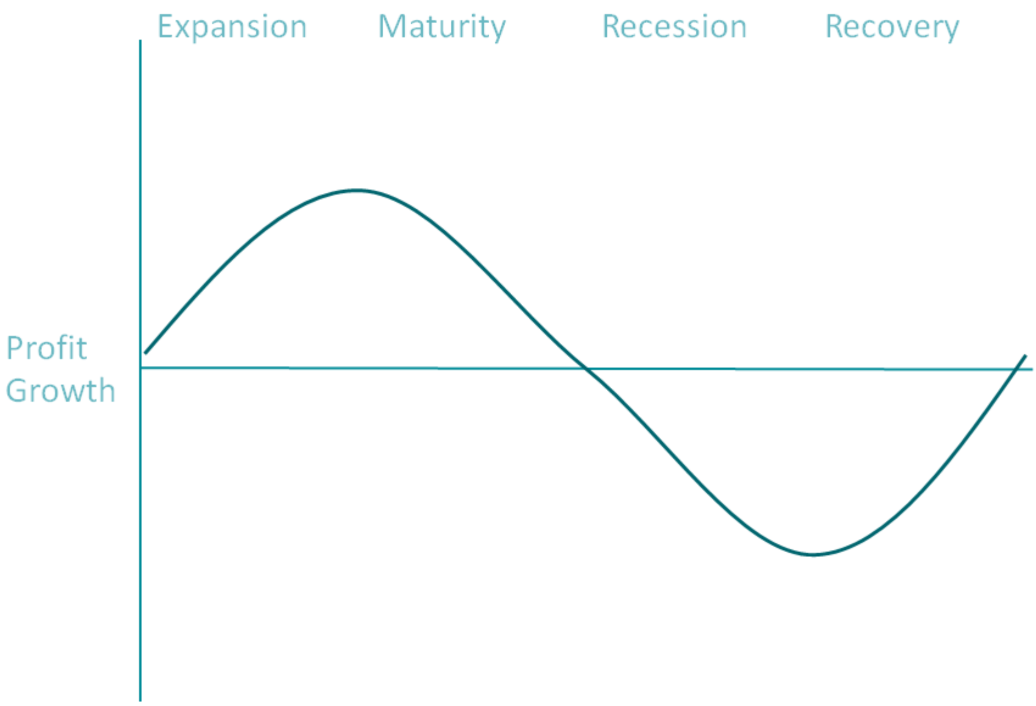

Figure 1 The life-cycle and the business cycle of a hotel property. (Denton 2009, p. 15.)

2.2.2 Characteristics of Hotel Operating Businesses

The hotel operations are typically a result of the co-operation between the property owner and the possible external entity that is responsible for the daily operations of the hotel. The hotel operating business is characterized based on how the hotel operations are arranged. Hotel property owners have mainly three possible options to arrange the owner and operator structure. The hotel owner may run the hotel himself, lease the hotel operations to an external hotel operator or enter into a management agreement with an external hotel operator. A hotel operating company may be considered as an intermediary between the owner and the hotel guests. In this chapter the three possible structures between the hotel owner and the operator are studied from the real estate owner's perspective and the risks of external entities have not been included in the study.

The first possibility is that the hotel owner runs the hotel himself, which is usually the case in small and privately owned hotels. In this case a property owner company owns the property through a joint-stock property company, and the same property owner company owns the operating company running the hotel. The property owner company receives income from the operating company and pays maintenance charges to the joint-stock property company. (Talja 1999, p. 24; Nuutinen 2003, p. 16.) This structure is presented in the Figure 2 below.

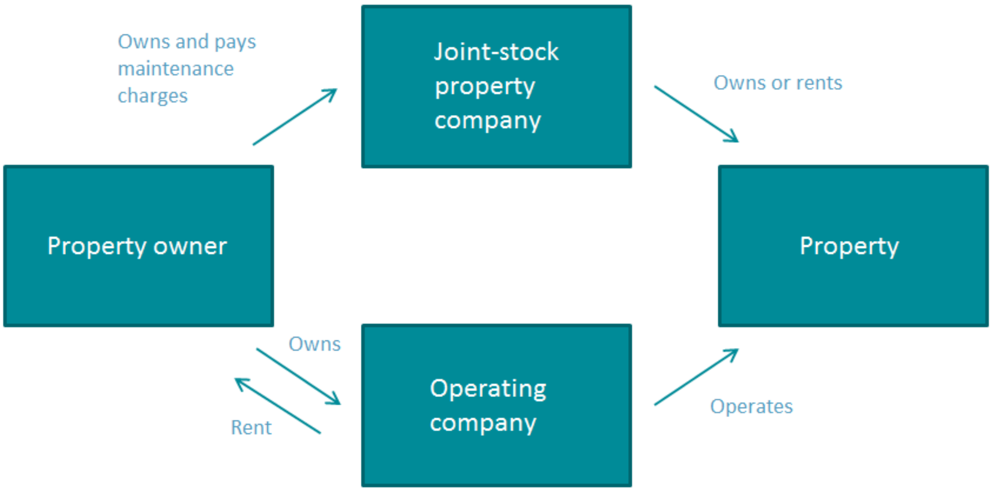

Figure 2 Property owner as an operator. (Talja 1999, p. 24.)

However, this hotel owner operator structure has some limitations. Hotel management and real estate investments require differing skills and resources, and thus, different specialists usually take these roles. When these roles are managed by the same people, the operations of the hotel may at times be inefficient. Another downside is that the property owner carries the risks related to both the property investment and to the hotel operations. However, the higher risk profile may lead to higher profits as there are no other contracting parties dividing the earnings. (Talja 1999, p. 24, 29; Nuutinen 2003, p. 16.)

The second owner and operator structure tackles some of the risks related to the first option. The ownership structure of this is similar to the first possibility, the only difference being that the hotel operating company is an external entity leasing the hotel property, and thus, the hotel owner does not need any special know-how on operations and management. (Talja 1999, p. 25; Lind 1995, p. 30-31.) This structure possibility is presented in the following Figure 3.

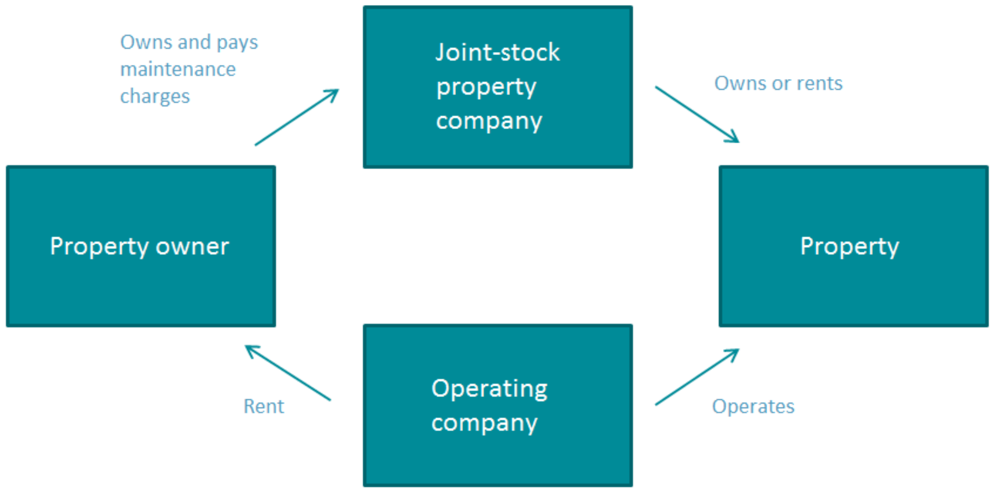

Figure 3 Operator as an external entity leasing the property. (Talja 1999, p. 25.)

The lease agreements with hotel operators are typically more complex than those made with office property tenants (Tiensuu 2009, p. 19). There are two possible lease agreement structures for the external hotel operator as it can either be fixed or turnover based agreement. (Talja 1999, p. 25; Lind 1995, p. 30-31.)

When the hotel is let to an external and independent operator with a fixed lease agreement, the agreement reminds of a typical office lease and the lease does not depend on the success of the hotel operations. In this case the hotel operator carries almost all the risks related to the operations, and thus, it usually is willing to pay less rent compared to a situation when the hotel owner carries part of the operation risks. (Talja 1999, p. 25; Lind 1995, p. 30-36.)

In turnover based lease agreement, the hotel owner carries some risks related to the success of the hotel. In turnover based lease agreement, the rent is calculated based on the sales generated by the hotel. The turnover percentages are usually determined separately for the lodging operations and for the restaurant operations, but it is also possible to determine a certain percentage of the total turnover. Furthermore, a minimum lease amount is typically agreed in case the turnover falls below a certain predetermined limit, and similarly a maximum lease amount can be defined in the contract. (Talja 1999, p. 25-26; Lind 1995, p. 31; Nuutinen 2003, p. 18; Ielaqua et al. 2012, p. 2.)

Although mainly the operator covers the risks related to the hotel operations in the two above mentioned cases, the owner carries the risk of the operator’s bankruptcy. As the lease structure places the owner in a passive position, he has little, if any, possibilities to influence on the operations and on the success of the hotel. This owner and operator structure also limits the owner’s possibilities to receive additional profit and the income is based solely on the lease. (Talja 1999, p. 29; Rushmore 2001, p. 360-361; Nuutinen 2003, p. 16.)

The third possibility to organize the owner and operator structure is to include a management company in the picture. The structure is based on the first possibility where the owner is also responsible for the operations. The difference between these models is that the operating company enters into a management contract and pays management fees to the hotel operator. Management contracts may be considered to be a form of agent contract. The purpose of the management contract is to outsource daily operations and marketing to an external entity, and thus, the owner is usually in a passive position when it comes to the daily actions and has only limited possibilities to control over the operation of the asset. (Lind 1995, p. 32-33; Talja 1999, p. 27-29; Nuutinen 2003, p. 17; Ielaqua et al. 2012, p. 3-4.) What should be noticed in this case is that the property is not let to an external entity, but an external entity is included in the picture to take care of the daily operations. This structure is presented in the Figure 4 below.

There are several types of management companies as some of them are independent and others are affiliated with hotel chain brands. According to Hanson and Smith (1999, p. 18-19), independent management companies may operate several hotel chains simultaneously whereas chain affiliated management companies are focused on specific chains. (Hanson et al. 1999, p. 18-19.)

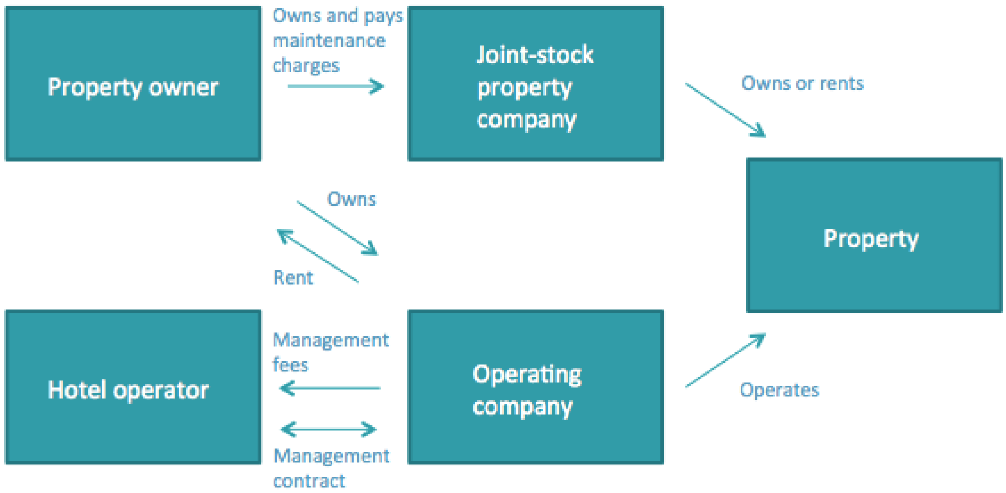

Figure 4 Management contract with a hotel operator. (Talja 1999, p. 27.)

Despite the fact that the hotel operations are run by an external operator, the owner carries the risk of the success and of the profitability of the hotel. The management contracts are structured so that they spur the manager to operate the hotel profitably as the contract may be terminated if the property owner is not satisfied. Additionally, this risk of low profitability can be reduced by agreeing on a guarantee that the owner will receive a certain level of profit. The gap between the actual profit and the guaranteed level is paid from the management company's own funds if the promised profit level is not achieved. The level of these so called guarantee funds is typically limited. Furthermore, the owner has to reckon with the bankruptcy of the operator. (Talja 1999, p. 29; Bader et al. 2007, p. 174.)

Management contracts as well as franchise agreements are common when hotel companies are entering new market areas. High-end hotels typically use management contracts whereas franchising is popular among lower and middle class hotels. The difference between these two internationalization approaches is that management agreements contract out the daily operations of the hotel from the owner to the management company whereas with franchising agreements little involvement by the parent company is needed. (Dev et al. 2002, p. 91-93, 103; Alon et al. 2012, p. 385.)

According to Dev et al. (2002, p. 95-104), there are four reasons based on which the decision between these two internationalization approaches is made. Firstly, the irreproducible resources, such as quality, speak for management contracts. Secondly, management contracts are more often chosen in locations where reliable investment partners can be found. However, there are two motives that speak for franchise agreements. In cases where the business environment of the market area is developed, franchise agreement is seen as a more viable choice. Furthermore, in some areas no trustworthy management companies can be found, and thus, a franchising is chosen. (Dev et al. 2002, p. 95-104.)

Hotel franchise is an agreement between a hotel chain and a hotel owner which allows the owner to use the chain’s name and services, such as reservation systems, in return for a franchise fee. The hotel owner is, however, usually responsible for the development costs of the hotel. The hotel owner is also responsible for the daily operations of the hotel, and therefore, franchising requires a smaller management structure compared to a hotel management company. In short, franchising can be seen as a way to transfer expertise with limited capital risks. At the same time it functions as a growth vehicle for hotel chains as it enables a chain to enter such areas quickly where it has not been able to expand on its own. From the hotel owner’s perspective this is also a positive matter as it shortens the usually rather long start-up period of a hotel. (Rushmore 2001, p. 326-328; Alon et al. 2012, p. 379-385.)

According to Talja (1999, p. 30) and Nuutinen (2003, p. 21), franchising and management contracts are the two most significant means to create larger hotel chains. The other two methods presented by Talja are an ownership chain and a marketing chain. In this case ownership chain means that the same hotel owner owns all hotels whereas in marketing chain there might be several owners but the reservations and marketing are done by the chain. (Talja 1999, p. 30.) These two methods are not presented more closely as they are not as significant as the above presented methods.

2.2.3 Characteristics of Lodging Markets

The lodging market is a cyclical market which fluctuates on daily, monthly and yearly basis. These fluctuations are caused by the characteristics of the market, such as the distinctive lease structure, customer groups and demand generators of the area. The underlying economic situation has also an impact on the cyclical nature of the market.

One of the main characteristic features that separates hotels and commercial properties is the lease structure. Whereas office and retail premises are let for several years, hotel operator leases hotels on a daily basis and usually only few long-term stays are spent in hotels (Lind 1995, p. 25). However, this lease structure has both pros and cons. A short letting period increases the risk of vacancy, but allows the hotel to determine the room rate on a daily basis. This enhances the inflation-hedging effect of hotel properties. Another benefit from the daily letting is that the transaction costs related to the process are somewhat smaller when compared to signing a long lease agreement. (Gallagher et al. 2000, p. 136-137.) However, it should be noted that hotel properties are usually let to a hotel operator, and thus, the risks and expenses related to the daily letting are carried out by the operator and not by the property owner (Talja 1999, p. 36).

The lease structure of hotels leads to varying demand of rooms not only on a daily but also on seasonal basis, and consequently, the demand of rooms is considered volatile. The daily changes in demand are closely linked to the customer group using the hotel and to the purpose in which the hotel is used. Especially hotels targeted towards business travelers suffer from low demand during weekends. In addition to these daily changes, the demand may vary seasonally. This fluctuation is caused by the use of the hotel but also by the location and customer group of the hotel. (Talja 1999, p. 17-20; Lind 1995, p. 19.) However, the hotel operator can tackle this type of fluctuation by developing different methods to attract other customer groups during more quiet seasons. Yet again, the operator is usually responsible of the risks and expenses caused by seasonal fluctuations.

