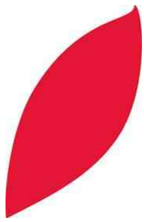

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HOSPITALITY

Investors check into Europe's hotels

Increased travel is helping put hotels on the radar of private equity real estate firms operating in Europe

Private equity real estate professionals haven't just been staying in Europe's hotels as they scout investments. Lately, they have been buying them.

In a noticeable pattern, Patron Capital, Mountgrange Investment Management, Starwood Capital Group, Morgan Stanley Real Estate Investing (MSREI) and Angelo, Gordon & Co have each made investments this past year, just to name a few.

This shouldn't surprise anyone in the hotel trade. Although hotels clearly suffered over the past three years, there were clear signs of rejuvenation in 2010.

Jos Short, founder of Internos Real Investors, which recently created a European hotel division, said there obviously had been a decline in travel in 2009, but travellers were "on the move again" in 2010. He pointed to the branded hotel sector, which accounts for just 20 to 25 percent of all hotels in Europe, as being of particular interest to investors.

"Within the branded hotel market, the most stable sector is the mid-market: the three-star and four-star hotels," Short said. "They are not immune from recession, but they are positioned to benefit from a less volatile clientele. This will be our focus."

While there have been some pan-European deals – for example, MSREI purchased a €150 million mezzanine loan secured by a portfolio of European hotels owned by The Blackstone Group in December – the majority of the private equity real estate activity surrounding hotels seems to be concentrated in London.

Last July, New York-based investment firm Angelo, Gordon & Co bought the four-star St. Ermin's in Westminster for €65 million from NH Hotels. It is now nearing the end of a £30 million (€35 million; $48 million) refurbishment programme for the property, which includes the complete redesign of 331 rooms, and will soon re-open its doors to the public.

Anuj Mittal, head of European transactions at Angelo Gordon, said the firm expects the investment to perform well. He pointed out that recent research showed the industry benchmark, revenue per available room (RevPAR), had increased significantly in London in 2010.

According to hotel advisory firm STR Global, an affiliate of accountancy firm Deloitte, RevPAR in London rose 11.9 percent to £112 in the 12 months to 31 December, while average room rates were up £12 to £136. Hotels in UK provinces also increased, but not as strongly.

Andrew Little, group head of hotels at law firm Berwin Leighton Paisner, said international property investors always have been keen on London hotels, even more so as prime London offices have started to look "expensive".

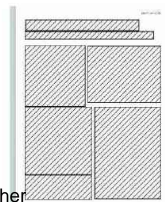
Last year, Greenwich, Connecticut-based Starwood Capital bought the four-star Cumberland hotel in London's West End for around £215 million pounds (€253 million; $324 million). Perhaps tellingly, it bought a prime London office the year before.

Among others to be investing in hotels is London's Mountgrange, which is backing a plan to build a chain of budget hotels in London under a franchise agreement with Tune Hotels. Tune was started by Malaysian entrepreneur Tony Fernandes in 2007 and operates 11 sites in Asia.

The new venture, Raag Hotels, will develop 15 properties with 1,500 beds in London by 2017. The concept is based on providing economical room prices to customers that book well in advance, a model running along similar lines to low-cost airlines. That plan was disclosed towards the end of last year.

More recently still, Patron Capital has agreed with Australian shopping centre developer Westfield to acquire the long-term leasehold and subsequently enter into a turnkey development agreement for the delivery of a Holiday Inn and Staybridge Suites at the site of the London Olympics, according to the *Financial Times*.

