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REGIONS

Investment in India problematic but possible

February 28 2014

Hotel development in India can be a speculative venture, with debt and equity capital markets that are not sophisticated and generally opaque.

Highlights

- India has approximately 93,000 rooms in the organized sector, according to an HVS report.
- Debt costs in India are nearly 13.5% or more, according to a Sarovar Hotels executive.
- New hotel development in India is primarily done by real estate companies.


A.J. Singh

By A.J. Singh
HNN columnist

The global economic recession and slowdown perpetuated by the financial crisis of 2008 continues to leave a residue of tentative investor sentiment in global expansion decisions. BRIC (Brazil, Russia, India and China) countries, which represent the major emerging countries, have experienced economic slowdowns. However, global hotel companies and investors do not want to risk decoupling their interests from these countries.

An emerging and wealthy middle class, regulatory reforms and a relatively stable political environment all provide good foundations for continued engagement. A keen understanding of business cycles offers the solace that "this too shall pass."

With a view to taking a realistic peek at the scenario in India, this article provides select insights and perspectives on business environment and trends impacting hotel investment and development in India.

Financing and development
Based on HVS' 2013 "Hotels in India trends & opportunities" report, India has a total inventory of approximately 93,000 hotel rooms in the organized sector. This number is expected to grow by 50,000 branded rooms in the next five years.

Mansoor Adil, a senior executive VP at Sarovar Hotels, which is based in India, indicated that financing hotel development projects in India is still expensive, with debt costs of nearly 13.5% or more. Although hotels are classified as "infrastructure" for purposes of development, interest rates on hotel loans have not reduced. Furthermore, loans have short-term maturities of seven years.

A major development barrier in India is the high and speculative cost of land, which makes most city hotel projects financially unfeasible based on income returns derived from the ongoing hotel business operations. Hotel feasibility estimates rely mostly on the assumption of a higher terminal value of the underlying real estate based on a 10-year projection.

My view is that this is the equivalent of investing in a speculative stock that pays no dividends and the investor relies on

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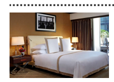
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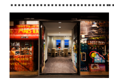
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capital appreciation of the stock to derive his or her return. This is also known as the “Greater Fool Theory,” where the stock is then sold to a “greater fool.” Combined with a long gestation period (30 to 39 months), hotel development in India can be a speculative venture, unless investors own land or acquire parcels at a low rate.

Due to these dynamics and constraints, new hotel development in India is primarily done by real estate companies as a way to diversify their portfolio mix. This also explains the growth of the mixed-use development model, such as combining hotels with retail or by companies with surplus cash that invest in all-equity development projects.

Overall, the state of the market for debt and equity capital in India is not sophisticated and generally opaque.

The hotel deal sentiment
As a cyclical business, hotel investor deal sentiments ebb and flow.

Assessing the current environment, Naveen Jain, president of Duet India Hotels, said domestic hotel companies (Taj Hotels, Resorts and Palaces; EIH Limited; and Leela Palaces, Hotels and Resorts) have continued to grow organically. However, institutional investors representing companies such as Duet, SAMHI Hotels and Xander Group have followed a combined strategy of greenfield/acquisitions based on their capabilities and appetite.

This model faces risks related to land acquisition and a state-controlled regulatory framework, with issues such as land ownership disputes, archaic laws and poorly maintained records. All these make the investment process cumbersome for uninitiated investors.

As a result, Jain recommends that international investors work with a seasoned on-the-ground team and actively participate in development with a local partner to navigate the complexities of hotel investment in India.

Deepak Talwar, a hotel veteran and former head of corporate affairs for the Oberoi Group, said several international hotel companies such as Marriott International, InterContinental Hotels Group, Accor, Starwood Hotels & Resorts Worldwide, Hilton Worldwide Holdings and others have extended their asset-light strategy in India to grow their brands. These are typically through management contracts, or franchise and marketing affiliations. These agreements range from a minimum period of 10 years to a maximum of 60 years, and the fees depend on the type of arrangement.

Indian hotel owners usually pay 3% of the sales and 7% to 8% of the operating profit to global brands. During the recent global slowdown there was pressure on the bottom line of hotel owners, which resulted in several cases of strained relationship and contract disputes between hotel owners in India and international management companies and brands. In some cases it resulted in joint-venture partners exiting India.

However, based on the current environment and my observations at the recent Hotel Investment Forum India, most of the major brands continue to maintain their presence in India and have plans to expand their portfolios, primarily in the mid-market sector as they expect the sweet spot of domestic travel in India to grow in the next five years.

A.J. Singh is the Professor of International Lodging, Finance and Real Estate Finance in The School of Hospitality Business. He has co-authored three textbooks, on International Hotel Management (2008) and Hospitality Asset Management (2009), and Best Practices in Sustainable Hotel Development and Operations was published in March, 2011. Dr. Singh was jointly responsible for the establishment of The Hospitality Business Real Estate Investment Management Specialization in The School of Hospitality Business at Michigan State University. He currently teaches the Hospitality Business Real Estate, International Lodging Development and Management and Financial Management courses at The School. He is an active member of HAMA (Hospitality Asset Managers Association) CHRIE (Council of Hotel, Restaurant and Institutional Education) and AHFME (Association of Hospitality Financial Management Educators) ISHC (International Society of Hospitality Consultants) and ULI (Urban Land Institute). Dr. Singh works closely with the Center for International Business Education and Research

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