The location of the hotel can be analyzed by looking into the so called demand generators of the area. These demand generators are typically linked to work or recreation possibilities of the area. The demand generators, such as amusement parks, other tourist attractions and companies and businesses, are the reasons why hotels are needed in a certain area. Hotels rarely function as demand generators themselves. (Rushmore 2001, p. 149-150; Talja 1999, p. 6; Nuutinen 2003, p. 15; Powers 1995, p. 358.) Changes in these generators may cause significant fluctuations in the occupancy level of hotels in a certain area, and thus, hotels that are dependent on one demand generator are more prone to changes in the occupancy rate.

Furthermore, these demand generators influence on the customer group of each hotel. Rushmore (2001, p. 71) defines the previously mentioned groups as commercial demand, meeting and convention demand and leisure demand. What is more, these demand groups have an impact on the above mentioned seasonal fluctuations of hotel occupancy rates. The commercial demand is rather stable throughout the year with a significant drop in December. The demand derived by meetings and conventions is strongest during spring and autumn while the demand during the winter and summer months is somewhat unstable. The leisure demand on the other hand is opposite to the meeting demand as the summer and winter months are attractive travelling periods depending on the nature of the attractions of the area. (Rushmore 2001, p. 116-117; Talja 1999, p. 17-19.)

In addition to the previously mentioned groups another customer group, unaccommodated demand, is caused by the cyclical nature of the hotel industry. Such travelers are looking for accommodation in a certain area without finding any, and thus, are either forced to postpone their journey or settle for a less when it comes to lodging facilities. This unaccommodated demand will not lead to a construction of a new lodging facility unless the overall occupancy rate of the city increases above 60 percent. (Rushmore 2001, p. 154-159.)

Yet another factor besides the demand generators and the customer groups that has a strong impact on the occupancy rate of a hotel is the underlying economic situation. The performance of hotels is highly sensitive to changes in the economic situation and reacts rapidly to the negative changes in economy as the rooms are let on a daily basis. (Kim et al. 2012, p. 28; Gallagher et al. 2000, p. 136). One notable consequence of difficult economic situation is the so called trade down effect. Ismail et al. (2002, p. 79) claim that during economic downturn travelers choose a hotel from a lower price range and class than during a good economic situation. Some leisure travelers that usually use budget hotels during their trips do not use hotel services at all during a tough economic situation. (Ismail et al. 2002, p. 75-79.)

In order to enhance the demand during low seasons, hotels offer differing discounts to keep the demand more stable. Hotels also use price discrimination as they increase prices during the peak season and decrease prices during the off-season. The daily letting of hotel rooms enables such price discrimination, and therefore, similar adjustments are usually not possible with other types of commercial properties. (Lind 1995, p. 19; Gallagher et al. 2000, p. 138.) Hotels can benefit from price discrimination similarly as airline companies. In some circumstances hotels might gain from leaving some rooms vacant for travelers in need of lodging in the last minute. Travellers that make advanced bookings are typically more price-conscious than those booking a room closer to the trip or during the trip. Thus, an optimal vacancy rate exists in the hotel market. (Gallagher et al. 2000, p. 138; Wheaton et al. 1998, p. 75.)

2.2.4 Characteristics of Hotel Investments

Real estate investments in general have several distinctive features compared to other investment targets, such as stocks and bonds. These characteristics are presented briefly before focusing on the characteristics of hotel real estate investments.

The unit value of real estate investments is high when compared to other possible investment targets such as stocks and bonds. Thus, small individual investors are rarely able to enter the market and even large investors may have difficulties constructing a diversified property portfolio. (Hoesli et al. 2000, p. 20.) Due to the high unit value of property investments, the use of leverage is common. According to Jaffe and Sirmans (2001, p. 26) investors can benefit from using debt financing when the rate of return of the investment is higher than the cost of debt financing. This gain is usually greater in property investments than in other investments forms. (Jaffe et al. 2001, p. 26.)

Another feature of properties that derives from the high unit value is the illiquidity of the investments. However, there are numerous other reasons for illiquidity. Properties cannot be sold on a specific trading market and transactions are time consuming and expensive compared to other forms of investment. (Hoesli et al. 2000, p. 23.) Furthermore, the seller usually has more information on the property compared to the buyer.

Property investments are considered as long-term investments. As mentioned earlier, land is an indestructible asset and buildings have a long life-span. However, nowadays properties are traded more frequently as part of active fund management strategies. Individual properties from larger portfolios are traded in order to improve the short-term performance of property portfolio. (Hoesli et al. 2000, p. 21.)

Active management is an essential part of property investments. The ownership of properties requires active management unlike for example stocks and bonds. Property investments require a significant amount of daily management as for example lease agreements must be negotiated, rents collected and maintenance taken care of. The amount of needed management depends on the property type, as for instance shopping centers require more management than logistic properties. (Hoesli et al. 2000, p. 21.) According to Jaffe and Sirmans (2001, p. 26), some investors are attracted to property investments, because they can manage and develop their investments directly, which is not possible with passive forms of investments.

Hotel property investments have both similarities and dissimilarities with other real estate investments. Hotel property investments can be characterized based on the specific life-cycle of the properties. In addition, hotel property investments have some features that differ from the other commercial property investments. They can for example be considered as better hedges against inflation than other commercial real estates, but at the same time hotel properties are more illiquid than other commercial real estates. Furthermore, hotel property investments derive income from several sources as explained below.

As mentioned above, hotel properties have a specific life-cycle that differs from the life-cycles of other commercial properties. During the first two to four years of operation, the hotel usually does not reach a net income level which would cover the debt service of the period in question (Rushmore et al. 2001, p. 320). Hence, the owner of the hotel must have a sufficient cash reserve to cover the costs and operating losses of the start-up period. These costs include for example promotional expenses and other expenses caused by low occupancy rate. (Phyrr et al. 1989, p. 873; Rushmore 2001, p. 170.) After this period, hotels generally achieve stable results (Frehse 2007, p. 8). According to Rushmore and Baum (2001, p. 321), the net income usually rises above a stabilized level for some years before declining due to the ageing of the property.

The occupancy rate of a hotel follows a somewhat certain pattern throughout its life-span. Normally, the breakeven point for hotels is between 50 to 60 percent (Rushmore et al. 2001, p. 195; Phyrr et al. 1989, p. 872). When entering the market, the occupancy level of a hotel is typically 5 to 15 percent below the average of the specific market. During the second year of operation, the occupancy level should be approximately the same as the market average. After the second year, the occupancy level should peak and exceed the market average by 5 to 15 percent. (Rushmore et al. 2001, p. 195-196.) A stabilized occupancy level reflects the occupancy rate of a property throughout the life-span of the hotel. The occupancy rate may fluctuate temporarily below and above the stabilized level. (Rushmore et al. 2001, p. 223.) All in all, the breakeven point of lodging properties is low, and therefore, there is a possibility of high profits when fully occupied (Phyrr et al. 1989, p. 872-873).

Another characteristic feature that separates hotel property investments from other commercial real estate investments is the short life-cycle of the hotel real estates. The economic life of a hotel property is approximately twenty to sixty years (Rushmore 2001, p. 80). However, renovations and repositioning of the hotel may elongate the life-cycle of the hotel investment (Rushmore 2001, p. 236). Larkin and Lam (2007, p. 24) suggest that the repositioning and the stabilization of an existing hotel ranges between three and five years.

Properties and shares are considered as hedges against inflation as the expected real returns are dependent on the demand and supply factors instead of the inflation rate. Simply put, an asset that functions as an inflation hedge has nominal returns which are positively related to inflation. (Tarbert 1996, p. 77.) Hotel properties are believed to offset inflation in the long run due the possibility to raise rents according to the inflation in a short term (Powers 1995, p. 286). Phyrr et al. (1989, p. 873) put it in other words by stating that hotels can be seen as excellent inflation hedges as they are not dependent on long-term leases and the industry as a whole is flexible and less vulnerable to inflation. Gallagher and Mansour (2000, p. 137) and Petersen and Singh (2003a, p. 167) go further and argue that hotel property investments may be the most effective hedge against inflation. Rushmore (2001, p. 231) claims that hotel property investments are countercyclical and the increase in room rates can exceed the inflation, and thus, such investments are good inflation hedges.

It has been argued that hotel properties are an illiquid investment target compared to other commercial real estates. There are few potential investors for lodging properties and the sales process includes several detailed and time-consuming phases such as transfer of lease and franchise agreements. Another factor that leads to low liquidity is the fact that hotel properties are only suitable for lodging use throughout their life-span. (Talja 1999, p. 39; Rushmore et al. 2001, p. 363.)

Unlike other commercial property investment types, hotel real estate investments derive income from several sources. In addition to room revenue, other major income streams can be derived from services such as food and beverage (Rushmore 2001, p. 181; Lesser et al. 1993, p. 11) and meeting rooms (Lesser et al. 1993, p. 11) to mention a few. Earlier these were seen as supporting necessities, but more focus has been put to these facilities during the recent years (Crandell et al. 2009, p. 295). Phyrr et al. (1989, p. 873) claim that these facilities are in most cases leased units, and thus, are not considered as business operations. Crandell and Dickinson (2009, p. 294) however argue that such services are an essential part of the hotel’s operating business.

In addition to the previously mentioned characteristics of hotel properties, they are sometimes considered more as a management-intensive business rather than a highly specified real estate asset class. Management-intensivity, or in other words, service-intensivity means that hotel properties are perceived to have more similarities with businesses than with other forms of real estate (Hess et al. 2001, p. 53). One factor that causes the management-intensivity of the hotel industry is the above mentioned daily letting of the rooms. Therefore, hotel real estates are labor-intensive and dependent on the management skills of the hotel operator. (Lesser et al. 1993, p. 11; Gallagher et al. 2000, p. 133; Frehse 2007, p. 8.)

One important concept related to hotel property investments is the rent-paying ability of hotel operators. The rent-paying ability illustrates the operator’s ability to pay rent for the needed space so that the business itself remains profitable. The rent-paying ability of the operator is usually presented as a percentage of the turnover. It can be defined so that it covers both the capital and the operating costs. However, usually the operating costs are deducted before determining the rent-paying ability. There are several factors that may affect the rent-paying ability in general. These factors include the field of operation and the business idea, the course of action, the sales margin, the cost structure and the location of the business. (Asplund 1992, p. 4-10.) Talja (1999, p. 26) adds that type of the hotel has also a major impact on the rent-paying ability of the operator. Talja claims in his master's thesis that the rent-paying ability of a hotel ranges between 25 to 40 percent of the turnover of the hotel (Talja 1999, p. 26).

2.3 Hotels as Individual Investments

2.3.1 The Definition of Risk

Every investment possibility and decision includes uncertainty, which is usually perceived as risk. Some claim that when it comes to investing, unlike in economics in general, no difference can be made between the concepts of uncertainty and risk. (Olkkonen et al. 1997, p. 87; Engblom 2003, p. 15.) International Valuation Standards Council, IVSC, (2012, p. 5), however, notes that these are two separate concepts that should not be confused. Risk is a measurable factor that may affect either directly the asset or the market on which the asset could be sold. (International Valuation Standards Council, IVSC, 2012, p. 3-5.)

Risk as a concept cannot be defined unambiguously as the exact definition is dependent on the use and purpose of the word. Simply put, risk describes the possibility of future losses that the owner of an asset may encounter (International Valuation Standards Council, IVSC, 2012 p. 3). However, there are five definitions that are commonly used from a broader view (Olkkonen et al. 1997, p. 88):

1. the probability of loss
2. the probability that expectations are not met
3. the difference or variance between the expectations and the realization
4. the variance of realized returns in relation to the expected or probable returns
5. the likelihood that the investor will not receive the required level of return.

A wider meaning and definition of risk includes two perspectives. Ahonen (2007, p. 27) reminds that a risk might have a significant negative or positive impact on an affair. The positive side of a risk can be observed through two of the above mentioned definitions. Both definitions three and four include a possibility of larger realized returns compared to the expected level of return. (Olkkonen et al. 1997, p. 88.)

What is more, risk can be divided into two separate parts: systematic and unsystematic. The systematic risk is derived from the changes in the economic situation and the market. This type of risk affects all investments in a similar way, and therefore, it cannot be avoided by diversifying investments in a portfolio. Thus, it is logical that this type of risk may also be called market risk or undiversifiable risk, as these risks are unrelated across investment targets. The unsystematic risk on the other hand is linked more on property related aspects such as location and lease agreement. This type of risk may also be referred to as unique or diversifiable risk. (Sharpe et al. 1995, p. 277; Berk et al. 2011, p. 311; Jaffe et al. 2001, p. 406.) It can be noticed that the positive aspect of risk is more closely linked to the unsystematic part of risk than to the systematic part.

According to the Capital Asset Pricing Model, CAPM, the systematic risk is marked with β. This measures the volatility of an investment caused by the assets sensitivity to market risk. When it comes to the CAPM, investors are not rewarded according to the total risk but only for the systematic risk as unsystematic risks can, at least in theory, be diversified away. All in all, the CAPM leads to the fact that the higher the risk, the higher the expected return for a certain investment target. (Berk et al. 2011, p. 359-360; Jaffe et al. 2001, p. 407-408; Hoesli et al. 2000, p. 127-128.)

2.3.2 The Relationship between Risk and Return

The relationship between risk and return is an important and a fundamental concept for real estate investors. Simply, this trade-off assumes that an investor requires higher returns for higher risks other things being equal. The concept shows to an investor that expected high rates of return are accompanied by high levels of risk and it also reminds that sometimes high rates of return are possible with less risky assets. In other words, when comparing two investments with same expected levels of return, investors usually prefer the less risky option and the same concerns the opposite case when two investment targets have the same level of risk, the one with higher returns is chosen. Consequently, there is a positive relationship between risk and return. (Jaffe et al. 2001, p. 28-29; Hoesli et al. 2000, p. 47; Olkkonen 1997, p. 87.)

The risk and return preferences vary among investors as others prefer safe investments and others riskier ones. Investors try to maximize their returns through investments that fit their risk preferences. Investors can be categorized into three groups based on their risk profiles and their risk appetite that are related to the investor’s ability and willingness to make risky investments. Some investors aim at avoiding risk, some are neutral and some are drawn towards risk. (Jaffe et al. 2001, p. 28; Olkkonen et al. 1997, p. 87.)

Moreover, investment targets and portfolios can be divided into three or four groups based on their risk and return expectations. These groups are core, core plus, value added and opportunistic. (Jaffe et al. 2001, p. 28-29; Hoesli et al. 2000, p. 47.) Hence, the risk appetite of the fund has an impact on the choice of assets and on the asset management strategy of the fund.

Core funds are typically perceived as low risk funds with a holding period that varies from five to ten years (INREV 2015a). Such funds invest in assets that are almost fully let and they require little if any capital expenditures. Thus, such properties produce stable cash flow for investors over long periods of time. (Shilling et al. 2012, p. 430-434; INREV 2015a.) According to the definition by INREV (2015a), core plus funds invest in similar assets, but with a more aggressive management style.

Value added funds on the other hand have a higher risk appetite. Assets in such funds require more active management, refurbishments and in some cases redevelopment. Therefore, value added investments require a substantial amount of capital expenditures during the investment period. These capital expenditures can be for example tenant improvements or small changes in the use of the property. (INREV 2015b; Shilling et al. 2012, p. 430-434.)

Opportunistic funds have even higher risk appetite than value added funds. According to Shilling and Wurtzebach (2012, p. 430-434), such investments are typically speculative or development projects. INREV (2015c) goes further by suggesting that opportunistic investment targets may include development projects without pre-letting, distressed assets or acquisition of large portfolios with a disposal strategy as smaller portfolios. Furthermore, the asset management of opportunistic funds can be considered aggressive as the holding period of assets in the portfolio is typically rather short (INREV 2015c).

Shilling and Wurtzebach (2012, p. 430) propose that the rates of return for core, value added and opportunistic investments are 8 to 12 percent, 12 to 18 percent and over 18 percent respectively. Another source suggests that core returns are below 9 percent, core plus from 9 to 11 percent, value added returns between 12 and 15 percent and opportunistic returns over 15 percent (EuroProperty 16th July 2007, p. 10). These risk and return expectations of property investors are demonstrated in Figure 5 below.