As for the long-range prospects of investment activity in the sector, look no further than the firms forming dedicated vehicles. Dallas-based Invesco Real Estate is out raising its second European hotel fund, while hotel specialist Azure Properties said in September it was in discussions with major private equity groups and commercial real estate funds on a joint venture to acquire up to £1 billion (€1.17 billion; $1.6 billion) of European hospitality assets. Indeed, as long as the global economy stays on track, there is every reason to expect more hotel deals soon. ◻



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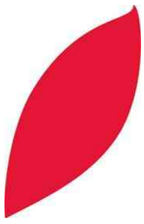

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St. Ermin's, London: an Angelo, Gordon investment

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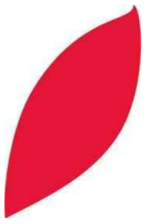

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The pain in Spain

Spain's macroeconomic problems have put off many real estate investors, but some hardy firms have managed to find attractive situations to invest in.

By Robin Marriott

PERE doesn't always get its timing right. Instead of heading to Spain in the spring or early summer, we decided to head to the Iberian Peninsula in wintry November. At least the weather reflected the mood of the local real estate markets.

Mirroring the cold snap that had settled over Madrid, Spain was suffering a chilling economic scenario: with struggling Ireland on the brink of accepting an €85 billion financial bailout from the European Union and the International Monetary Fund, players throughout the financial markets were suggesting that Spain could be next. Therefore, when *PERE* touched down, Spanish businessmen were huddled together in cafes, concerned that the crisis of confidence in Ireland would flare up in Spain.

Against the suggestion that Spain could be sent into an economic purgatory, *PERE* met or spoke with an eclectic mix of real estate professionals. We took on intelligence from opportunity funds (Orion Capital Managers and Harbert Management), investment and asset managers (Drago Capital and Momentum Real Estate Investment Managers) and investment advisers (Exmoor Group and REIM Partners). We also spoke with accountant Ernst & Young, commercial lender Eurohypo, property company Neinver, property services firm CB Richard Ellis and a core-plus fund manager in the form of Rockspring Property Investment Managers, whose founders have been investing in Spain since 1987.

What *PERE* learned was that the icy macroeconomic problems facing the country had put off many groups, including The Blackstone Group, at the time we visited. We also discovered the lack of a true distressed market wasn't helping opportunity funds in their quest to put capital to work, either. Nevertheless, at least a dozen hardy firms have been able to find attractive situations, we were told.

In fact, in the past 14 months, Doughty Hanson, Orion Capital, Moor Park Capital, Rockspring Property, Germany's Deka Immobilien, AEW Europe, New York's WP Carey, London's Patron Capital, Alpha Tiger, RREEF, AREA Property Partners and Europa Capital have all invested in Spain. However, rather than enter into classic distressed property deals – buying partially leased offices, for example – the types of investment these players have been making have largely been one type: sale-leasebacks.

Indeed, in the week prior to *PERE*'s arrival, Cerberus Capital Management, the New York alternatives firm, partnered with Drago on a €95 million sale-leaseback transaction with Caja Madrid. The firms bought 97 bank branches that Caja Madrid leased back on 25-year terms.

At Drago's downtown Madrid office, co-founder Oleguer Pujol said the strategy was simple: to sell off the bank units individually or in lots. "What we have bought is a portfolio of well-located assets providing a long-term steady income from a first-class tenant," he added.

Selling family silver

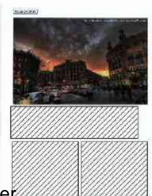
Caja Madrid is just the latest example of a Spanish savings bank bolstering its finances by selling the family silver. In total, savings banks have sold and leased back around €8.5 billion worth of bank branches and other real estate assets in the past three years, according to data from CB Richard Ellis, and a mix of investment firms have stepped in as buyers.

The trend began in 2007, when Drago teamed up with London-based Sun Capital and Pearl Group to buy 1,152 branches from Banco Santander for €2 billion. Then, in September 2009, came the first of two tranches sold by BBVA to a consortium of Deutsche Bank's alternative asset management group RREEF, New York opportunistic firm AREA Property Partners and London private equity real estate firm Europa Capital. The first, valued at €1.15 billion, involved 944 bank branches and three offices, and the second was a €364 million package last year. Also in 2010, Banco Sabadell sold 378 branches for €403 million to a consortium led by London-based investment manager Moor Park Capital, which reportedly included New York's Och-Ziff Capital Management.

