A NEW DAWN IN THE LAND OF THE MIDNIGHT SUN

ARE THE NORDIC COUNTRIES AT A CROSSROADS BETWEEN MANAGEMENT AGREEMENTS AND LEASES?

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Introduction

To lease or to manage, that is the question...

As the closest European countries to the Arctic Circle, the Nordic countries (Denmark, Finland, Norway, Iceland and Sweden) are unique business and leisure destinations. Although these five countries have a shared history and cultural background, each one has its own distinct individuality, presenting further growth opportunities and potential for the future.

The hotel investment market within the Nordics has long been dominated by a handful of regional investors and companies. As a result, the region has developed into a stable, attractive, if perhaps insular, and self-reliant hotel market – in terms of both development and product. There are currently only a handful of brands with significant presence across the region, although the large multinational hotel companies are making progress in entering the market. One of the main barriers to entry, besides high operating costs which come into play once the hotel is up and running, is that most hotel agreements in the Nordics are based on leases with the operator – a real estate interest – rather than management agreements, the preferred route for the large international chains.

In terms of tourism demand, the Nordics is a very regionally focused market; the five Nordic countries are the top producers of international room nights for each other, with Germany as a fifth contributor. On average, intra-regional demand for each country represents around 30% of total international overnights. In 2010, total overnights to the Nordic countries increased by approximately 7.1%, with more than 5.5 million overnights being generated from the five Nordic countries. Additionally, the tourism industry is an important contributor to the Nordic countries' economies. On average, tourism generates 3% to 4% of each country's GDP, according to the World Travel and Tourism Council (WTTC).

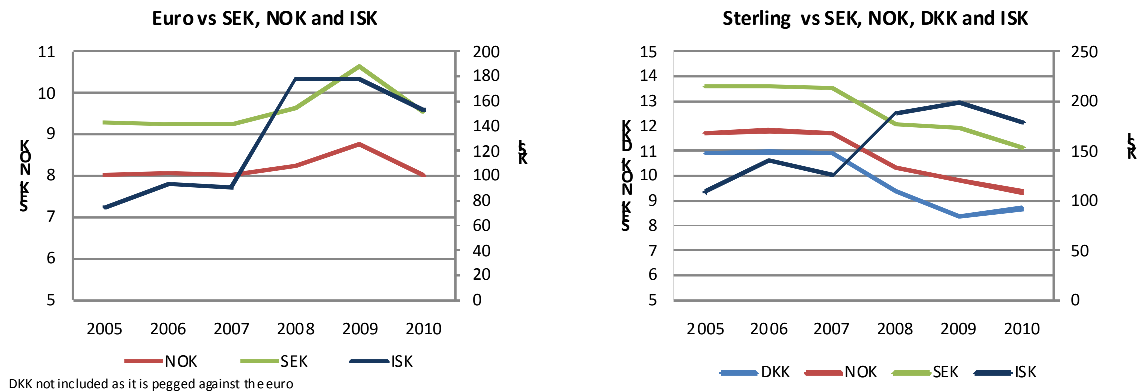
Exchange Rates

The dynamics of the different countries is evident when examining currency exchange rates against sterling and the euro, as shown in Chart 1.

The three countries forming the Scandinavian peninsula – geographically only Norway and Sweden, but, on account of the close historical, cultural and linguistic associations, Denmark and the Danish archipelago are included in this group – are quite distinct from Finland and Iceland.

Denmark has followed a fixed monetary policy since the 1980s (first against the Deutschmark, and since 1 January 1999 against the euro), although the national currency remains the Danish kroner. Norway, Sweden and Iceland's national currencies are also called kroner. Finland adopted the euro in 2002.

CHART 1: EXCHANGE RATES AGAINST THE EURO AND STERLING 2005-10



The three Scandinavian currencies behaved similarly between 2005 and 2010 against pounds sterling, indicating that the pattern of foreign investment and trade is relatively similar to the UK. In 2010, NOK and SEK both continued to strengthen against sterling, most likely owing to the strong economic performance and stability of the two countries, whilst ISK shows a clear pattern against both the euro and sterling, illustrating the economic meltdown that Iceland suffered in 2008 and has been working to recover from since.