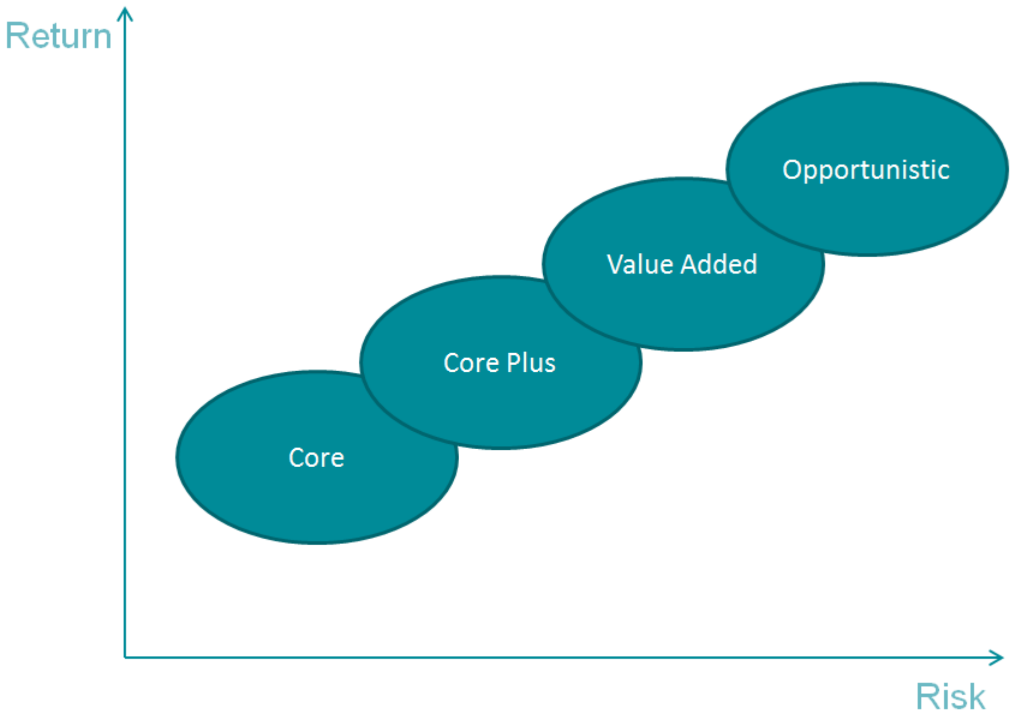

Figure 5 Risk and return expectations of investors.

According to Hennessey (2009, p. 75-76) and Rushmore and Baum (2001, p. 364), hotels are usually perceived as a risky asset class. The riskiness of each asset must be determined separately as highly desirable hotels can be seen as value added targets and others as opportunistic investment possibilities. The market situation has a significant impact on the risk spectrum of hotel properties as during an investment boom hotels may be purchased for a core fund. In addition to property level risks and general market conditions, the general hotel market situation should be carefully analyzed. (Denton 2009, p. 21; Hennessey 2009, p. 75-76; Rushmore et al. 2001, p. 364; Rushmore 2001, p. 222.)

2.3.3 Risks and Benefits of Hotel Investments

Risks associated with real estates can be divided into smaller groups in several possible ways depending on the source and on the purpose of the classification. Sometimes risks are divided into two categories on how they are formed. In this case risks can either be static or dynamic. Static risks are existing and fundamental problems whereas dynamic risks are resulted by changes in the political, economical and social environment. On the other hand, risks can also be subdivided into speculative and pure risks. Speculative risks are taken in the hope for higher returns and pure risks are unforeseen events that can only cause some expenses and possible losses. (Hintikka 1999, p. 27-28.)

However, risks related to real estate investments are commonly subdivided into the following groups: business risk, inflation risk, financial risk and political risk. Business risk illustrates the possibility that the expected returns are not achieved. It is usually resulting not only from the characteristics of a property but also from changes in the economic situation. Business risk is one contributor to the unsystematic risk of commercial real estate investments. Inflation risk or in other words purchasing-power risk is caused by the unexpected increase in prices. Financial risk describes the possibility of defaulting on borrowed funds. It is sometimes considered as an additional risk as it does not concern properties that are solely funded by equity. A high level of debt leverage increases the susceptibility to financial risk, and thus, it increases the level of systematic risk. Political risk is related to the changes in for example legislation, zoning and also in rent control system. (Jaffe et al. 2001, p. 29; Hintikka 1999, p. 29-31; Kim et al. 2012, p. 36.)

As mentioned earlier in this thesis, hotels are a rather risky investment target compared to other commercial property investment possibilities. Liu and Quan (2011, p. 1) remind that hotel investors face not only the risks associated with commercial properties but also risks associated specifically to hotel investments. Moreover, all hotel types have some distinctive risks linked to them, but this thesis focuses on the main threats and possibilities related to hotel investments in general. The majority of these risks and benefits are closely associated with the characteristics that are previously presented in this thesis. These positive aspects of risk can be considered as the main drivers for individual hotel property investments.

One of the main risks related to hotel properties is the long start-up period and their rather rapid obsolescence which together shorten the profitable life-span of the property. During the long start-up period, hotels are not generating income to their owners. On the contrary, hotel owners and investors are usually forced to finance the operations during this time period before the occupancy rate and the room rates reach a sufficient level to generate income. To create a viable hotel property investment target, all parties involved in the development of the hotel should work well together as the development process is extremely capital intensive. (Rushmore et al. 2001, p. 362-363; Talja 1999, p. 38; Younes et al. 2007, p. 70.) This cyclicality of income generation reflects to the operating risk of a hotel property, as this risk is higher during the first years of operation and decreases after a stabilized income level is reached (Younes et al. 2007, p. 71).

The rapid obsolescence of hotels is another factor, which requires additional investments from the owner. As the trends in the hotel market, such as the layout, design and amenities, change in short cycles, hotel properties should be updated constantly. However, these updates and repairs are not always economically profitable, and therefore, changes are postponed and the property becomes gradually less competitive when compared to more recently built hotels. All types of hotel properties are prone to internal obsolescence, but the amount invested in the initial development may affect the need of major repairs, as low-cost layouts are not as easily modified according to current trends. (Rushmore et al. 2001, p. 362-363; Talja 1999, p. 38; Younes et al. 2007, p. 74.)

In addition to the changes in the functionality of hotels, external changes may have a strong impact on the profitability of a hotel. These changes might result from environmental, economic, legal and social factors. There are several examples of such external factors as they can be related to an economic downturn, overbuilding in a specific market, new airline routes or even to some events. These changes may affect the economic profitability of a hotel over the long haul and may not be changed with own actions. (Rushmore et al. 2001, p. 363; Talja 1999, p. 39; Younes et al. 2007, p. 74.) Terrorism and natural disasters, such as the tsunami in 2004 and SARS disease in 2002-2003, are examples of unpredictable external events that often have a significant impact on tourism, and thus, on hotel occupancy rates (Larkin et al. 2007, p. 24-25). One good example of an external event that changed the hotel market in a specific area is the terrorist attacks in New York in 2001. The attacks caused a decrease in the nights spent and also in the room rates in the area, which led to a decrease in hotel property values in the market area in question (O'Neill et al. 2002, p. 53-54).

The overbuilding or new hotel construction in a specific market may in some cases be considered as a major external risk for an existing hotel. Younes and Kett (2007, p. 73), however, remind that hotels might in fact be hedged against such risk. This hedging is a consequence from the possible barriers of entry, which may be for example scarcity of land, zoning restrictions and planning regulations as well as limited amount of available capital. (Younes et al 2007, p. 73.)

The operational environment of hotels has changed recently as the Internet has brought new possibilities to the market both in terms of opportunities but also new supply. Especially Airbnb has become a growing competitor for hotel chains as its rising occupancy penetration rate enables competing with leisure and commercial hotels. The company's business concept does not include the ownership or the operating of the rooms, nor does it provide similar amenities across their supply. (Kurtz 2014, p. 4-5.) Airbnb is nowadays a strong competitor for world's leading hotel operating companies as it is challenging InterContinental Hotels Group and Hilton Worldwide for the number one largest hotel operator in the world without actually owning any hotel properties (Business Insider 2013; Multibriefs Exclusive 2014).

The above mentioned changes in the environment of a hotel may impact the hotel's performance in a short notice as hotels reflect the market changes rather accurately. Such changes have typically a long lasting impact on the economic viability of a hotel. However, it should also be noticed that the location of the property does have some influence on the seasonal fluctuations of a hotel. Especially the low seasons of a certain hotel market may have a significant impact on the value of a hotel. These seasonal influences on hotel operations are perceived as a major risk of the hotel property sector. Typically the more the income stream of a hotel property fluctuates, the higher is the operating risk level of the property. (Rushmore 2001, p. 149-150; Talja 1999, p. 39; Newell et al. 2006, p. 279; Younes et al. 2007, p. 72.)

Both the long term and short term impacts and fluctuations may be tackled if the hotel is operated effectively. The knowhow of the hotel management has a major impact on the success and on the value of a hotel. In case the hotel management works diligently towards a more effective cost structure by cutting costs and improving the efficiency of the operations, the hotel may avoid being unprofitable during a turbulent time period. (Talja

1999, p. 38; O’Neill et al. 2002, p. 54.) The cost effectiveness of a hotel may be enhanced by for example reducing personnel, diminishing management and training costs as well as by reducing the inventory levels of operating supplies (Mason et al. 2009, p. 121). Rushmore and Baum (2001, p. 362) summarize that the competency of a hotel manager may be measured based on the ability to maximize revenues and minimize costs in long run. This ability to increase profits and reduce losses decreases the probability of the realization of business risk (Kim et al. 2012, p. 31).

The management agreement should also be up-to-date as an outdated management agreement may cause additional difficulties and misunderstandings (Newell et al. 2006, p. 279.) Despite having a competent management running the daily operations of a hotel, hotels are a volatile form of real estate. Traditionally hotel property investments have had more volatile returns than other forms of real estate (Hess et al. 2001, p. 58). Liu and Quan (2011, p. 3) and Hess et al. (2001, p. 58) propose that the volatility of hotel investments is mainly caused by the lack of long lease agreements or in other words the daily letting of the rooms, and hence, by instable cash flow streams. Rushmore (2001, p. 233) acknowledges that this type of volatility occurs in the short term and that there are two suitable manners to encounter such risks. Firstly, a longer holding period may smooth out the possible fluctuations in the received income. Secondly, the timing of the hotel investment is crucial as the returns vary more than those other commercial properties. (Rushmore 2001, p. 233.)

A direct consequence from the volatile cash flow stream and risky nature of hotel investments is the higher cost of loans. Liu and Quan (2011, p. 4) note that lenders typically charge a higher risk premium that leads to higher borrowing cost and also to the application of a more conservative underwriting criteria for hotel loans than for other commercial real estate loans. Rushmore and Baum (2001, p. 323) remind that the number of lenders willing to finance hotel project is also somewhat limited. The higher borrowing cost and the scarcity of active lenders might also be factors that limit the investor group interested in hotel properties. The limited number of potential investors may lead to a long disposal period of the investment, and thus, hotel property investments are an illiquid investment target. (Talja 1999, p. 39; Liu 2011, p. 4; Rushmore et al. 2001, p. 323.)

Investment decisions are usually made based on the financial attributes of the investment target. However, at times decisions are done solely for psychological reasons as some investors may invest in distinctive assets only for emotional reasons. (Mason et al. 2009, p. 111.) This may cause mispricing of hotel investment targets as emotional reasoning often leads to overpaying for an asset that might seem secure. Sometimes such rationing may cause the overestimating of the likelihood of a rare but favorable event. (Rushmore 2001, p. 236.)

One beneficial financial motivator in acquiring hotel property investments is the inflation hedging possibility. Inflation risk is one of the most frequently identified risks associated with commercial property investments and hotel property investments are able to tackle that risk at least to some extent. The inflation hedging effect of hotel properties is derived from the daily adjustable rent levels which might exceed the existing inflation rate. (Mason et al. 2009, p. 111; Phyrr et al. 1989, p. 873; Rushmore 2001, p. 231.) According to the study conducted by Newell and Seabrook (2006, p. 287) hotel investors considered financial attributes the most important factors when making hotel investments. They found out that the investor's focus is mainly on investment performance analysis characteristics such as historical rates of return and revenue per available room, RevPAR. (Newell et al. 2006, p. 287.)

Despite having a rather volatile cash flow, hotel properties may prove profitable investment targets. The costs of hotel properties are mainly fixed and the amount of variable costs that depend on the occupancy rate of the hotel is relatively low (Pan 2007, p. 749). Hence, after reaching the breakeven point, the profits tend to increase significantly in a short time period. (Rushmore et al. 2001, p. 363.) Phyrr et al. (1989, p. 720-721) suggest that when the occupancy rate of a hotel reaches approximately 65 to 70 percent, the owners make some profit, and when the occupancy level rises to 75 to 80 percent, the profit can be considered very good. Hence, the profitability of a fully booked hotel may be extremely good.

All in all, there are quite a few advantages and disadvantages associated to hotel property investments. Some aspects can be seen to have both negative and positive features related to them. The Figure 6 below summarizes the above mentioned risks and benefits of individual hotel property investments.

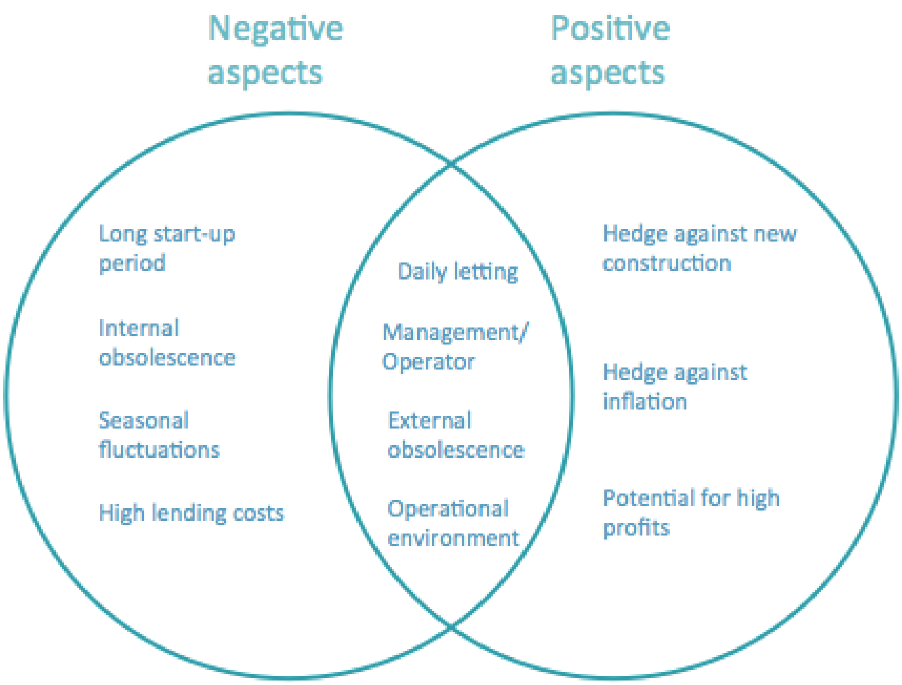

Figure 6 Positive and negative aspects of hotel property investments.

2.3.4 Risk Management

As noticed previously, hotels, as an asset group, are a risky investment target. Differing risk management processes are being used to reduce the impact of the risks in case they realize. When it comes to hotel property investments, the risks may be managed with for example adequate cash reserves, thorough renovation plans and low breakeven levels. As the life-cycle of a hotel property is rather short, it is important to budget both major external renovations as well as internal changes. The cash reserves, which are quite small, are typically used only to update the furniture, fixtures and equipment.

The risk management process should be initiated simultaneously with the acquisition process of a hotel property as at this point both the property itself but also the hotel market should be evaluated. Rushmore (2001, p. 233-234) highlights the importance of the location and the hotel market. Sometimes an underperforming hotel in a promising market is a less risky and a more tempting investment target than a well performing hotel in a difficult market. For an investor the first case is more suitable as in such situation the investor may enhance the performance of the hotel with his own actions instead of waiting for the market situation to improve. As Rushmore (2001, p. 234) points out, old hotels usually have the best locations in a city and in a market, and therefore, a renovation of an old hotel may prove to be a good decision for maximizing returns and minimizing risk. (Rushmore 2001, p. 233-234.)

The timing of the acquisition should also be considered carefully when making a hotel property investment. The hotel property market cycle change considerably slowly compared to for example stocks that change on a daily basis. The most lucrative time in investing hotel properties is when the market is on the way up (Corgel et al. 1997, p. 32) and is showing improvements in occupancy rates and also in average rates (Rushmore 2001, p. 233). Furthermore, in order to maximize the returns from the investment, the acquisition should not be made when the market is stable and new lodging properties are being built. (Rushmore 2001, p. 233.)