According to Jamie Rea, managing director of Hines in Spain, the trend is clear. "The strategy is buying wholesale with the idea of selling retail," he said.

By retail, Rea means selling branches to non-financial institutions such as high-net-worth Spaniards, who earned fortunes off the back of Spain's real estate boom. Since the credit crunch, many wealthy Spaniards have hoarded their wealth, but they are looking for a safe place to invest their money. Some may have lost money recently on the volatile stock market and decided that real estate is a more stable long-term investment, he noted.

The wholesale/retail strategy was exemplified perfectly in December, when the private property investment vehicle of retail mogul Armancio Ortega, who founded the eponymous Inditex fashion chain behind the global Zara chain, bought 48 of the 378 branches that the Moor Park consortium acquired last July. When *PERE* was in Madrid the previous month, Ori-



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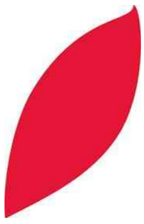

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on Capital's head of Spain, Roberto Roca, presciently pointed to the Ortega family as among those looking to buy such prime property. He noted how shares in Inditex had risen about 32 percent since the start of 2010. Sure enough, Ortega's private property investment company, Pontegadea, popped up to pay €55 million for those bank branches in what is thought to be the first deal by that company since the credit crunch.

According to those *PERE* met with, it is Spain's high-net-worth individuals that have been the preeminent buyers of prime property in Spain for assets of up to €60 million. "You see that the high-net-worth individuals are the ones being the most active," said Javier Kindelan Williams, national investment director for Spain at CB Richard Ellis. "They see capital values have returned to reasonable, historic levels."

The caja tango

There may be more opportunities to come for high-net-worth individuals to buy from institutional real estate investors. That is because *PERE* has been informed that more savings banks would be selling and leasing bank branches in 2011. After all, these banks, or cajas, are undergoing huge structural changes having over-extended their mortgage lending businesses in Spain's construction boom, which led to the country having the highest proportion of home owners anywhere in Europe and which has considerably weakened them since.

Concerned Spanish regulators have reacted by ordering the cajas into what some call 'false mergers', where the balance sheets are merged but the fascias and other aspects of the two banks remain unchanged. Caja Madrid, which entered into its sale-leaseback in July, is one of those combining. It is joining with another national player, Bancaja, to create Spain's largest savings bank.

Experts said that regional cajas (as opposed to national ones) could provide the next wave of branch sale-leasebacks, but they also warned that investors might become wary of the risks. Their point was that some of the bank branches could be situated in non-prime locations, while the financial strength of the selling bank might be questionable and the alternative uses for some of the properties might be limited. "There is liquidity in places like Madrid, Barcelona, Bilbao, Valencia and Seville as they are large cities and offer potential alternative uses," CBRE's Williams said, "but that is not quite the same for other places."

Of course, that raises the question of how many more sale-leaseback deals private equity real estate firms might get involved in. As Hines' Rea noted, opportunity funds have been buying portfolios at net initial yields of 6.75 to 7.5 percent and selling to individuals at below 6 percent. "[That strategy] makes sense, plus one would get good cash flow in the meantime without taking much risk," he said. "But I don't think the IRRs are going to be what one might see from a typical opportunity play." By extension, the chances of making 20 percent-plus from a sale-leaseback of bank branches would clearly be reduced if too many assets came to the market. CBRE's Williams wondered aloud whether the market could become saturated, noting how some bank branches already had come back to the market a second time.

Nevertheless, Spain's savings banks have so far provided fodder for hungry real estate companies that have otherwise been a little disillusioned with Spain because of a lack of classic distressed deals. Spanish banks have not been forced by the Bank of Spain or anyone else to deal aggressively with their loan books. Meanwhile, investors have grown wary of buying semi-vacant assets in a country that could enter even trickier waters should a bailout materialise. At the same time, lending banks have shied away from underwriting risky deals in the country, so even if one finds an opportunistic deal it is not that easy to find financing. All of this helps explain why sale-leasebacks have gained such traction. In fact, Spain (together with Italy) accounted for nearly one-third of all sale-leasebacks in Europe in 2009.