The impact on tourism of the currency fluctuations is twofold, with strengthening exchange rates leading to the destination becoming relatively more expensive for inbound foreign tourists, as well as international destinations becoming more affordable for outbound tourists. The same applies to hotel investors looking to purchase or invest in properties in these countries. Denmark and Finland enjoyed a relatively steady relationship with EU countries, whilst Norway and Sweden became more expensive for tourists and Iceland considerably cheaper.

Capital Cities

We will begin by examining the landscape of the hotel market in the five Nordic capital cities, Reykjavik (Iceland), Oslo (Norway), Stockholm (Sweden), Helsinki (Finland) and Copenhagen (Denmark), as these are the main entry points for both commercial and leisure visitors to the region, and to individual countries.

Although the cities share some similarities in travel patterns and demand, there are essential differences which impact the dynamics of hotel performance and investor appetite for these markets.

Copenhagen, as the hub for Scandinavian Airlines, is the most easily accessible Nordic city, which is reflected in the visitation numbers to the city and Denmark as a whole. Geographically, this city is closer to other European countries than the other Nordic countries; many foreign companies looking to enter the Scandinavian market begin in Denmark. Owing to its easy access and attractive city centre, Copenhagen attracts both leisure and corporate demand.

Stockholm, often referred to as the Venice of the North as it comprises 14 separate islands, is in the investor spotlight at the moment as the top RevPAR performer out of the five Nordic capitals. Its multitude of museums, cultural attractions, restaurants and vibrant nightlife make Stockholm an attractive city-break destination, which has helped to boost hotel performance. Additionally, Sweden's economy appears to have rebounded well from the downturn, further brightening the city's outlook.

Oslo, with a population of just under 1 million (in the wider metropolitan area), is the smallest of the three Scandinavian cities. The city is Norway's trade, banking, industry and shipping hub, and has a number of cultural attractions; thus, making it attractive for both business and leisure travellers. The recent tragic events in Norway have sadly put the country in the spotlight, but it is hoped that visitation will not be adversely affected to a great extent.

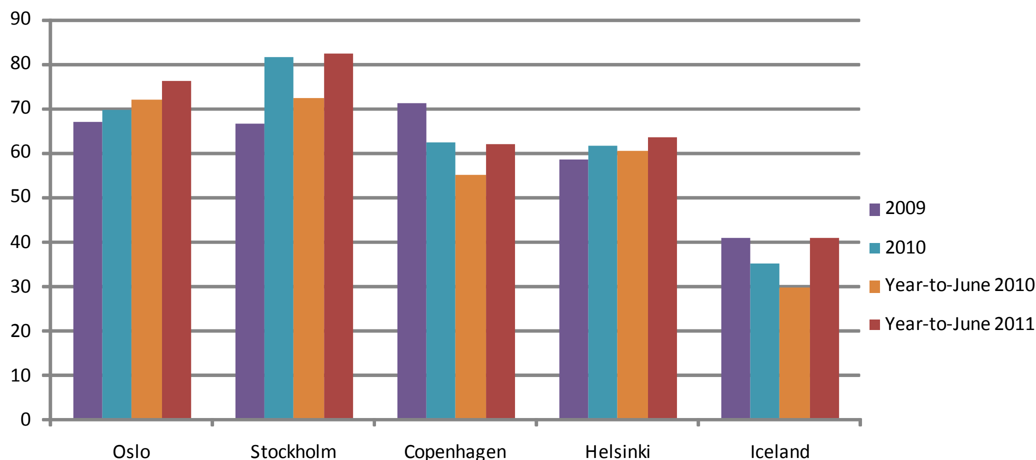
Helsinki is a modern city on the Baltic Sea with more than half a million residents. In 2000, Helsinki was an official European City of Culture while celebrating its 450th anniversary. It was was also chosen to be the World Design Capital in 2012 by the International Council of Societies of Industrial Design, beating Eindhoven for the title.