The timing is of essence also when drafting an exit strategy for a hotel property investment. The exit strategy should also be outlined before committing to the acquisition of the property. The cash flows may be projected somewhat reliably over a short holding period, which lead to a lower risk level. However, hotels are commonly a long term investment, and therefore, the uncertainty of the projected cash flows decrease and the risk level respectively increases. (Rushmore 2001, p. 235-236.) Younes and Kett (2007, p. 70) suggest that the common holding period of a hotel investment is somewhere between five and twenty five years.

The risks associated with hotel property investment acquisition and exit may be at least partially dealt with already before committing to the acquisition. However, not all risks can be avoided by a careful analysis of the investment target or by creating a solid plan for the investment period as several risks realize during the investment period of the investment. These risks are mainly related to the fluctuating revenues and to the fixed cost structure of a hotel property (Younes et al. 2007, p. 72), and may be avoided by selecting the hotel management carefully and by taking advantage of the already existing services provided by them.

When committing to a hotel property investment, the chosen operator is an influential factor when it comes to the profitability and successfulness of the investment. As one of the most significant cost items in a hotel property investment is the personnel, the operator must have the competence to create a profitable cost structure by optimizing the needed amount of staff and also of the inventories needed. Additionally the operator must have experience in similar hotel environments to be able to operate the asset in an economically viable manner. In order to ensure the hotel operator’s commitment in a specific asset, a minority interest in the real estate may be required. (Rushmore 2001, p. 239.)

In addition to optimizing the level of fixed costs of a hotel property, a competent operator should be able to tackle the risks related to the fluctuating demand of hotel services. As the number of rooms in a short term is fixed, an increase in demand may lead to turning potential customers away, and thus, to losing potential profits. On the other hand, a decrease in demand generates losses as the cost level of hotel properties is somewhat fixed. A competent operator may even out the difference between these extremes by attracting more customers during the low seasons by for example offering promotions. Another method to narrow down the impacts of demand fluctuations is to find other companies to operate alongside that offer services, such as parking or gym, and products, such as souvenirs. (Bednarska 2004, p. 43.)

From an investor's viewpoint, the chosen contract structure with the hotel operator or the management company is an effective way to spread the risk between the owner and the external entity operating the hotel. Hence, the agreement structure should be selected according to the investor's risk appetite. When a fixed lease agreement is chosen, the hotel operator bears the majority of the risks related to the hotel operations and the lease is not dependent on the success of the hotel. In turnover based agreements, the hotel owner carries some of the risks related to the hotel's performance. On the other extreme is a management agreement, where the risks of the success and profitability of the hotel are carried solely by the hotel owner. (Talja 1999, p. 25-26, 29; Ielaqua et al. 2012, p. 2-3.) The Figure 7 below illustrates the risk and return relationship of these above mentioned agreement structures.

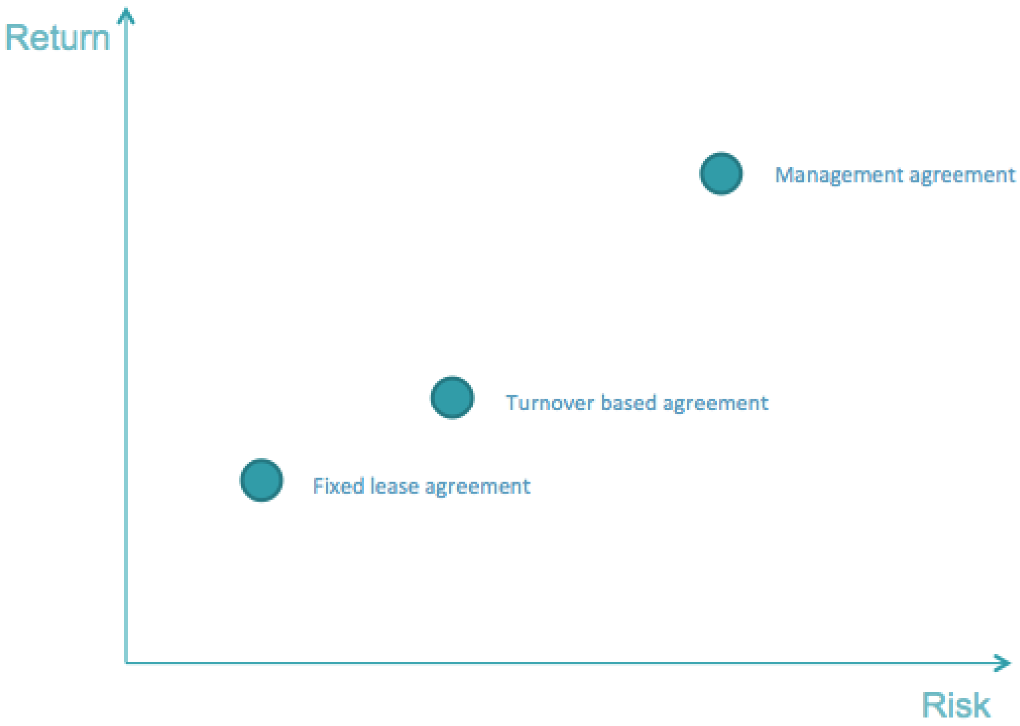

Figure 7 Risk and return relationship of lease agreement structures from the owner's perspective (Ielaqua et al. 2012, p. 4).

In case the hotel is a new construction or a development project, an experienced and well-known franchisor or operator may shorten the long start-up period of hotel. The choice of the hotel chain is important for several reasons that are related to the start-up period of a hotel which may facilitate the market penetration phase of the hotel in question. These reasons include for example a recognizable name and services such as a reservation system. The affiliation has an impact also on the image of the property, on the market orientation, and on the ability to compete in the market and against existing competitors. (Rushmore 2001, p. 350.)

2.3.5 The Analysis of Hotel Performance

According to the Capital Asset Pricing Model, which was briefly presented earlier in chapter 2.3.1, a high level of risk is closely linked with a high level of expected returns. The performance of hotel properties is measured with specific ratios that have been developed in the lodging industry. Such ratios include average occupancy rate per room, average room rate, revenue per available room, RevPAR, average length of the stay and total revenue per guest. In this chapter the focus is on the occupancy rate, on RevPAR and on average daily rates, ADR.

When considering other types of commercial real estate properties, occupancy rate is used to describe the amount of let area of the total area of the property. However, the same method does not apply for hotel properties as they are typically let to an operator that takes up the whole property. Therefore, occupancy rate in hotel industry describes the number of let hotel rooms compared to the total number of rooms in the hotel. (Nuutinen 2003, p. 25.) Tang (2011, p. 1) defines occupancy rate as the number of rooms occupied in proportion to the number of rooms available for occupation.

Occupancy rate can be used to analyze a hotel and its market area, but it should not be considered as a reliable indicator of the success of the hotel operations. As the definition of Tang already suggests, the occupancy rate can be enhanced temporarily by decreasing the room rates. (Nuutinen 2003, p. 25.) Some might suggest that hotel occupancy rate is a good method to analyze the hotel's performance beforehand. It should, however, be noticed that it is difficult to predict the occupancy rate ahead but with sufficient data the turning points of occupancy rate may be estimated. As the occupancy rate is volatile, it is challenging to estimate the pattern according to which it varies. (Tang 2011, p. 57.)

One key ratio that can be used to analyze the performance of hotel properties instead of occupancy rate is the average daily rate or in other words the average room rate. ADR describes the average room price of leased hotel rooms and it is calculated by dividing the revenue received from the rooms by the number of rooms sold.

$$ADR = (Rooms\ Revenue)/(Number\ of\ Rooms\ Sold)$$

One thing that should be noticed when calculating the ADR is that it may vary considerably within one property, as it is dependent on the room type, on the customer segment, on the analyzed weekday and on the analyzed season. ADR tends to decrease if the occupancy rate decreases. Sometimes the ADR is seen as an indicator of the success of the hotel's operative side. However, the ADR and the occupancy rate of a hotel cannot be used alone to analyze the financial performance of a hotel nor can they be used to properly compare two hotels with each other. (Schmidgall 1999, p. 198; Nuutinen 2003, p. 25.)

Revenue per available room (RevPAR) is a ratio that combines the occupancy rate and the ADR together, and thus, it is often used to analyze the financial performance of a hotel. RevPAR can be used to compare the relative performance of a hotel with varying scenarios of room rates and occupancy rate (Hess et al. 2001, p. 57). It is calculated by dividing the revenue of the rooms by the number of available rooms.

$$RevPAR = (Rooms\ Revenue)/(Available\ Rooms)$$

RevPAR is usually seen as an indicator of a hotel's actual revenues. Hotel companies, investors and other entities regard it as an effective measurement of the balance between the room supply and demand. Despite being commonly used in the hotel industry, some consider it as an unreliable measure of hotel's performance. Some operators may sometimes try to falsely enhance the RevPAR, which means that the operator focuses more on the revenues than on the profit margins. Furthermore, hotel companies may have differing methods in calculating the components of the RevPAR calculation as some seasonal hotels may not take into account the low seasons and some hotels may deduct some rooms from the total stock due to refurbishments. Furthermore, RevPAR does not take into account the cost structure of a hotel. Although RevPAR is used to benchmark hotels against each other, it is not a reliable indicator if the cost structures of the compared hotels are not similar. (Schmidgall 1999, p. 198; Nuutinen 2003, p. 26; Slattery 2002, p. 135-137.) However, RevPAR can be considered a relevant measurement when analyzing the hotel industry as a whole in an economy. RevPAR can be seen to move similarly with the GDP. (Slattery 2002, p.146-147.)

2.4 Hotel Investments as Part of a Portfolio

2.4.1 Risks and Benefits of Hotel Investments in a Portfolio

The chapter 2.3.3 focuses on the risks and benefits associated with individual hotel property investments. The presented risks and benefits include for example operational risks and benefits, inflation hedging possibilities as well as external and internal obsolescence. Despite the features that are presented in the chapter above, it should be noticed that these same factors are also closely related to hotel investments when part of a portfolio. In this chapter the focus is solely on such risks and benefits that may occur in a portfolio.

Hotel properties create unique diversification possibilities which are probably one of the main reasons to include hotel property investments to a portfolio. Hotel properties may be used to diversify multi-sector portfolios, but also hotel portfolios themselves may be well diversified. When diversifying and determining the allocations of differing asset classes in a portfolio, the decisions are commonly based on the expected performance and the riskiness of a certain asset class, the possible benefits of the diversification potential of the asset class and on the inflation responsiveness of the asset class (Quan et al. 2002, p. 82). What should be noticed is that hotel properties have not been widely used to diversify multi-sector property portfolios due to the lack of understanding the business and the somewhat high-risk profile of hotel properties (Petersen et al. 2003b, p. 13).

According to Rushmore (2001, p. 229), the diversification benefits of hotel property investments result from the countercyclical behavior of hotel properties compared to for example stocks. Simply, the purpose of diversification is to create a portfolio with a lower overall risk than what it would be if not diversified. Petersen and Singh (2003a, p. 161; 2003b, p. 11) and Kim et al. (2012, p. 28) suggest that the lower risk level is achieved by reducing the unsystematic risks that result from investment target specific factors such as lease agreements and location. When aiming at diversifying a portfolio, the criteria of the asset should be that the investment targets are not strictly correlated. Petersen et al. (2003b, p. 18) note that hotel properties have a low correlation with other commercial property groups including office, retail, industrial and apartment properties. Quan et al. (2002, p. 87) go further by claiming that hotel properties have a negative correlation with other commercial properties. According to the analysis conducted by Petersen and Singh (2003a, p. 168-169), hotels have a remarkably low correlation with apartments and retail properties, and hence, hotels' diversification benefits function best in portfolios consisting of retail properties and apartments. Petersen and Singh (2003a, p. 168) also remind that the other commercial property groups correlate with each other. The differing investment characteristics of hotel properties, such as the possibility to adjust rents according to the inflation on a short term, may be the reason behind the low correlation between hotel properties and other commercial properties (Quan et al. 87-88).

As mentioned above, hotel properties seem to behave countercyclically when compared with stocks. However, hotel properties may be used to diversify a portfolio consisting of other asset classes such as stocks, bonds and other fixed-income investments to a limited extent. Williams and Wippel (2013, p. 2) point out that the inclusion of hotel properties in a portfolio including for example stocks and bonds, enhances the efficient frontier of the portfolio. What should be noticed is that whereas stocks and hotel properties have a low or negative correlation, bonds and other fixed-income investments seem to behave in a similar manner with hotel properties, and thus, in these cases hotel properties do not bring significant diversification possibilities to the portfolio (Quan et al. 2002, p. 88). Hartzell et al. (1986, p. 238, 245) noted that while real estate investments can lead to significant diversification benefits when added to portfolios of stocks and bonds, it might, however, be more cost efficient and attractive to focus on multi-sector property portfolios.

In addition to the diversification benefits of hotels in a multi-sector real estate portfolio or in a multi-sector portfolio including additionally other asset types than real estates, portfolios that include only hotel properties can also be well diversified. Rushmore (2001, p. 239) reminds that there are several possible ways to spread risks in a hotel property portfolio. Market risk can be tackled with geographical spreading whereas investing in different hotel types, affiliations and varying hotel sizes, product risk can reduced. (Rushmore 2001, p. 239.) Giannotti et al. (2011, p. 25) also note that geographical diversification and allocation to different hotel sectors are notable diversification methods not only when considering hotel property investments but also when considering property markets in general. The geographical diversification can be done based on for example the characteristics of the area and whether the area is more tempting for business or leisure travellers, on the seasonality of the area, and even on the weather characteristics of the area (Giannotti et al. 2011, p. 30).

These two previously mentioned diversification methods of hotel property portfolios have also been recognized in the market. Pandox AB reports in their Business Operation Report 2013 (p. 14-16) that the geographical diversification is one of the main aspects of their strategy and that it provides them a certain risk diversification but also results in a larger number of business possibilities. What is more, geographical diversification over several continents brings varying business models to the portfolio as for example in some areas franchise and management agreements are more commonly used than lease agreements (Pandox Business Operation Report 2011, p. 3025). Another diversification approach used by Pandox AB is to invest in several market segments, in other words to hotels with varying price ranges and also to collaborate with several hotel brands and operators (Pandox Business Operations 2013, p. 16-17; Pandox Business Operations 2011, p. 0014-0015, 1018). Whereas Pandox AB focuses on hotels with differing price levels, Dividum Oy spread their risks by investing in varying hotel types such as business hotels, conference hotels and hotels offering leisure activities (Dividum Oy 2003 Annual Report 2004, p. 14, 18, 21). According to the 2003 Annual Report of Dividum Oy (2004, p. 14), the risk was also spread by choosing hotels of varying sizes to the portfolio.

2.4.2 The Performance of Hotels in a Portfolio

As mentioned above, hotel properties are perceived as a highly risky asset class. This risk profile is accompanied by the expectation of returns that exceed those of the other asset classes and are above the market average.

Although data on lodging property performance has been collected for a shorter period of time than data on the performance of other commercial property and the data set can be considered somewhat unreliable, there is evidence that hotels meet the expectations as they have substantially higher returns and risks than other commercial real estates (deRoos et al. 1996, p. 21, 27). Firstenberg et al. (1988, p. 28) suggest the expectations of high returns are met as they note that among five main real estate types, hotels are by far the most risky asset class but at the same time the returns received from hotel property investments outperform the other asset classes. It is, however, noted that the hotel property returns are more volatile than those of other commercial property asset classes (Petersen et al. 2003b, p. 16; deRoos et al. 1996, p. 27).

The volatility of returns may be managed by diversifying hotel holdings by brand, market segment, by geographic spreading and by investing in other asset classes. Hotel investments are seen as suitable additions to portfolios aiming at high return levels. (Corgel et al. 1997, p. 30-32.) Petersen and Singh (2003a, p. 172) suggest that the diversification benefits of hotel properties in a multi-sector property portfolio include a reduced risk level with only a marginal reduction in the level of received returns.