Eroski mania

It is not just the cajas that have been selling and leasing back property, though. Other Spanish companies have been doing so, and none has been as active as Spain's third-largest supermarket group, Eroski.

Eroski, which has been busy reducing corporate debt, provided real estate investors with at least seven transactions last year [see deal chart, page 31]. The buyers of its retail and logistics properties included Paris-based AEW Europe via its opportunistic fund, the European Property Investors Special Opportunities, which paid around €150 million for retail units with weighted average unexpired leases of 20 years.

Meanwhile, London-based Rockspring entered into two deals. In one it bought downtown supermarkets in the Basque country for €45 million and, in the other deal, two standalone units on a retail park in Bilbao. The supermarkets were purchased and leased back to Eroski on 20-year leases with rents fixed upwardly and linked to an index. The net initial yield was 7.5 percent.

Rockspring director James Preston, who is based in Madrid, said the firm generally was "net negative" on Spain due to its financial difficulties, but it nevertheless invested in the downtown supermarkets because of their "defensive" qualities. The supermarkets were at the "value end" of retailing, he noted.

Eroski has been a welcome source of property sales, that is for sure, but other companies are expected to similarly raise capital from their assets.

Adolfo Ramirez-Escudero, CBRE's executive managing director of capital markets in Spain, recently predicted: "We will see more sale-leasebacks from corporates, just as we saw with Eroski. It is true that the fundamentals of the market are still weak and rents will adjust further, but these deals have the security of long leases and therefore are immune to short-term adjustments."

Ramirez-Escudero was speaking after his firm advised Madrid-based Distribuidora de Television Digita (DTS), the largest provider of digital pay television in Spain, on the corporate sale-leaseback of its headquarters in Tres Cantos to WP Carey for €80 million. Two years ago, DTS' parent company, PRISA, sold and leased back three of its most emblematic assets: its headquarters in Madrid; the editorial office of newspaper El País; and Cadena Ser's headquarters in Barcelona, all to Drago for €315 million. Since then, Mercedes-Benz also has raised money via sale-leasebacks.

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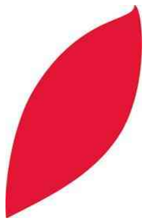

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Loan pools

However, it isn't all about the leaseback. Though sale-leasebacks have provided an abundance of big-ticket transactions, the other source of deals in Spain has been corporate debt and loan books. In 2009, GMAC sold a real estate loan book business to Fortress Investment Group. Also in 2009, Goldman Sachs sold corporate debt in Spanish property company Inmobiliaria Colonial to a 50-50 joint venture between Orion Capital and Los Angeles' Colony Capital.

Upon landing in Madrid in November, it was pretty obvious which bank would be likely to provide the next deal: everyone *PERE* spoke with talked about Royal Bank of Scotland (RBS). The UK bank was a very aggressive Spanish real estate lender up until the credit crunch. Since the UK taxpayer stepped in to help it, the bank has been exiting various businesses around the globe in a radical restructuring.

In Spain, RBS has decided to sell a performing real estate loan book through adviser Morgan Stanley, as well as a sizeable non-performing loan book. The non-performing loan book is drawing interest from funds managed by large global firms such as Morgan Stanley Real Estate Investing and Goldman Sachs' Whitehall Street funds, according to those on the ground, and is reputed to be about $1.6 billion in size.

International banks typically have been the ones to decide to sell assets, but it is a different story when it comes to Spain's banks. They have not provided the avalanche of loan pool sales first hoped for by opportunity funds, leaving them as disappointed here as they have been in other parts of the world.