As well as its capital, **Reykjavik** is also the largest city in Iceland. It is in the southwestern part of the country and is the heart of economic and governmental activity. During the summer months, the city enjoys 22 hours of daylight and its main attractions and nightlife appeal to visiting tourists. Owing to Iceland's natural beauty, Reykjavik enjoys a high level of leisure demand, although this is limited by a strong seasonality pattern due to the harsh winters.

Hotel Performance

Chart 2 shows RevPAR in euro for four of the five cities and for Iceland as a whole, for 2009 and 2010 and year-to-June 2010 and 2011. We can see the clear impact on RevPAR of the increase in supply in Copenhagen, a market which continues to be attractive for investors despite its apparent struggle to recover from the new supply, although year-to-June RevPAR is encouraging. Oslo and Helsinki, on the other hand, both show an increase in RevPAR even in 2011, and these figures are pre-summer thus further growth is likely by the end of the year. Stockholm is starting to feel the impact on occupancy of its new supply carving out a demand base, although thanks to a strong average rate RevPAR is still showing growth in 2011.

CHART 2: REVPAR FOR OSLO, STOCKHOLM, COPENHAGEN, HELSINKI AND ICELAND 2009-YEAR-TO-MAY 2011 (€)



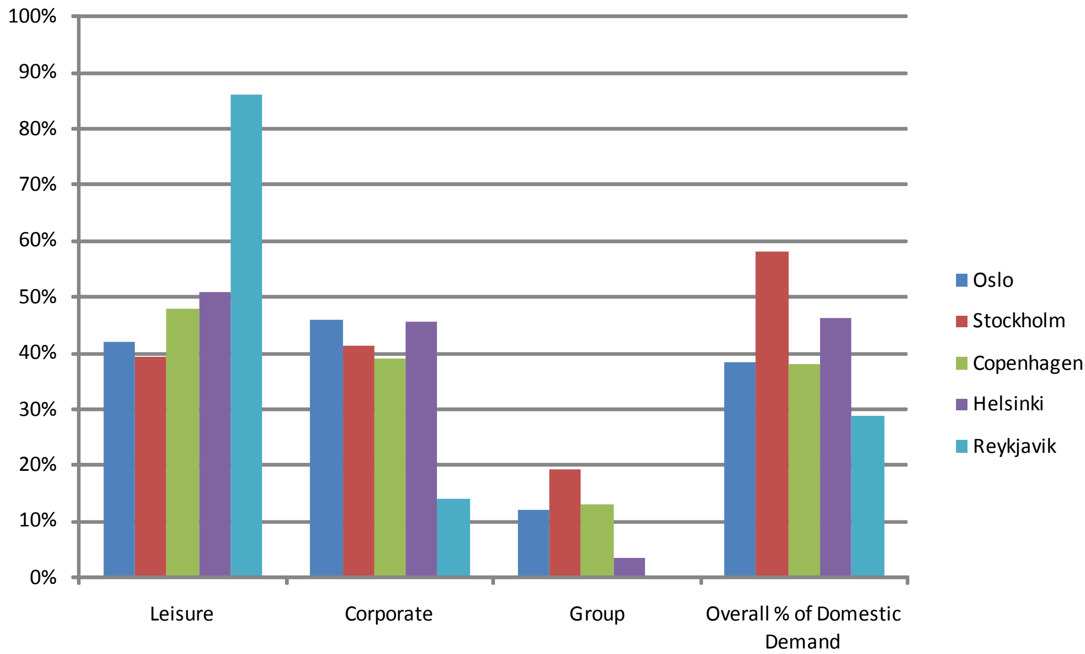
Source: STR Global

Iceland's RevPAR decreased in 2010, although year-to-June 2011 shows a very healthy improvement on the same period in 2010, encouraging us to expect a slight increase in RevPAR by year-end 2011.