Whereas several studies agree on that hotel property returns exceed those received from other forms of real estate, there is more discussion on how the optimal diversification benefits could be obtained. Researchers seem to have differing viewpoints on the correlation between hotel properties and other forms of real estate when it comes to portfolios that are solely focused on real estate investments. Some studies have suggested that hotel properties have a low or negative correlation with other commercial real estate classes (Petersen et al. 2003b, p.18, Quan et al. 2002, p. 87). According to Firstenberg et al. (1988, p. 28), the most efficient multi-sector property portfolio would include office and hotel properties when considering the returns whereas Petersen et al. (2003b, p. 16) indicate that hotels and apartments are the two best performing asset classes.

3 Empirical Research

3.1 Thematic Interviews

Interviews are typically seen to remind conversations, and thus, they are perceived as a simple research method. Despite being a rather flexible method to acquire data, interviews are affected by the context. Therefore, the results should be carefully analyzed before they can be generalized. (Hirsjärvi et al. 2011, p. 11-12.)

There are several possible ways to conduct interviews which can de differentiated from each other based on the amount of structure, and consequently, are commonly divided into structured, semi-structured and unstructured interviews. In other words, interviews can vary from standardized questionnaires to in-depth interviews with very little guidance from the interviewer. The structure of interviews also affects on the research design as structured closed-ended questions are typical in quantitative studies whereas unstructured open-ended questions are common in qualitative studies. (Robson 2002, p. 269-270; Hirsjärvi et al. 2011, p. 47; Creswell 2009, p. 3.)

In this thesis a semi-structured interview and a short questionnaire were used to acquire data. A semi-structured interview method was chosen as the main method in this thesis. This type of interview can be classified as a qualitative research method as the interview questions were open-ended. A semi-structured interview, also known as a thematic interview, is built around certain topics. A thematic interview consists of predetermined questions but the exact wording of the questions may vary, some explanations may be given and the order of the questions can be changed. Furthermore, the interview may be modified by adding questions or leaving some of them out based on the interviewee and his knowledge and position. (Robson 2002, p. 269-270; Hirsjärvi et al. 2011, p. 47.) In addition to the thematic interview, interviewees were asked to fill a short questionnaire containing closed-ended question. The questionnaire was used to collect quantitative data.

In the beginning of the interviews some background information of the interviewees' companies was discussed. After that the interview was built on the key themes of the thesis, i.e. the main drivers, risks and risk management techniques that are used when investing in hotel properties. Furthermore, lease and management agreements were discussed and the trends on the hotel property market were briefly gone through. The interview questions are presented in Appendix 2. The purpose of the short questionnaire created based on the literature review was to find out whether the number of hotel property investments will increase or decrease within the next few years and what are the most significant risks and benefits related to the hotel property investments. The questionnaire is presented in Appendix 3.

3.1.1 Interview Sample

As this thesis focuses on the hotel property investments in the Nordics, the interviews were made in three Nordic capitals. A total of 13 representatives were interviewed in this study of which six in Helsinki, four in Oslo and three in Stockholm. The interviewees were selected so that they represented differing real estate companies focusing on asset management, advisory or property investments. All interviewees are listed in the following Table 1. The interviews were conducted in November and December 2014 at the interviewees' offices except for one interview, which was done via e-mail due to a tight timeframe. The number of interviews can be considered sufficient as the interviewees were remarkably unanimous on the discussed matters.

The interview questions were designed so that they enabled the interviewees to present their viewpoints and ideas freely and to discuss their experiences in-depth. The questions were not sent to the interviewees beforehand although it would have given them a possibility to familiarize themselves on the subject in advance. This was not done as it might have led to predetermined answers that would have represented the company's official alignments and not the interviewee's own experiences and opinions.

The interviews were not recorded as notes were seen as a sufficient method to collect the key ideas of the interviewees. Furthermore, it was considered that the room for misunderstandings and errors in the notes was minimal, and therefore, the interviewees were not asked to review the notes made during the discussions.

Table 1 The list of interviewees.

Country	Company	Name	Title	Branch
Finland	CapMan Real Estate Oy	Markku Jääskeläinen	Asset Manager	Fund
Finland	CapMan Real Estate Oy	Mika Matikainen	Head of CapMan Real Estate, Senior Partner	Fund
Finland	Exilion Capital Oy	Ari Talja	Managing Director	Fund
Finland	Konsultointi Respa Oy	Markku Veijalainen	Consultant	Advisor
Finland	LähiTapiola Kiinteistövarainhoito Oy	Vesa Eskoli	Real Estate Investment Director	Investor
Finland	VVT Kiinteistösijoitus Oy	Pekka Korhonen	Managing Director	Fund
Norway	DTZ Realkapital Verdivurdering AS	Jørn Høistad	Managing Director, Partner	Advisor
Norway	DTZ Realkapital Verdivurdering AS	Arthur Havrevold Lie	Senior Advisor	Advisor
Norway	KLP Eiendom AS	Christopher Raanaas	Director, Hotel management	Investor
Norway	Pandox AB	Leif Kristen Olsen	Vice President, Area Manager, Norway and Sweden	Investor
Sweden	DTZ Sweden AB	Clas Hjort	Head of Corporate Finance	Advisor
Sweden	DTZ Sweden AB	Mats Högström	Director	Advisor
Sweden	Home Properties AB	Per-Olov Karlsson	Managing Director	Investor

The interviewees were selected from different companies within the field of real estate so that they represented advisor companies, asset management companies and property investors. The asset management companies and the property investors were chosen so that they all have hotel property investments in their portfolios. More detailed information on the companies can be found in Appendix 1. Based on their backgrounds and fields of operation, interviewees are divided into three categories: advisors, funds and investors. The advisor group consists of real estate valuers, experts of corporate finance, other real estate advisors and consultants. Fund managers and portfolio managers form the fund category whereas institutional property investors were classified as investors in this study. The categorization of interviewees is presented in the following Figure 8.

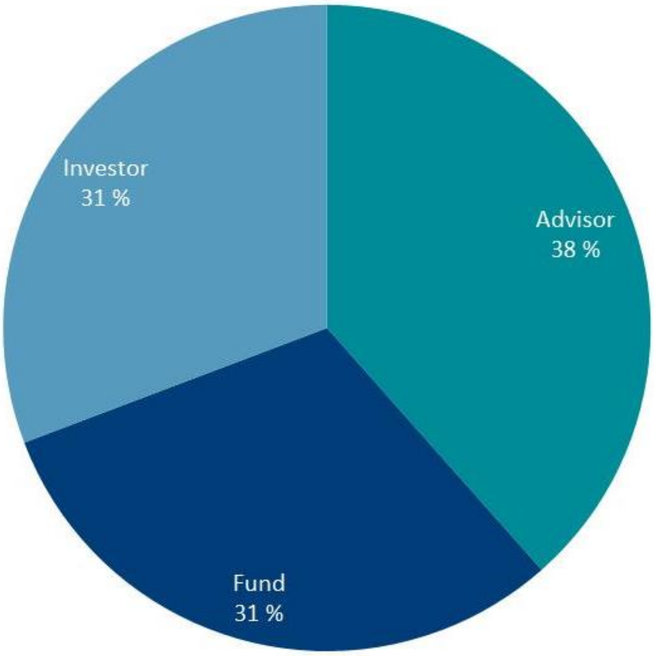

Figure 8 The categorization of interviewees based on their background.

3.2 Presentation of the Investigated Markets

3.2.1 Finland

The biggest hotel property owners in the Finnish market are CapMan's hotel property fund and the hotel property fund managed by Pandox AB. S-Group (S-Ryhmä), which is mainly perceived as a hotel operator, has also invested in hotel properties. Some of the Finnish institutional investors, such as LocalTapiola Real Estate Asset Management Ltd (LähiTapiola Kiinteistövarainhoito Oy), Ilmarinen Mutual Pension Insurance Company (Keskinäinen Eläkevakuutusyhtiö Ilmarinen) and Valion Eläkekassa, have a few hotel property investments in their direct real estate portfolios. (KTI 2015, p. 58-59.)

According to the information received from the Finnish interviewees, the hotel property investors in Finland prefer lease agreements to management agreements. Apparently one hotel operator company had managed to enter the Finnish hotel market with a management agreement, but their agreement has been re-negotiated afterwards and turned into a lease agreement. The interviewees' willingness to include a turnover component to the lease agreement was dependent on the risk appetite and on the knowhow of the investor. The majority of the interviewees classified as funds or advisors in Finland considered the turnover component as something that should be incorporated to new lease agreements.

The Figure 9 below shows the key ratios of hotel performance in Helsinki, which is the main hotel market in Finland. The key rations presented below include the average price per room, the occupancy rate and the RevPAR. Additionally the percentual change in GDP has been added to the figure. (Statistics Finland 2015a; OECD 2015.)

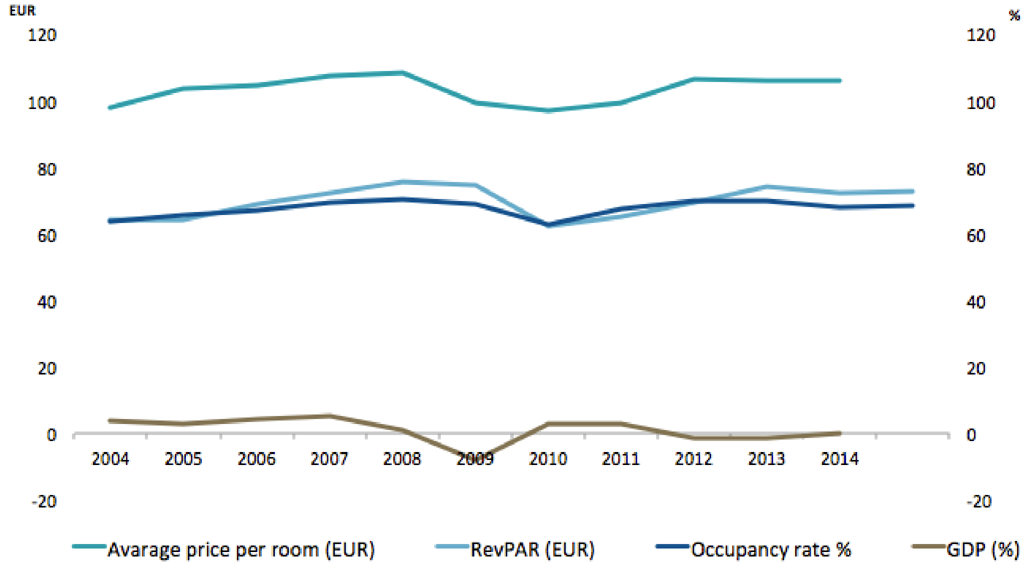

Figure 9 The key ratios of the hotel market in Helsinki and the percentual change of the Finnish GDP (Statistics Finland 2015a; OECD 2015).

3.2.2 Sweden

The hotel investment market in Sweden has been active during the past years. The biggest hotel property owners at the moment include Home Properties AB, Pandox AB and Fastighets AB Balder (publ) (Lundin 2008, p. 51; Fastighetsvärlden 2007; Fastighetsvärlden 2015).

According to the Swedish interviewees, the hotel properties are mainly let with lease agreements that include a turnover component. This was considered as the preferred agreement structure among property investors. The interviewees noted that this agreement structure prevents large international hotel operator companies from entering the Swedish hotel market as they are typically using management agreements. However, it was brought up in the interviews that there are a few hotels, which have a management agreement with the property owner.

The key ratios of the hotel market in Stockholm, which is the main hotel market in Sweden, and the percentual change of the Swedish GDP are presented in the Figure 10 below. (Statistics Sweden 2015; OECD March 2015.)

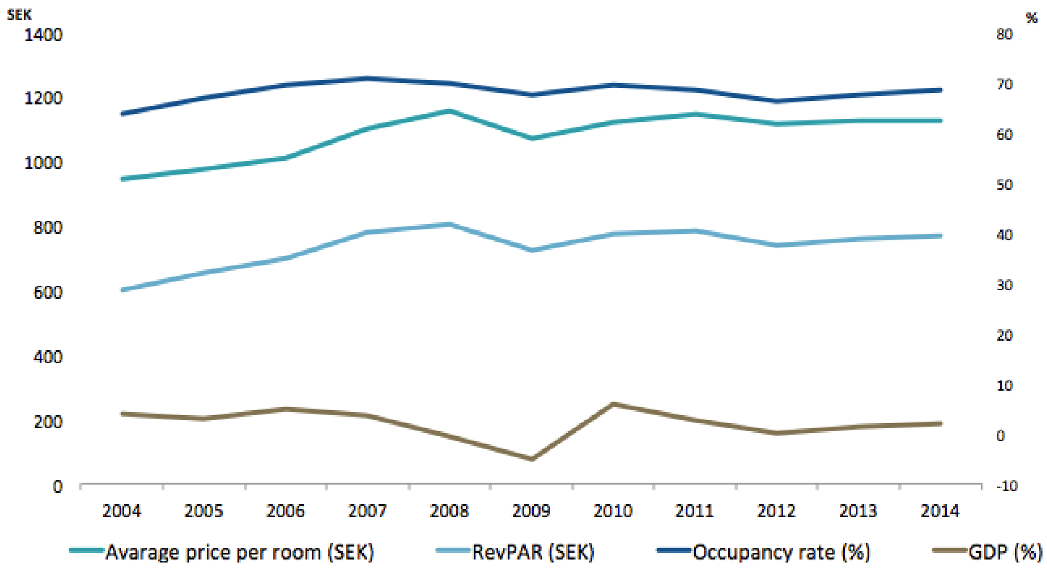

Figure 10 The key ratios of the hotel market in Stockholm and the percentual change in Swedish GDP (Statistics Sweden 2015; OECD 2015).

3.2.3 Norway

The Norwegian hotel market differs from the Finnish and Swedish market as private investors have a significant role on the market. Olav Thon, Petter Stordalen and Arthur Bouchardt are major players in the Norwegian hotel market. Other noteworthy investors in the Norwegian market include Pandox AB and KLP Eiendom AS.

According to the interviews conducted in Norway, the investors prefer lease agreements with turnover components like in Finland and Sweden. It was, however, brought up that Olav Thon Group has management agreements in their hotel properties. The exact structure of the management agreements and the liability distribution was not known.

The key ratios of the hotel market in Oslo and the percentual change of the Norwegian GDP are shown in the Figure 11 below. (Statistics Norway 2015; OECD 2015.)

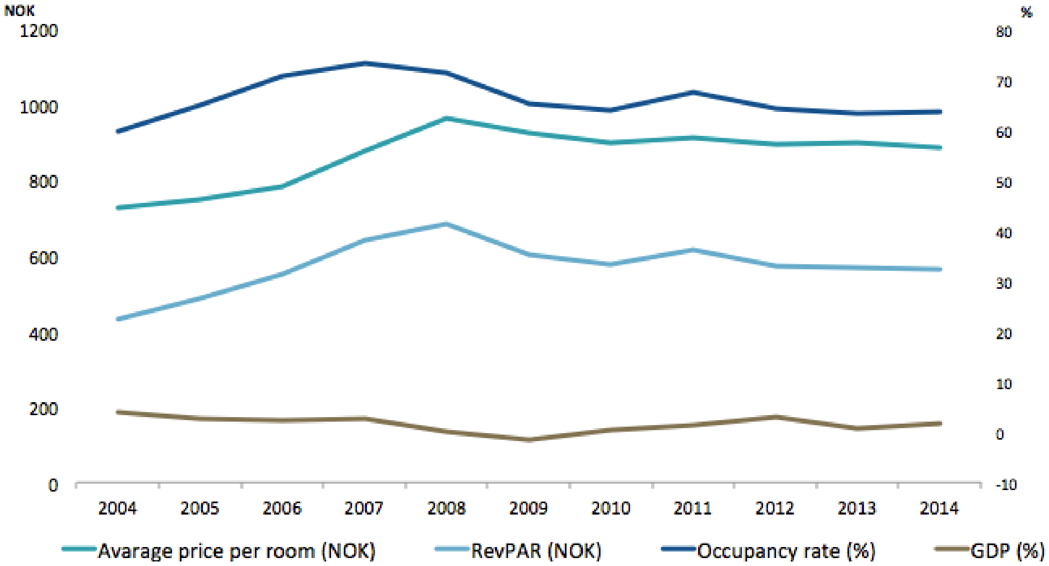

Figure 11 The key ratios of the Oslo hotel market and the percentual change of the Norwegian GDP (Statistics Norway 2015; OECD 2015).