Alberto Alvaro Gonzalez, co-founder of Momentum Real Estate in Madrid, said his firm had been looking to partner with opportunity funds in Spain on opportunities primarily from the banks. This is because, while the speed of repossessions hasn't been fast, the banks now own or have the power to decide the fate of a vast number of assets.

"We have looked into single commercial real estate assets, such as offices, logistics, industrial and shopping centres, as well as debt portfolios – mainly residential mortgages because that is what the Spanish banks tends to have the most of," said Gonzalez. "The challenge is that, like many other countries, the banks have not been very active in taking action – rather than foreclose aggressively, they are instead marking assets as if they expect things to recover. But on the investor side, the expectations of 20 percent-plus returns are very difficult to match. With the negative forecast on the macro economy, it means investors need a steep discount on acquisition prices that banks are not willing to, or even can't, give."

Gonzalez went on to explain that recent regulations by the Bank of Spain had accelerated the rate at which banks should provision for their loan books, but on a lower basis. Prior to the new regulation, they were provisioning at a slower pace, but they had to provision 100 percent of the loan. That was unrealistic as the loan had some value because of the real estate collateral. "The rationale is that these loans retain some value, even if they haven't been repaid in the last 12 to 18 months," he said. However, as a result, the incentive to sell at a loss is lower. "The banks think that over time they will have a better solution."

Pure opportunity

Opportunity fund Orion Capital still thinks banks must address their issues at some stage. In 2009, the firm managed to make two investments, but it has not made any since.

"We still see Spain as potentially providing some very interesting opportunities," Orion's Roca said. "The economy continues to be very weak, but the banks will have to sell some properties. That will happen when they decide that what the market is offering for those assets is acceptable, which hasn't quite happened. One has to remember that in the last 18 months the banks have become the largest property owners either directly by providing mortgages or indirectly by taking debt for equity or controlling some of the bigger property companies. By the nature of their business, they really shouldn't be holding so much property."

Momentum's Gonzalez concurs. "For the investor, the good news is that liquidity is finally going to be an issue for some of Spain's financial institutions in the first half of 2011," he said. "That creates a number of opportunities, unless cheaper sources of liquidity become available."

As *PERE* left Spain, the banks felt like they could and should provide the big opportunity. But as in so many places in the world, opportunity funds will have to wait for it. In the meantime, there are always those sale-leasebacks. □

The local partner

Alberto Alvaro Gonzalez
Co-founder and head of investor relations
Momentum Real Estate Investment Managers

Gonzalez: almost impossible to get 20 percent returns

The partners of Momentum used to work at accountancy firm Arthur Anderson, property services firm CB Richard Ellis and even US banking regulator the Federal Deposit Insurance Corp in the early 1990s during the US Savings & Loan crisis before setting up their firm to partner with opportunity funds in buying Spanish property.

Gonzalez said the problem is that banks have not been very active. In addition, the outlook for the Spanish economy is grey, and there is some expectation real estate values could fall further. Coupled with a lack of available debt, it is almost "impossible" to expect 20 percent-plus returns, he noted. That said, he cautioned that there is increasing speculation that Spain will require a bailout similar to Ireland. "If this happens, perhaps it will create the distressed situation investors need," he said.

The opportunity fund

Roberto Roca
Head of Spain
Orion Capital Managers

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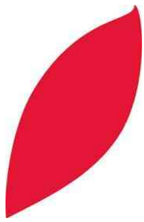

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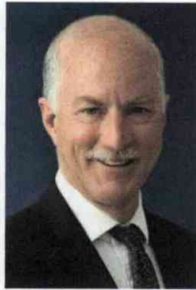

Roca: prime offices will fill up first

Opportunistic real estate firm Orion Capital Managers opened an office in Spain in 2009 and hired Roca, formerly of LaSalle Investment Management and AEW Europe, to run it. The firm struck two deals on behalf of Orion European Real Estate Fund III, with a total of €1.28 billion of capital commitments, the year it opened.

