November 18, 2017, 10:59 pm IST **Economic Times** in ET Commentary | **Edit Page**, India, Lifestyle

REAL ESTATE

Hotel is Where the Heart Is

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The outlook for India's tourism industry looks optimistic. The growth in demand for hotel rooms has strengthened to nearly 8%. The faster-growing supply, at over 15%, does not deter the broadly positive forecasts for occupancy rates in the near future.

Given the bidirectional association between the average daily room rate (ADR) and occupancy rates, a relatively flat ADR is more of a tactical, rather than strategic, concern. Hotel investments appear to be more attractive in the current scenario than in the recent past.

Raising capital for financing hotel development and investment has been a challenge. First, due to the perception that hotels are a risky investment, mortgage debt at 10-14% is expensive, financial leverage is often constrained, and relatively fewer banks are willing to finance. Second, hotel loans usually have shorter amortisation periods — 10-15 years — that stress cash outflows on an ongoing basis when loans are fully amortising, or at maturity, in case of balloon payments.

On the other hand, the burgeoning Indian middle class ceases to be disillusioned by the idea of buying homes for investment purposes. Ironically, investing in residential properties has been under scrutiny by analysts. Low current yields of 1-3%, uncertain value appreciation at an average of about 6% and high financing costs (12-15%) often render home investments as financially imprudent. So, could hotels possibly be pitched to retail investors as an alternative to residential investment?

As of now, India doesn't seem to have a well-developed mechanism for retail investors to invest in hotels. In some Western countries, this option gained some traction a decade ago, primarily in the form of 'condominium hotels'. However, such models have not been successful due to low yields and liquidity concerns in the property market. The low yield phenomenon, however, does not seem to be an issue in India.

Imagine a typical ownership model. Lata Kumar buys one of the 200 rooms at a hotel for ₹1 crore. She acquires a fee-simple title and decides to use it for 30 days herself. The remaining 335 room-nights are to be sold by the hotel management, 'HotBrand Inc', to guests. Irrespective of how many days the room is left for renting by guests, she is liable to pay nearly ₹3,700 a day towards fixed expenses amounting to a total of ₹1,10,000.

FILE PHOTO

Home suite home

For the remaining 335 days, she earns a profit of ₹2,800 a day (accounting for all expenses, fees and vacancy losses) amounting to ₹9,45,000. This means roughly ₹8,35,000 in profit. Thus, after enjoying a 30-day occupancy, Lata generates over-8% yield. Adding the 9% value appreciation, the total return is 17%. If the cost of debt is reasonably lower than this, her return on investment could be higher.

Through families like the Kumars, HotBrand Inc can raise equity capital without going through the hassles of reaching out to the public over the counter or exchanges. Besides, in many cases, they also have some degree of occupancy assurance. It may decide to earn profit either through management or franchise fees, or by owning rooms, or both.

Such investment models are not devoid of challenges. Venture structuring is a major challenge. First, HotBrand Inc must create an independent clearing house to manage owner relationships. The additional administrative costs must be delegated to owners reducing their yield.

HotBrand Inc also needs to have serious real estate portfolio management competencies. Unless HotBrand Inc positions itself as a pure hotel management services firm, or a real estate investment trust (REIT), the issue of double taxation may arise. Since the regulatory body may not recognise the hotel business as a pure-play real estate activity, the REIT would have to structure another company for hotel operations.

As the structure gets complex, HotBrand Inc must adopt extra measures to ensure transparency in cash flow to the owners who, traditionally, have been sceptical of real estate players in India. Besides, some alternative, less-risky investments, such as mutual funds, offer higher yields.

Second, HotBrand Inc must participate in an economy of agglomeration — for instance, by building a sizeable consortium of such hotels across companies and locations — to ensure a relatively liquid secondary market for ownership. While some tenure restrictions may be warranted, the owners must be assured that there will be buyers when they decide to dispose of the asset.

Third, banks must be made aware of the business models to facilitate lending to retail investors. Owners may find it difficult to raise the minimum amount of cash to buy a room as banks could perceive the lack of a secondary market as a risk. However, given more attractive yields compared to residential investments, and a small spread between mortgage rates and the unleveraged return on such an investment, investors may have an incentive to pool their equity.

With the introduction of the Real Estate Regulation Act (Rera) and the REIT Act, among others, the landscape for real estate investments seems to be improving. Transparent business models, enhanced awareness and economy of agglomeration can pave the way for a test run.

Quality operations and superior experience as a vacation home may be the key to success.

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