3.3 Results from the Interviews

3.3.1 The Main Drivers for Hotel Property Investments

As mentioned in chapter 2.3.2, hotels have traditionally been considered as a risky real estate asset class. In Finland this perspective may partially derive from the experience of unsuccessful hotel property investments made before the economic downturn in 1990. Even today some investors are not willing to invest in hotel properties. However, the majority of interviewees suggested that the traditional point of view has become more positive during the past decade.

The interviewees recognized several reasons for the more positive attitude in the Nordics. First of all, hotel property investments are considered suitable for both individual investors and for larger and more professional investors. In general, the hotel industry as a whole was seen more professional today than in the past in the sense that the operators and other actors are more organized and also the agreements are nowadays more standardised. Second of all, hotel properties were seen as a worthy investment target in the current market situation. At the moment prime office properties and other core investment targets are rarely sold in the market, which increases the demand for other property asset classes. Hotel real estate investments were also considered opportunity driven and it was mentioned that there is less competition between investors when analysing a potential hotel property investment target than when analysing an office property. Furthermore, hotel real estate investments were seen to give an advantage when trying to differentiate from other real estate funds and investors acting in the field. It was, however, noticed that hotel property investments require a special skillset from the owner, and therefore, not all investors are able to make such investments.

When the interviewees were asked how the demand of hotel property investment will develop in the near future, 69 percentages thought that the number of such investments will either increase or increase substantially, 23 percentages considered that they will remain at the current level and only 8 percentages had a more negative viewpoint to this matter. This distribution is shown in the Figure 12 below. Although the interviewees considered that the demand of hotel property investments will increase, the interviewees' general opinion was that no new hotel funds or other investment companies will be established in the Nordic region in a short-term. Some interviewees, however, suggested that new funds may be established when already existing portfolios are being restructured.

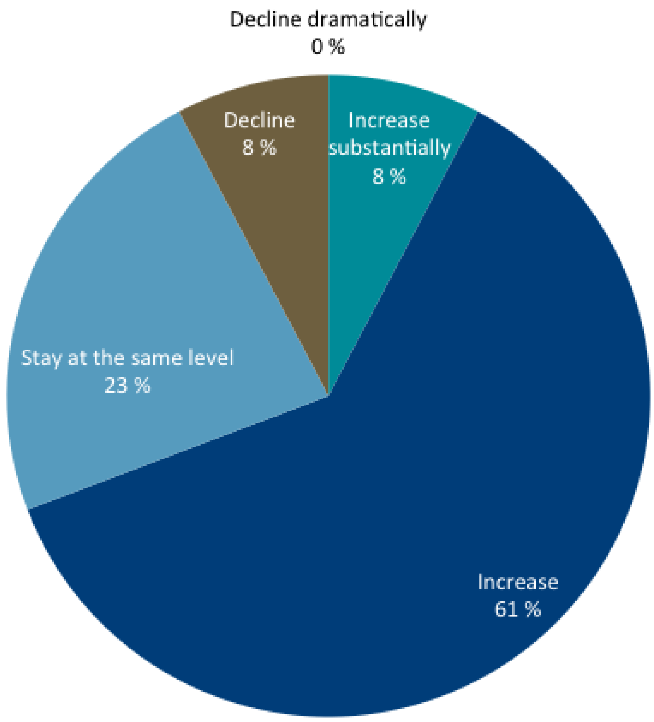

Figure 12 The interviewees' vision on how the demand of hotel property investments will develop within the next 3 to 5 years.

The interviewees identified numerous drivers behind hotel property investments. These drivers varied little despite differing investment strategies of the interviewed companies.

One of the characteristic features of hotel properties is that they are rarely converted into other purposes. This was considered as a positive feature of the property class in question as hotels typically retain their purpose of use for long periods of time. In case a hotel is not performing well, the concept of the hotel may be changed or the property may be taken in another lodging purpose before developing a totally new purpose of use for the property. This is due to the fact that the functionality and the profitability of a hotel depend on whether a certain concept is suitable in a specific location and market and it is usually more feasible to find a new concept of operation for the hotel than to convert it in another use.

When determining a hotel concept for a certain property, a market survey should be made. Some interviewees pointed out that the hotel market is foreseeable to some extent. Especially the hotel RevPAR seems to follow the movements of the GDP with a slight delay. Some interviewees noted this predictability and considered it to have a positive impact on the hotel property investment decision.

There are numerous other reasons behind hotel property investment decisions that are related to the lease agreements and to the lease agreement structures. Some interviewees mentioned that the lease agreements have become standardized to some extent and also more simplified within the past decade. Therefore, the agreements are more understandable from the investors' viewpoint and investors have become more interested in investing in hotel properties.

According to the interviewees, the main driver behind hotel property investments is the long maturity of the lease agreements and the somewhat stable cash flow throughout the contract period. What is more, some hotel lease agreements are turnover based which makes it possible for the investor to receive some upside if the hotel is performing well. In addition, the lease agreements have other positive features related to them. First of all, in practice hotel properties are let to one user and very little, if any, space is left for other possible tenants. Hotel properties are usually let to hotel operators with good financial standings and in most cases a security is demanded from a parent company. The small number of lease agreements per hotel property facilitates the asset management of the investor. Another factor that decreases the workload of the asset manager is the liability distribution between the investor and the operator. Several interviewees mentioned that from the investor's point of view, it is desired that the hotel operator is responsible for the daily operating and maintenance expenses and only the structural repairs are covered by the investor.

3.3.2 The Main Risks and Benefits Related to Individual Hotel Property Investments

One of the main benefits of hotel property investments, according to the interviewees, is that hotel property investments may be considered to need less effort when it comes to asset management than for example shopping centers. Hotel properties are typically let to only one tenant, hotel operator, with ten to twenty five year lease agreements. Such contracts provide the property owner with a stable and reliable cash flow for the whole contract period. In other words, this means that the property owner receives a stable profit for the investment.

What is more, several other benefits of hotel property investments that derive from the long lease agreements were identified in the interviews. It was pointed out in the interviews that the property owners find it easier to commit to substantial investments related to structural repairs of the property when the building is let with a long lease agreement. Another benefit from the long lease agreement is that there is no need to make tenant improvements to the property every five years, which may be the case in for example office properties. The long lease agreement enables the owner to think about the investments in a long run and through the whole life cycle of the property. It was mentioned in the interviews that the decisions of major investments should be done in co-operation with the hotel operator as part of the expenses may be covered by the operator. This, however, depends on the liability distribution between the owner and the operator.

It is common in hotel property lease agreements that the structural repairs are covered by the property owner and the daily operating and maintenance costs are covered by the operator. This liability distribution was seen as a major benefit of hotel property investments by the majority of the interviewees classified as investors or funds for two reasons. It decreases the needed amount of investments paid by the owner and it decreases the workload of the asset management company. However, several interviewees from all interviewee groups emphasized that the property owner should oversee that the liabilities of the operator are fulfilled during the contract period. This should be done by both inspecting the changes during a property visit and by observing the profitability of the hotel operations. In case the operating and maintenance needs are not done, major risks may arise. The interviewees noted that the occupancy rate and the room rate of a poorly maintained hotel may suffer substantially which may further weaken the hotel's turnover, and thus, decrease the upside received by the investor. Another risk from the investor's point of view in this situation is that the property is in poor condition after the contract period ends and major investments are required to attract a new tenant to the property.

From the investor's viewpoint operators tend to have other positive impacts on hotel properties in addition to the liability distribution. Some interviewees reminded that the start-up period of a new hotel is a major threat as it is time consuming and it takes time before such investment becomes profitable. Some interviewees, mainly from the advisory and fund groups, stressed that a well-known operator may shorten this period, whereas some others from the investor group considered that the significance of the operator is not crucial any longer.

As mentioned earlier in chapter 3.3.1, some interviewees suggested that one of the benefits of hotel property investments is that their purpose of use rarely needs to be changed during the life-cycle. In many cases a change in the hotel concept is sufficient when trying to enhance the profitability of the hotel and the profitability of the property investment. However, the interviewees' opinions varied when asked about conversions of old office properties into hotel properties. Some considered that such investment targets are good possibilities whereas others were not interested in such development projects. Some interviewees suggested that conversion projects include more micro level risks than macro level risks. The majority considered the main risk of such investments to be the amount of building costs that might prove to be difficult to predict accurately. As building costs tend to be underestimated in the beginning of the investment process, an extra leeway should be left when determining the investment price. A number of interviewees suggested that the price of the frame of the building is one of the most determining aspects when considering property conversions. Furthermore, the building frame should be designed so that the floor space could be used effectively in hotel use meaning that there should be a possibility to build hotel rooms on both sides of a middle aisle. In addition to the building costs, another financial aspect needs to be considered. A conversion is probably not the best choice if the future rental level does not exceed substantially the rent received if no development is made. All in all, a conversion can only be done if the building frame is suitable for hotel use and the project seems financially viable.

Some interviewees suggested that the financing costs could also be seen as a risk when it comes to hotel property investments. Especially the possibility of a rising interest level was brought up in the discussions. The need to prepare oneself for the changes in the interest level was considered wise. Some interviewees mentioned that in general the financing costs of hotel property investments do not differ significantly from those of other commercial property investments.

One major threat identified in the interviews was the possible external obsolescence of a hotel property. The interviewees from all backgrounds and countries mentioned several examples that may affect the market positioning of a hotel property. One major concern was that a local company would go out of business, and hence, the lodging demand of the area would decrease. This has happened for example in Oulu, in Finland, when Microsoft Corporation decided to close their business in the city in question.

Another threat related to the external obsolescence that was noticed was the fact that some hotel locations are dependent on for example transportation connections and changes in those would make the hotel less reachable. One example of a change in demand generators was identified in Norway, where a new airport serving Oslo was built to Gardemoen replacing the old airport in Fornebu. The lodging demand of the old area decreased substantially and new demand generators have been developed to the area.

The change in demand generators is only one example of market risk. The increased capacity of a certain area was seen as a major threat for existing hotel properties. New supply tends to decrease the average occupancy rate of an area and it might take several years for the market to recover to the previous level. Another example of market risk that was distinguished in several interviews was that it might be difficult to find a new operator for an old hotel property if all major hotel operator chains are already present in the market.

In order to avoid the previously mentioned market risks and to make a profitable investment, a special skillset is needed from the investor. Several interviewees, especially from the fund and investor groups, underlined that a hotel investor should have both knowledge of the lodging and hotel market but also expertise on hotel operations. It was, however, noticed that less understanding on hotel operations is required if there is no turnover percentage on the lease agreement. The amount of knowledge was also seen as a competitive advantage against other investors and funds. However, the number of people with the required professional experience is somewhat limited, and thus, it might prove to be difficult to find new experts.

The Figure 13 below summarizes the main risks and benefits of hotel property investments according to the interviewees.

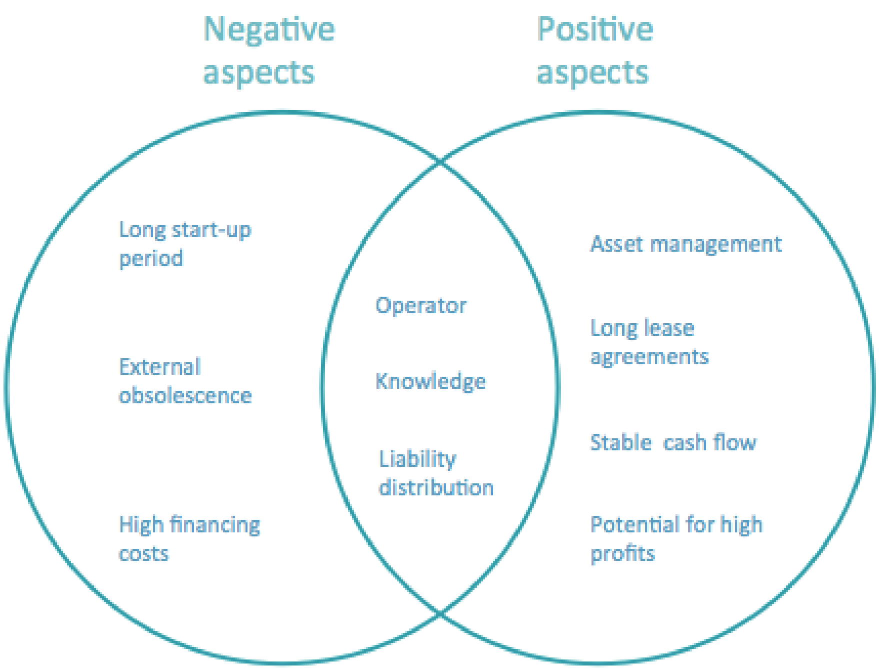

Figure 13 The main risks and benefits of hotel property investments according to the interviewees.

When the interviewees were asked to highlight the main risks and benefits of hotel property investments in a questionnaire format created based on the literature review, the interviewees pointed out that the operator and management of the hotel are the most important factors when making an investment decision. On the other hand, the daily fluctuations of the occupancy rate and of the room rate were not considered as major factors as the risks related to such matters are mainly covered by the hotel operator. The Figure 14 below presents the median of the interviewees' answers.

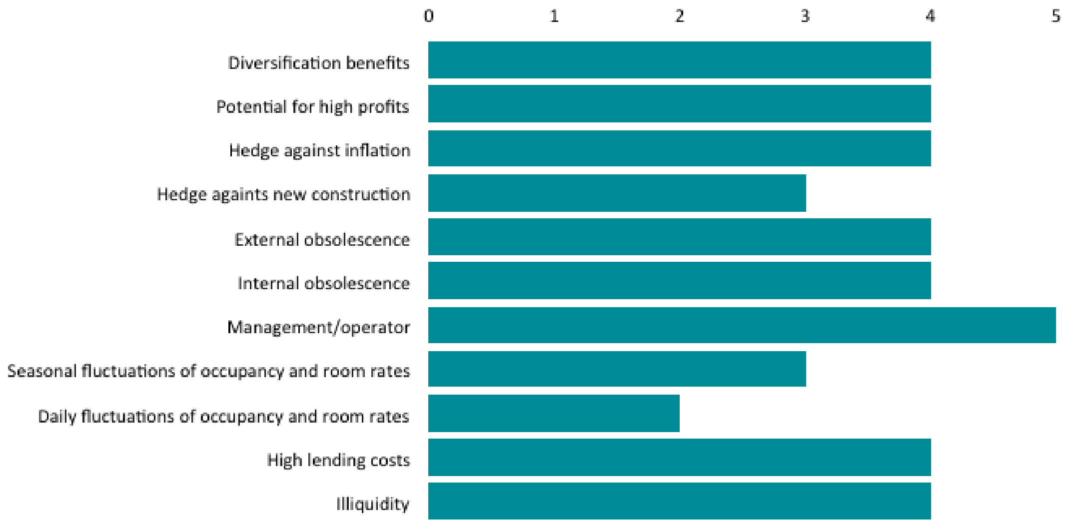

Figure 14 The interviewees consideration of the most important risks and benefits of hotel properties.

3.3.3 The Main Risks and Benefits of Hotel Property Investments in a Portfolio

In addition to the above discussed risks and benefits of individual hotel property investments, various risks and benefits on a portfolio level were identified. Some interviewees reminded that all hotel property investments should be analyzed individually despite being a part of a larger portfolio. This was mainly due to the fact that all property portfolios consist of different assets of which some are more attractive than others and the risks vary among them.

The interviewees thought that a portfolio gives the investor a better possibility to spread risk. According to the interviewees, the risk can be spread by investing in hotel properties in different markets and countries, by letting the hotel properties to several hotel operators or by investing additionally in other property asset classes. The majority of the interviewed investment companies or funds had more weight on one country and had invested in few targets outside the main focal area. The same problem seemed to concern the chosen operators as the majority let multiple hotels to the same external operator.

Numerous interviewees had taken notice of the possible problems that may result from putting more weight on one operator instead of spreading the risks by choosing multiple operating companies. The main risk in this case is the operator's bankruptcy which would have a major effect on the value of the portfolio and which could also complicate the process of finding a new operator to the vacated hotel properties. Several interviewees pointed out that this problem derives from the fact that there are only three to four large operating companies in the market and many of the interviewees, especially representatives from investor and fund groups, hoped that new strong operators would enter the market. There are two reasons for the limited number of operating companies in the market. Firstly, large international operating companies are demanding management contracts that are not preferred by hotel property owners. Secondly, according to general market practices, smaller operating companies tend to merge with larger ones and this has also happened among hotel operator companies.