In the first, Orion bought the Plenilunio shopping centre in Madrid for €235 million from Banco Santander's real estate fund, Banif Inmobiliario. Roca noted that the 70,000-square-metre asset had 200 tenants and, as part of the transaction, it also acquired an office property in Las Rozas leased to Hewlett Packard.

In the second deal, Orion bought Goldman Sachs' debt in Inmobiliaria Colonial, the Spanish property company with prime offices in Spain and Paris. The debt was bought in a 50-50 joint venture with Colony Capital, some of which was later converted to equity as part of restructuring in 2010. Roca said the fundamental thought process for the Colonial deal was this: "To acquire a piece of a property company that in our view probably had one of the best office portfolios in Madrid, Barcelona and Paris. Even though there is a weakening of the letting market in Spain, once the markets and the economy recover, these assets will be one of the first to catch the upswing because of the good locations of these buildings."

The lending bank

Nicole Juergensen
Head of the Madrid branch
Eurohypo AG

Juergensen: low risk and low leverage

Germany's Eurohypo was one of the most active lenders in Spain's real estate market in recent years and suffered as a result. However, since those heady days in the run-up to the credit crunch, a new team led by Juergensen has joined and the bank is making loans again, albeit in areas seen as low risk.

In the wake of the credit crisis, the number of banks with money set aside to lend has declined dramatically. "Pre-crisis, there were three or four times as many," Juergensen said. "Right now, there are banks that have stopped pursuing lending because they want to focus on getting a grip on their portfolios. Then there are banks that are selling off their entire portfolio because they want to exit the country due to new strategic decisions made at their headquarters. Others still are open in principle but are not aggressively going after new business, and most banks open for new business prefer to team up in syndicates or form club deals, even for the smaller investments."

For its part, Eurohypo is taking a look at mortgage financing again so long as the borrower puts in a substantial amount of equity. The bank lent to AEW Europe in its sale-leaseback deal with Eroski in 2010. "This was a low-leverage deal with assets giving substantial cash flow," Juergensen said. "What we will never do again is corporate loans without any mortgage guarantee."

The core fund

James Preston
Director
Rockspring Property Investment Managers

Preston: net negative on Spain, but likes value retail assets

London-based Rockspring was one of the first international property fund managers to start investing in Spain, beginning in 1987. It opened an office in Madrid in 2005, although by then it was selling properties, having become concerned much earlier about the formation of a property bubble in Spain.

Preston said Rockspring was "net negative" on Spain and that, over the next two years, the "pain" would really be witnessed. "Spain's problems are not necessarily much different than other countries' problems, but they are much bigger," he said.

Austerity measures would impact consumer consumption this year, yet the firm's deals in the country have been for retail properties. Preston explained that these were sale-leaseback deals involving value retailing, a sector that was defensive. The firm is avoiding shopping centres.

"Spain certainly saw huge development of ever-larger glitzy shopping centres, helped by cheap debt and goods manufactured cheaply in China, which in turn fuelled retailers such as Inditex," Preston said. "This could be the single most underperforming asset class in the next 20 years."

The property agent

Javier Kindelan Williams
National director of capital markets
CB Richard Ellis

Williams: focusing on bank branch sale-leasebacks

Global property services firm CB Richard Ellis has seen sale-leaseback volumes rise significantly in Spain in the last couple of years as banks and other companies use their real estate to raise capital. A report by the firm in 2009 said the UK and Germany historically had dominated sale-leaseback activity in Europe, on average accounting for more than half of all activity. Yet the two countries' share of overall activity has been decreasing as the trend spreads into new

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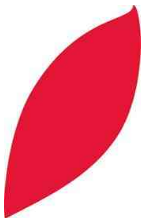

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markets, with Spain and Italy's share rising to 28 percent of the year's activity.

Williams said Banco Santander began the trend, followed by BBVA and regional banks such as Banco Galicia and Sabadel. "It is one of the areas we are focusing most on, but some of the regional banks are concentrated in areas that investors might be less interested in," he cautioned.

Central Madrid: cash-strapped savings banks have been selling assets

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