Market Segmentation

The following chart illustrates the breakdown of hotel demand for each city, divided into three segments, as well as the overall percentage of domestic demand for each city.

CHART 3: MARKET SEGMENTATION BY ROOM NIGHTS



Sources: Statistiks Denmark; Statistiks Norway; Stockholm Visitors Board; Visit Helsinki

Segmentation varies between the destinations, based on their attractiveness to leisure travellers and the importance of domestic demand. Copenhagen and Stockholm are easily accessible and popular destinations for weekend breaks for leisure guests from around Europe. Oslo is not Norway's primary leisure destination; Bergen, on the west coast amidst the famous fjords, attracts more leisure demand. Helsinki, similarly to Copenhagen, has a higher proportion of leisure than corporate guests. Reykjavik is largely a leisure-driven market, particularly during the summer months, with the corporate segment amounting to less than 20% of overall demand. Groups are not a significant segment for Reykjavik. In contrast to the other four Nordic capitals, Reykjavik also benefits from a much higher percentage of international travel, as domestic demand accounts for less than 30% of room nights. This can be attributed partly to Iceland's small geographic area (which renders accommodation needs for the domestic market less necessary) and its relatively small population base (320,000 inhabitants).

The region's domestic markets, in terms of both leisure and business travel, are vital, and this is reflected by the high percentage of domestic demand. Intra-regional demand is also highly relevant; this is supported by airport passenger statistics, which are not shown here, but illustrate that on average both Stockholm and Oslo recorded approximately 50% international travellers and 50% domestic over the last decade. Only 25% of passengers passing through Copenhagen airport are domestic travellers, the rest being international, as it is the worldwide hub for Scandinavian Airlines. The geographical sizes of the countries and relative distances from one business hub to another affect the percentage of domestic visitation.

Hotel Supply

Although in four of the five cities the majority of rooms supply is branded, the distribution of this inventory amongst brands is uneven. Radisson Blu (part of Rezidor Hotel Group) is in the top three hotel room suppliers in each of the five cities.

- The largest supplier of hotel accommodation in Oslo is Thon Hotels and Resorts, with 16 hotels and 2,664 rooms. More than 50% of rooms supply in the city is controlled by only three hotel companies, Thon Hotels and Resorts, Rica Hotels and Radisson Blu;
- In Stockholm city centre, Scandic dominates the market with 14 hotels (3,421 rooms). The top three brands in the city, Scandic, Radisson Blu and Clarion, account for just over one-third of total rooms supply;
- In Copenhagen and Helsinki, Scandic and Radisson Blu are the two main brands; however, in Copenhagen the three top suppliers represent barely one quarter of overall rooms supply, indicating a more diverse market. Sokos Hotels, a domestic Finnish brand, also has a strong presence in Helsinki with almost 20% of the city's rooms inventory;
- Reykjavik, the smallest of the five markets in terms of hotel rooms – with just under 3,000 rooms compared to more than 17,000 rooms in Stockholm – is dominated by two domestic companies: CenterHotels and Fosshotels (which comprise 14% and 9% of total supply, respectively).

Across the entire Nordic region, the largest brand in terms of hotel properties is Choice Hotels Scandinavia (Clarion, Quality and Comfort brands), with 159 hotels and more than 24,000 rooms. Although Choice Hotels is not predominant in the Nordic capital cities, it is widespread throughout the region with a number of hotels in secondary cities. The second largest is Scandic, with approximately 142 hotels. However, Scandic is the leading hotel company within the region in terms of room quantity, with more than 26,000 rooms throughout Sweden, Norway, Denmark and Finland, making it the largest operator overall.