In addition to the possibility to spread risk, a portfolio gives the investor an opportunity to hedge against certain risks. Many interviewees from all backgrounds considered that the ownership of several hotel properties diminishes the bargaining power of hotel operators when negotiating on a new lease agreement. Some interviewees suggested that hotel asset management could be considered more professional when the portfolio consists of multiple hotel properties. They believed that such professionalism would enable larger profits.

In addition to the property and portfolio level attributes, the macro economy may have a significant impact on the portfolio. The inflation development is one key issue when analyzing a hotel property investment. The room rates can be adjusted by inflation on a short term, but the rental income received from the operator by the investor is adjusted once or twice a year. Thus, the inflation expectation has an impact on the forecasted rent. In case, the expectation is not met, the forecasted rent is not received, and consequently, the value of the hotel property suffers.

Besides the macro economy, other macro level trends have an impact on the performance of the portfolio. One current trend that was mentioned often in the interviews was the establishment of new online booking websites such as booking.com and trivago.com. These sites have diminished the amount of hotel bookings via the operator’s own websites. This has also given the smaller operating companies a possibility to compete on the same customer groups with the larger companies. In addition to the online booking systems, it was also mentioned that the influence of social media is affecting the hotel property market. Customer experiences are often shared in social media, and thus, poor customer feedback may in some cases harm not only the reputation of a specific hotel but also the reputation of an operating brand.

3.3.4 Hotel Owner and Operator Structures

As it can be noticed from the two previous chapters, 3.3.2 and 3.3.3, the owner operator structure is a key issue related to hotel property investments. All interviewees were asked what types of lease agreements they have in their hotel properties or what they have come across in their work. A majority also described these lease agreements in more detail and justified the reasoning behind the chosen structures.

All interviewees considered that a lease agreement with an external operator is the most recommendable structure from an investor’s perspective. The other possibility is or an owner operator structure. One of the interviewed companies had the possibility to operate hotels themselves, other property owners had leased their properties to external operators. However, the lease structures and the terms of the contracts varied among the interviewees. Some of the contracts were fixed lease agreements with an indexation. This was considered as a good option for especially such investor that does not have extensive knowledge on hotel operations. Another benefit from the fixed lease agreement was that in such case all risks related to the profitability and success of the hotel operations is solely carried by the operator.

Despite being a simple solution from the investor's point of view, the most common operator contract type was a partially turnover based agreement. These agreements were mainly structured so that there is a turnover percentage on top of a minimum rent. In this case the hotel property owner carries partially the risks related to the hotel operations, and therefore, such agreements seemed to be commonly used by such entities that are at least on some level focused on hotel property investments. The interviewees mentioned that there are basically two alternatives to determine the turnover percentages. The first option is to use a certain percentage for all operations, which in other words means that the same percentage is used for both hotel and restaurant operations. In this case the turnover percentage was estimated to be approximately 20 percent. The more common possibility is to determine separate percentages for the hotel and for the restaurant operations. All interviewees were unanimous that the turnover percentage for restaurant operations varies between 8 and 12 percent. The hotel turnover percentage, however, was suggested to be mainly dependent on the location and on the type of the hotel and in general it varies between 20 and 30 percent. Some centrally located hotels might even pay approximately 35 percent. The type of the hotel may also affect the percentage as a hotel with limited personnel may be willing to pay up to 45 percent.

One matter that several interviewees stressed was that the turnover percentages should be determined so that the investor receives as high income stream as possible but at the same time the hotel operations should remain profitable from the operator's viewpoint. In other words, the turnover percentage can be seen to describe the rent-paying ability of hotels. At times some costs are deducted from the income before determining the rent-paying ability, but the majority of the interviewees considered that the rent-paying ability and the turnover are equal. As mentioned before, there are some factors that affect the turnover percentage more than others. The interviewees suggested that the rent-paying ability of a hotel depends greatly on the location of the hotel. Other factors that affect the rent-paying ability of a hotel include the cost structure of the operations and the commissions paid for online booking companies. The Figure 15 below presents the interviewees' perception of the variation of the rent-paying ability calculated from the hotel's turnover based on the location of the hotel.

	Under 20 %	21-25 %	26-30 %	31-35 %	Above 36 %
Large cities		2	3	6	2
Medium sized cities	1	3	7	2	
Small cities	2	6	4	1	
Cities with fluctuating demand	3	8	1	1	

Figure 15 The variation of the rent-paying ability of hotels based on their location.

Despite the fact that an operator as a tenant was the most commonly used form of owner operator structure, some other possibilities are at times used by hotel property investors. One interviewee highlighted that they have a possibility to operate part of their investments themselves. This method was used mainly after a repositioning of a hotel in a certain market as sometimes hotel operator chains do not fully understand the opportunities of a newly opened hotel and are not willing to take any risks related to the possible failure of the new concept. In such cases the owner operates the hotel themselves for a certain, somewhat limited time, for two reasons. Firstly, to prove the concept works and secondly, to achieve a higher rent from the future operator.

The above mentioned owner operator structure is not commonly used among hotel property investors, but it is more common among smaller privately owned hotels. Another owner operator structure that is not frequently used by hotel property investors is the management agreement structure. The majority of interviewees mentioned that large international hotel operator companies preferably make such agreement when entering a new market. The investors on the other hand are not willing to enter into management agreements due to the unfavorable risk and liability distribution between the operator and the property owner from the investment point of view. As hotel property investors hesitate to sign management agreements, it keeps large international hotel operator companies from entering the Nordic hotel market.

3.4 Key Findings of the Interviews

In general, it should be noted that the interviewees were remarkably unanimous on the matters discussed during the interviews. Hence, very little difference can be found between the three categories of interviewees and no difference can be made on a country level.

As a conclusion, hotel properties were considered as tempting investment targets and the majority of the interviewees believed that the number of such investments would increase in the near future. Several reasons behind hotel property investments were identified in the interviews. Hotel properties were regarded as suitable investment targets for varying investor groups for multiple reasons that include the somewhat limited amount of needed asset management and the possibility for inflation hedging.

One of the main findings of the interviews was that hotel properties are considered as an investment target that to some extent requires less work than other commercial property types. This is mainly due to the lease agreement structure of hotel properties. Firstly, hotel properties are typically let to only one external entity with a considerably long lease agreement. Secondly, the lease agreement usually includes a liability distribution between the property owner and the operator that is beneficial from the investor's viewpoint. The liability distribution often means that the operator is responsible for the daily upkeep of the property and the investor covers only the structural repairs. These two factors reduce the workload of the asset manager.

However, in order to make a profitable hotel property investment, the investor should have a specific skillset and knowhow from the field. It should be noticed that it is not only the location of the hotel property or the operator that alone determine the profitability of the investment. The key to a successful hotel property investment seems to be that the hotel concept and location of the hotel attract the same customer group. In case the hotel property proves to be an unsuccessful investment, it is usually more profitable to rethink the hotel concept and to direct the hotel to a more suitable customer sector than to change the purpose of the use of the property completely. Hence, hotel properties can be considered to retain their purpose of use for long periods of time.

At times it may prove to be challenging to find a suitable hotel operator for a specific location. There are only few hotel operators in the Nordic hotel market and the interviewees considered that as a challenge. The small number of hotel operator companies increases the investor's risks related to the bankruptcy of an operator. Furthermore, the services and possibilities provided on the Internet are changing the field of hotel operators. In order to decrease the bankruptcy risk of an operator and to retain the operator's business on a profitable level, the lease agreements should be well thought out. Especially if the lease agreement between the property investor and the hotel operator is turnover based, the percentages should be determined so that the investor has a possibility to receive an upside from the investment and at the same time the operations of the hotel operator remain profitable. The rent-paying ability of hotel operators in average was considered to be 10 percent of the restaurant's turnover and 30 percent of hotel operation's turnover.

4 Discussion

The aim of this research was to find out if hotel properties are worthy investment opportunities and what risks and benefits are related to such investments. Additionally, this study tried to gain a deeper understanding of investors’ viewpoints with regard to hotel property investments. In order to attain the goal of this study, a literature review and thematic interviews were made. In general, it should be noted that these two research methods gave similar results that support and complement each other. Especially the risks and benefits that were identified in the literature review were also brought up in the interviews.

The importance of the operator on the performance of a hotel property investment was emphasized in both the literature review and in the interviews. As mentioned in the empirical part, the interviewees highlighted the operators’ influence on hotel property investments. The interviewees considered the operators as the most significant factor in determining the successfulness of an investment, and hence, they were seen as a key factor in the decision making process. In addition to the empirical part, it was acknowledged in the literature that the competence and knowhow of the hotel operator has a considerable impact on the value of the hotel property (Talja 1999, p. 38).

The interviewees considered that a long lease agreement with one counterparty, operator, is a crucial factor and a benefit to the property owner. Hence, it can be regarded as a noteworthy aspect when reasoning a hotel property investment. Several interviewees argued that due to long lease agreements the cash flows from hotel property investments could be considered somewhat stable and reliable throughout the contract period. This argument, however, contradicts the claims presented in the literature review, according to which, the daily letting of hotel rooms and the volatility of the cash flows are characteristics of hotel properties. Some articles suggested further that the daily letting of hotel rooms is one of the main characteristics of hotel properties and a major risk that is related to them (Lind 1995, p. 25; Gallagher et al. 2000, p. 136). In the literature, the lack of long lease agreements was considered to cause the volatility and instability of the cash flow streams (Liu et al. 2011, p. 3; Hess et al. 2001, p. 58). Hess et al. (2001, p. 58) even considered that the income received from hotel property investments is more volatile than those of other commercial property investments. This discord between the literature review and the empirical part could, however, be explained by the difference in the considered lease agreement periods. In this respect Talja (1999, p. 36) and the interviewees noted that this daily letting is the hotel operator’s responsibility.

According to the interviewees, the length of the lease agreement was seen only as one benefit of hotel property investments. It was noted that especially the liability distribution between the property owner and the operator is a positive aspect of hotel property investments as it means that the operator is in charge of the daily management and upkeep of the hotel and the property owner is solely responsible for the structural repairs. This aspect was further seen as an advantage in the investors’ viewpoints when analysing and reasoning the possibility to invest in hotel properties. This liability distribution was not discussed in detail in the literature review, however, the outsourcing of the daily operations and management was brought up in the literature review by Talja (1999, p. 25) and Lind (1995, p. 30-31).

The literature review suggested that the outsourcing of the daily operations to an external hotel operator mitigates the amount of risk carried by the property investor. It was mentioned that the amount of risk carried by the hotel operator has an impact on the rent paid by the operator. If the hotel is let to an operator with a fixed lease agreement, the operator carries the majority of the risks related to daily business of the hotel. Part of these risks may, however, be carried by the hotel owner in which case a turnover component is added to the lease agreement. (Talja 1999, p. 25-26; Lind 1995, p. 31; Nuutinen 2003, p. 18). This difference in the division of risks between the owner and operator was also pointed out in the interviews. The investor's knowhow on the hotel operations was considered to have a significant impact on the choice between a fixed lease agreement and a turnover based agreement.

Further with respect to outsourcing of the daily operations it was noted in the literature review that as those operations are taken care of by the hotel operator, the property owner has little possibilities to influence on the operations and is, thus, placed in a passive position when it comes to the operating business. Although the risks related to the daily operations may be thrust on the operator, the owner always carries the risk of the operator's bankruptcy. (Talja 1999, p. 29; Rushmore 2001, p. 360-361; Nuutinen 2003, p. 16.) The interviewees were conscious of this bankruptcy risk, and therefore, some interviewees pointed out that a security from the parent company of the operator is crucial and typically required.

The literature review indicated that in addition to the operator, external changes might have a strong impact on the profitability of a hotel in a long term. These external changes might result from economic, environmental, legal or social factors, and hence, the investor cannot impact on those with own actions. (Rushmore 2001, p. 363; Talja 1999, p. 39; Younes 2007, p. 74.) Examples of such events include natural disasters (Larkin et al. 2007, p. 24-25) and changes in the operational environment caused by the Internet (Kurtz 2014, p. 4). Examples of external changes in all countries were also mentioned in the interviews. However, the external obsolescence was not considered as a major risk but more as a concern by the interviewees.

Although the results from the literature review and from the interviews mainly supported each other, there was one risk aspect that was not perceived similarly, i.e. costs related to the financing of hotel property investments. According to Liu and Quan (2011, p. 4), the loan costs for hotel properties are higher than those of other property investments. Rushmore (2001, p. 323) added further that not all lenders are willing to finance hotel property investments. The literature suggests that the higher lending costs result from the risky nature of the hotel properties and from the volatility of the cash flow streams (Liu et al. 2011, p. 4). However, according to the interviewees, today there is little, if any, difference between hotel property financing and the financing of other commercial property asset classes. In this connection it was noted by the interviewees that the prevailing low interest rate level in debt financing has enabled investors to acquire hotel properties. However, the interviewees emphasized that the situation is not permanent, and thus, it was considered wise to prepare beforehand for the possible changes in the interest rates. According to the interviewees, this can be done by not paying all dividends to the owners.

The empirical part suggested that although hotel property investments were a part of a larger portfolio, they should always be studied as individual assets. The diversification possibilities of hotel properties were acknowledged both in the literature and in the empirical part. However, the additional benefits that investors could receive by owning several hotel properties were not brought up in the literature review. The interviewees proposed that having several hotel properties in a portfolio increases the investors' bargaining power and negotiation advantages against hotel operators.

The empirical part indicated that investors perceive hotel property investments positively in the Nordics. According to the interviewees, the predictability of the market was seen as one reason for the more positive attitude towards hotel property investments. It was also brought up in the literature that as the RevPAR of hotels moves similarly with the GDP, it brings certain predictability to the investments (Slattery 2002, p. 146-147). Other reasons for the growing interest towards hotel property investments that were mentioned in the empirical part are the more standardised and simplified lease agreements and the increased general professionalism of the market. The current economic situation was considered to drive hotel property investments as such investments were perceived to some extent as opportunity driven possibilities.

Overall, it could be mentioned that the literature review and the empirical part gave somewhat similar results. When it comes to the importance of the hotel operator on the performance of a hotel property investment and to the impacts of external changes on the profitability of such investments, the two research methods were unanimous. However, there were some differences in the literature review and in the empirical part, especially when focusing on the length and structure of the lease agreements and on the financing costs of hotel property investments. The differences in the lease lengths were caused by different viewpoints whereas the difference in the perceived financing costs can be explained by the changes in the market conditions.

4.1 Validity of the Research

It should be mentioned that there are some constraints related to this thesis. Firstly, it should be noted that there are some limitations in the literature that has been used in this study. Thus far the research on hotel properties has been focused on the United States of America and very little research has concentrated on the Nordic hotel market. Hence, the characteristic features of the hotel property investment market in the Nordics are not widely brought up in the literature. It should also be mentioned that part of the literature used in this thesis could be considered somewhat dated as some of the studies have been made in the 1990 and in the early 2000. Hence, the recent changes and the development in the property market are not studied in the literature which can be seen as a weakness.

Secondly, the empirical data that was collected for this study did not entirely meet the expectations. Initially Denmark was also included in the scope of this study, but no interviews were obtained. However, it should be noted that the hotel markets of the countries under survey were considered to have some similarities, and therefore, the limitation of the scope was seen justified. It should also be brought up that the quality of the interviews was good and relevant answers were received from all interviewees.

4.2 Proposed Further Research

As this thesis suggests, hotel properties are an interesting real estate type that has distinct characteristics related to it. In this thesis, hotel property investments in the Nordics have been studied from investor's point of view. This can be considered as a new approach to the topic and as a basis for further studies.

The previous studies have observed hotels more from a business point of view than from a real estate viewpoint, and the focus has been on the optimization of the services provided by hotels. At the same time the real estate viewpoint has been set aside, and thus, more weight should be put on hotels as a specialized form of real estate to fully understand their characteristics. Hotel properties can also be considered to merit an increasing amount of research from a real estate point of view as it may be seen as a new field from the tourism perspective.

Furthermore, the current studies of hotel properties as investment targets have mainly discussed the possibilities of hotel property real estate investment trusts, REITs. This is due to the fact that nowadays the legislation enables the creation of such investment vehicles. This has undoubtedly led to a shift in the focus. The empirical part of this thesis, however, suggests that direct investments on hotel properties will increase in the near future, and hence, diversification benefits and the performance of hotel properties should be studied more widely.

In addition to putting more focus on the performance of direct hotel property investments, the Nordic countries should be studied as a separate investment area. The studies have thus far been highly focused on the United States of America. The market practises and the investor's preferences differ greatly from those in the United States, and therefore, no direct deductions on the previous studies can be made.

5 Conclusions

The goal of this study was to investigate whether hotel properties are a viable investment target in the Nordics and what are the current trends in the Nordic hotel property market. Additionally, the purpose of this thesis was to find out what risks and benefits are associated with hotel property investments and to increase the understanding of the impact of these features, and further to illustrate the thinking behind the hotel property investment decisions to some extent.

This thesis identified some of the Nordic investors' key arguments when reasoning a hotel property investment. Firstly, the significance of the chosen hotel operator was highlighted as it has an impact on the profitability of a hotel property investment. Secondly, the interviewees emphasized the importance of the lease agreement structure and the length of the lease agreement to the value of a hotel property investment.

These above mentioned arguments are examples of the advantages related to hotel property investments. The chosen operator has an influence on successfulness and on the value of a hotel property investment. The length and the structure of the lease agreement are also considered to have a positive impact on a hotel property investment. Hotel lease agreement structures usually enable investors to outsource the daily operations and upkeep of a hotel to an external hotel operator. Depending on the lease agreement structure and on the success of the hotel, a hotel property investor has a possibility to receive upside and potentially high profits from the investment. It should, however, be mentioned that there are also some disadvantages to hotel property investments. The bankruptcy of a hotel operator is a noteworthy threat to an investor. Additionally, the external obsolescence and changes in the operational environment can effect negatively on a hotel property investment.

It should be brought up that when it comes to the advantages and disadvantages of hotel properties, the literature review and the empirical part gave somewhat similar results. The importance of the hotel operator and the impact of external changes were mentioned in both the literature review and empirical part. There were, however, differences between these two parts when it comes to the length and structure of the lease agreements and on the financing possibilities of hotel property investments. Furthermore, according to the literature, hotel properties are perceived as risky investment targets. However, the interviewees had a more positive approach to hotel property investments and they indicated that such investments could be considered as core investment opportunities.

This study suggests that the demand of hotel property investments in the Nordics will increase in the near future although new hotel property funds or other investment companies were not considered to enter the market within the next few years. It should be noted that due to the current investment climate, investors have put more focus on hotel properties than before. Several reasons for the increasing demand and interest towards hotel property investment opportunities were identified. Firstly, at the moment hotel properties are suitable assets for multiple investor groups as both individual investors as well as more professional investors are able to make such investments. Hotel properties suit for investors' varying risk and return appetites, and these aspects can also be altered to meet the investors' investment profile. The riskiness of the asset may be adjusted by for example choosing an agreement type that meets the investor's expectations. The chosen agreement structure also impacts the rate of return. Secondly, the current high level of return and the fact that return from hotel properties have historically exceeded those received from other commercial property classes speak for the hotel property investments.

Having mentioned that hotel properties are suitable for varying investor groups, some investors are, however, able to benefit more from their investments. In general, the risks and advantages related to hotel properties differ from those of other commercial property groups, and therefore, successful hotel property investments require understanding of these aspects and special knowhow from the investors' side. It is crucial that investors have an understanding of the hotel operators' business and also some knowledge on the lodging and hotel market. Yet, it should be noted that not all investors have these skills and that provides others an opportunity for differentiation in the real estate market. Hence, the number of investors competing over the same investment opportunities decreases.

It is also worth noticing that hotel properties are a long-term investment target, and thus, they are most suitable for long-term investors that are not expecting to receive instant profit from their investments. This is due to the fact that the uncertainty of the projected cash flows tends to decrease and the fluctuations of the cash flow streams level out in the long run. Hotel property lease agreements are typically long and require collaboration between the owner and the operator especially when it comes to renovations. A long investment period enables the property owner to develop a co-operational relationship with the hotel operator that might further support the owner in understanding the business and to enhance the profitability of the investment.

In addition to the advantages obtained through the long holding period, the ownership of multiple hotel properties could facilitate the investors to gain even more from their investments. It could be concluded that in order to avoid some risks from realizing and to receive additional benefits from owning numerous hotels, it would be prudent to have either several hotel properties in a property portfolio or a separate hotel property portfolio instead of having just a single hotel property investment. These additional benefits include for example the investors' increased bargaining power against the hotel operator when negotiating on a new lease agreement or on renovations.

To conclude, this thesis suggests that hotel properties can be considered as a noteworthy and viable investment target in the current market situation for multiple investor groups. Investors should, however, be aware of the risks and benefits associated with hotel properties as they differ from those of other commercial property asset classes. To further benefit from hotel property investments, a long holding period should be considered and several assets should be owned simultaneously.

Furthermore, it is worth noting that the topic of this thesis has not been widely investigated earlier. The viewpoint and the geographical scope of this thesis differ from previous research made in this field. Hence, this study can be considered to have a new approach to the topic and to bring new information to scientific literature.

6 Summary

Hotel properties have become more mainstream assets during the past decade compared to what they were before. Today a wide pool of investors has begun to consider hotel properties as a viable addition to their existing property portfolios and further as an alternative and substitute to traditional commercial property asset classes. Historically this was not the case as some institutional investors avoided hotel property investments whereas private equity real estate funds and other hotel property investment companies dominated the market. This was due to the fact that hotel properties have been regarded as a risky asset class and there has been a lack of sufficient understanding of the hotel business. However, the current market situation in the Nordics provides a suitable investment climate for investors to focus also on hotel properties. Firstly, long lease agreements with hotel operators and the low interest rate level enable investors to receive high enough returns from their hotel property investments. Secondly, the debt financing possibilities have improved. Thirdly, the current economic situation provides a good time for investors to engage in new hotel development projects to fully benefit from the new capacity when the economy starts to grow again. It should also be noted that tourism is a growing industry worldwide and the number of yearly tourists continues to increase. This ensures the demand of hotel properties.

The focus of this thesis was to find out what makes hotel properties a worthy investment target in the Nordics, and especially what types of risks and benefits are related to them both as individual investments and as on a portfolio level. Some importance was also given to the characteristic features of hotel properties and to the thinking behind hotel property investments in order to provide a deeper understanding of such investments. The study was conducted by doing a literature review and thematic interviews.

According to the literature review, there are both risks and benefits related to hotel properties. The main pros and cons that were highlighted in the literature review include the importance of the external hotel operating company and the long lease agreement, the changes in the operational environment, the fluctuating occupancy rate and the volatility of the cash flow stream. It was noted that although investors enter into long lease agreements with hotel operators, hotels are leased to customers on a daily basis. This leads to a fluctuating occupancy rate but it also gives the possibility to adjust the nightly rates on a somewhat short notice. Thus, hotel properties were considered to function as inflation hedges to some extent but they were also considered to generate volatile cash flow streams. Moreover, it was pointed out that the hotel operator is an important factor when it comes to the success and profitability of a hotel property investment. A skilful operator should be able to tackle some of the difficulties related for instance to the fluctuating demand. The external obsolescence and the changes in the operational environment were considered to have an impact on the occupancy of the hotel. These changes were considered to result mainly from environmental, economic, legal or social factors of the area.

It should, however, be pointed out that this topic has not been extensively studied from a similar viewpoint and the geographical scope of this thesis also differs from previous research. This study can be considered to have a new approach to the subject. In order to fully understand how Nordic investors perceive the risks and benefits related to hotel properties, a total of 13 thematic interviews on the topic were conducted. Six of the interviews were made in Finland, four in Norway and three in Sweden. The interviewees were selected so that they represented different real estate companies and had varying backgrounds, and hence, the sample consisted of advisors, fund and portfolio managers as well as institutional investors. All interviewed investors had hotel property investments included in their portfolios.

It turned out that the interviewees had somewhat similar viewpoints on the main risks and benefits that are related to hotel property investments. The two most significant factors from investors’ perspective were considered to be the selection of the hotel operator and the long lease agreement signed with them. The majority of the interviewees highlighted the importance of the chosen hotel operator on the profitability of the investment. However, the bankruptcy risk of the hotel operator was also brought up in the majority of the interviews. Additionally, many interviewees suggested that the key to a successful hotel property investment is that the hotel concept created by the operator and the location of the hotel must attract the same customer group. According to the interviewees, a long lease agreement with an operator is one of the most significant benefits of hotel property investments. A long lease agreement is seen to provide some stability and it enables a more profound and beneficial relationship with the hotel operator.

What is more, the interviewees brought up various reasons why hotel properties were considered viable investment targets in the Nordics. According to the interviewees, hotel properties are a suitable investment target in the current market situation for multiple investor groups. It was also mentioned that hotel properties can be seen as substitutes for core investment targets that are nowadays rarely sold in the market. Furthermore, it was considered that there is less competition on hotel property investments between investors. Hotel properties were also seen to give investors an advantage when trying to differentiate from others as such targets require special knowhow from the investor. Moreover, hotels were considered to retain their purpose of use for long periods of time which was also perceived as a positive aspect of such investments.

All in all, this study suggests that hotel properties are a noteworthy and viable investment target in the current market situation in the Nordics for both institutional and private investors. Based on this research, investors should look for hotel property investment opportunities, however, noting that the risks and benefits of such investment targets differ slightly from those of other commercial property asset classes.

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Appendix 1 – Presentation of the Interviewed Companies

Advisors

DTZ

DTZ is one of the world's leading property advisor companies and it operates in 52 countries throughout Europe, Middle East, Africa, Asia Pacific and the Americas. In the Nordic countries DTZ has 7 offices and it offers several differing services including for example real estate valuation, transaction advisory, brokerage and tenant representation.

Konsultointi Respa Oy

Konsultointi Respa Oy is a consulting firm for enterprises in the hotel, restaurant and travel industries. They specialize in business development projects providing a variety of services including lease agreement consultation. (Konsultointi Respa Oy 2015.)

Funds

CapMan Real Estate Oy

CapMan Oyj is listed in the Helsinki stock exchange. CapMan Real Estate Oy manages four private equity real estate funds. These funds include investments in the office, commercial, retail and hotel property sectors in the Nordic countries. One of the funds focuses solely on hotel property investments and it includes a total of 39 hotel properties in Finland and in Sweden. (CapMan Annual Report 2013.) In 2008 CapMan Hotels RE Ky acquired Dividum AB from London & Regional Properties Ltd.

Exilion Capital Oy

Exilion Capital Oy was established in 2007 to manage Exilion Real Estate 1 Ky property fund. Elo Mutual Pension Insurance Company (Keskinäinen Työeläkevakuutusyhtiö Elo), Keva Pension Agency (Keva) and Etera Mutual Pension Insurance Company (Keskinäinen Eläkevakuutusyhtiö Etera) own the company in question and they are also co-partners of the fund. The fund focuses on commercial property investments, such as offices, shopping centers and hotels, with a moderate risk profile in the Helsinki Metropolitan area. At the moment, there are two hotels in the portfolio comprising approximately 30 to 40 percent of the investments. (Exilion Capital Oy 2015.)

VVT Kiinteistösijoitus Oy

VVT Kiinteistösijoitus Oy has been established in 2012 to manage a property fund. The main investors of the fund are Varma Mutual Pension Insurance Company (Keskinäinen työeläkevakuutusyhtiö Varma), The State Pensionfund (Valtion Eläkerahasto) and Tradeka Sijoitus Ltd (Tradeka-Sijoitus Oy). The main focus of the fund is in commercial property investments in growing cities that may be acquired by either developing a new property in co-operation with a construction company or by acquiring an existing real estate. They have one hotel property in their portfolio. (VVT Kiinteistösijoitus Oy 2015.)

Investors

Home Properties AB

Home Properties AB focuses on investing in and developing hotel properties. Their investments are located mainly in Sweden and some in Norway. In addition to these, Home Properties AB owns one property under development and one office property. Their investment focus is on large cities and regional centers in the Nordic region. (Home Properties AB Årsrapport (Annual Report) 2013.)

KLP Eiendom AS

KLP Eiendom AS is a major subsidiary of Kommunal Landspensjonskasse, KLP, which is Norway's largest life-insurance company. Consequently, KLP Eiendom AS is one of Norway's largest property companies and manages all property investments made by KLP. Their aim is to invest 14 percent in real estate, in more detail into office, retail and hotel properties. KLP Eiendom AS owns 14 hotel properties totaling 22 percent of their real estate portfolio. These hotel properties are located in Norway, Sweden, Denmark and in the United Kingdom. (KLP Annual Report 2013.)

LähiTapiola Kiinteistövarainhoito Oy

Local Insurance and Tapiola merged in 2012 and currently they are one of Finland's largest insurance companies. They offer for example insurances, investment and banking services for several differing client groups. LocalTapiola Real Estate Asset Management Ltd (LähiTapiola Kiinteistövarainhoito Oy) manages a property portfolio which is worth approximately EUR 3.2 billion. Currently LocalTapiola Group owns five hotel properties, partially owned together with Elo. Furthermore, they have one office property in their portfolio that will be converted into a hotel property. The total weight in hotel properties in their portfolio consisting of direct property investments is 10 percent. (LähiTapiola Kiinteistövarainhoito Oy Vuosikertomus (Annual Report) 2013.)

Pandox AB

Pandox AB is a hotel property company that focuses on investing solely in hotel properties, developing and leasing them forward. The main target of the company is to acquire underperforming hotel properties. In addition to owning hotel properties, Pandox AB functions as a hotel operator. Currently Pandox AB owns 105 hotel properties that are located in 10 countries. The majority of the hotels is located in Sweden, Finland, Norway and Denmark. (Pandox Business Operations 2013.)

Appendix 2 – Interview Questions

Background information

1. Could you shortly describe your organization?
2. What property classes are included in your portfolios?
3. What is the amount of hotel property investments in your portfolio?

Main Drivers in Investing in Hotel Properties

4. What is the main driver/reason behind hotel property investments?
    a. When investing in a new hotel property or portfolio, what are the key drivers that you are looking for e.g. operator (independent/ large operator), location and what types of cities (occupancy rates, room rates)?
5. What are the main benefits of individual hotel property investments? How about in a portfolio?
6. What are the main value drivers of hotel properties?

Risks and Risk Management Techniques

7. What are the main risks associated with individual hotel property investments? And in a portfolio?
8. How much property side risks would you be willing to take when investing in a hotel property? In other words, what type of lease agreements would you be willing to make and how much does the condition of the building affect your decision.

Lease agreements/Management agreements

9. Do you have lease agreements or management agreements with the hotel operators running business in your properties?
10. Are the rents fixed, turnover based or a combination of these two?
    a. If fixed, are they indexed?
    b. If turnover based, what are the approximate percentages for hotel operations, for restaurant operations and for possible conference operations.
11. What is the rent-paying ability of hotels in average and what does it depend on?

Trends

12. Have you noticed any changes when it comes to lease/ management agreements?
13. There has been a trend towards smaller operating companies and towards individual boutique hotels instead of large and well-known operating companies. How do you think this trend will develop within the next years?
14. What are your thoughts about the current trend concerning the development of old properties that are converted to hotel use? What are the main risks and benefits related to these?
15. Have you noticed any other major trends in the hotel property sector recently? What?

Hotel Property Funds in Nordics and in Europe

16. Do you know if there are any new hotel property investment funds or companies being put up in Europe at the moment? Where? Do you know if these funds are closed or open-ended?

Appendix 3 – Questionnaire

1. How do you think the demand of hotel property investments will develop within the next 3 to 5 years?

    a. Increase substantially
    b. Increase
    c. Stay at the same level
    d. Decline
    e. Decline dramatically

2. In your opinion, what is the rent-paying ability of hotels located in the following cities?

	under 20 %	21-25 %	26-30 %	31-35 %	above 36 %
Large cities					
Medium sized cities					
Small cities					
Cities with fluctuating demand (e.g. ski resorts)					

Please turn the page

3. When investing in hotel properties how important are the following benefits and risk aspects?
1 being not important, 3 being somewhat important and 5 being very important

Diversification benefits	1	2	3	4	5
Potential for high profits	1	2	3	4	5
Hedge against inflation	1	2	3	4	5
Hedge against new construction	1	2	3	4	5
External obsolescence	1	2	3	4	5
Internal obsolescence	1	2	3	4	5
Management/Operator	1	2	3	4	5
Seasonal fluctuations of occupancy and room rates	1	2	3	4	5
Daily fluctuations of occupancy and room rates	1	2	3	4	5
High lending costs	1	2	3	4	5
Illiquidity	1	2	3	4	5