CHART 4: BRANDED HOTEL SUPPLY IN OSLO, STOCKHOLM, COPENHAGEN, HELSINKI AND REYKJAVIK

			Rooms Supply				Top Three Brands			
	Hotels	Rooms	Branded		Unbranded			Hotels	Rooms	% of overall rooms supply
Oslo	72	10,376	9,156	88%	1,220	12%	Thon Hotels	16	2,664	26%
							Rica	11	1,605	15%
							Radisson Blu	3	1,346	13%
Stockholm	115	17,116	11,347	66%	5,769	34%	Scandic	14	3,421	20%
							Radisson Blu	5	1,590	9%
							Clarion	4	1,274	7%
Copenhagen	85	13,121	4,658	36%	8,463	64%	Scandic	5	1,212	9%
							Radisson Blu	3	968	7%
							First Hotels	3	778	6%
Helsinki	27	8,141	6,225	76%	1,916	24%	Scandic	4	1,625	20%
							Sokos	7	1,542	19%
							Radisson Blu	2	627	8%
Reykjavik	13	2,949	1,343	46%	1,128	38%	CenterHotel	5	413	14%
							Radisson Blu	2	297	10%
							Fosshotels	4	262	9%

Sources: HVS Research; STR Global

Many of the top-five hotel chains in the world are underpresented in the region. There are only three properties under Marriott brands and three under Hilton brands across the three

Scandinavian capitals (albeit that Scandic has periodically passed through Hilton's hands). Starwood has one Sheraton hotel in Stockholm and one Luxury Collection property in Helsinki. InterContinental Hotels Group recently opened a Crowne Plaza outside Copenhagen. There are only four internationally branded hotels in Reykjavik: two Radisson Blu hotels, a Park Inn and a Hilton (all of which are operated either under lease agreements to the brand or franchised).

However, at the beginning of the year Marriott stated its intention to grow within the Nordic region by announcing its first hotel in Finland. It has been reported that the group is looking at doubling its portfolio in the region by 2015. Hilton is also eager to gain a larger presence in the region, and has significantly ramped up its development resources following the opening of the Doubletree by Hilton Oslo City Centre last year. These growth plans further emphasise the region's growing importance to the major international chains.

Chart 5 lists the new supply expected to enter four of the region's capital cities over the next few years – there are no new hotels planned in Iceland that we are aware of.

CHART 5: NEW SUPPLY IN THE NORDIC REGION 2011-2013

Property	Number of Rooms	City	Country	Opening Date
Bella Sky Comwell Hotel	814	Copenhagen	Denmark	May-11
Scandic Stavanger Forus	240	Stavanger	Norway	Jul-11
Scandic Vulkan	149	Oslo	Norway	Sep-11
Scandic Victoria Tower	299	Kista	Sweden	Sep-11
Scandic Grand Central Stockholm	391	Stockholm	Sweden	2011
Scandic Århus City	226	Arhus	Denmark	2012
First Hotel Flesland	248	Bergen	Norway	2012
Scandic Fornebu	298	Oslo	Norway	2012
Radisson Blu Hotel Uppsala	185	Uppsala	Sweden	2012
Helsinki Marriott Hotel	272	Helsinki	Finland	2013
Radisson Blu Sorlandet Resort	290	Arendal	Norway	2013

Source: HVS – London Office

We make the following comments on the proposed supply in the preceding chart.

- Danish company Comwell Hotels opened the **Bella Sky Comwell Hotel** in May**.** The 814-room property is the largest hotel in the Nordic region and is adjacent to the Bella Centre in Copenhagen. Apart from the usual facilities, it has a unique sky lounge on the 23rd floor with panoramic views of the city and surrounding countryside;
- Scandic Hotels is the most active hotel company in the region with a number of openings planned in the next two to three years. Scandic has a total of 1,603 rooms in its pipeline to be completed by 2013 in Denmark, Norway and Sweden. Norway alone accounts for more than 40% of the company's development pipeline, with two hotels opening in Oslo and one in Stavanger: the **Scandic Fornebu,** the **Scandic Vulkan** and the **Scandic Stavanger Forus**. Scandic's flagship hotel will open in Stockholm this autumn: the **Scandic Grand Central Stockholm**. This hotel, which will be housed within a historic building, will have 391 rooms, one restaurant, two bars and nine meeting rooms. These expansion plans further emphasise Scandic's desire to strengthen its brand presence throughout its home region;
- First Hotels, a Norwegian hotel company, will be opening the **First Hotel Flesland** in Bergen, within close proximity to Bergen Flesland Airport. In addition to 248 rooms, the hotel will have extensive meeting and conference facilities with capacity for a maximum of 700 people. Other facilities include a restaurant, a fitness centre and parking spaces. The

hotel is expected to open in 2012, in time for the opening of the new terminal at the airport in 2013;

- Rezidor has also been growing its portfolio within the Nordic region with the addition of two hotels in Norway and Sweden. The **Radisson Blu Sorlandet Resort** in Norway, opening in 2013, is expected to be one of the country's largest resorts with 290 rooms, two restaurants, a lobby bar, meeting and conference facilities and a spa/wellness centre. Additionally, the resort will also offer 40 chalets for sale, a year-round skating rink, a cinema, an aqua park, indoor parking, a marina and a shopping gallery. In Sweden, the 185-room **Radisson Blu Uppsala,** in the Uppsala Travel Centre, is a short distance from Uppsala city centre and approximately 18 km from Stockholm's Arlanda Airport;
- The **Helsinki Marriott Hotel** is expected to open in 2013. The 272-room hotel will have more than 1,000 m^2 of meeting space, a health club and food and beverage outlets. This will be Marriott's first hotel in Finland and it will be within a ten-minute drive of the city centre, a short distance from the airport and in close proximity to the Tapiola and Keilaniemi commercial districts.

Transactions

The market remains very regionally constrained with a handful of investors – mostly Norwegian pension funds or high-net-worth individuals – and few outside investors.

- The **Radisson Blu Strand** in Stockholm recently sold for SEK600 million, or SEK4.5 million per room (EUR430,000), a record for Stockholm and Scandinavia as a whole. The hotel was sold to the Swedish Order of Freemasons by Home Properties, who owned the original building. The transaction brings ownership of the underlying building full circle as the Swedish Order of Freemasons constructed the property for the Stockholm Olympics in 1912;
- Home Properties also sold another of its properties: the **Ibis Nyköping** in Sweden. The hotel was acquired by a joint venture including Sveafastigheter, Midstar and Event Holding for an undisclosed sum. The sale is in line with Home Properties' strategy to realign its portfolio to include only hotels operated by Nordic Choice Hotels;
- International investors in the Nordic region – with the exception of Copenhagen – remain few, with the most recent transaction being the purchase of the Courtyard by Marriott Stockholm by Invesco Real Estate Fund in early 2010 for an estimated EUR66 million, or EUR237,000 per room.

In terms of hotel values, HVS' 2010 Hotel Valuation Index ranked Stockholm and Copenhagen 13th and 16th, ahead of Frankfurt, Berlin and Brussels. In 2010 Stockholm showed an increase of 3% over 2009 values, whilst Copenhagen displayed a slight decrease of less than 1%. However from 2011 onwards both markets are forecast to increase in hotel values thanks to augmented investor interest and strengthening market conditions.

Lease vs Management Contracts

So let's get back to the discussion between hotel management agreements ('HMAs') and leases. The pros and cons of each type of contract have been widely debated. This debate gained particular momentum over the last 18 months, as banks scrutinised financing for hotel projects. Leases have traditionally been viewed as a more secure income stream, particularly when backed by a corporate guarantee from an internationally regarded operating company. But are the structure of leases and MAs moving more and more towards a middle ground, particularly as all parties seek to align their interests?

To better understand the differences between lease agreements and MAs, it is prudent first to examine the implied risk of each structure to the owner and the operator. Under the MA, the owner fundamentally owns not only the real estate, but also the business itself. The owner is thus responsible for the costs associated with operating the business (including suppliers and employees), and pays the operator for the professional, day-to-day management of the hotel operation through management fees. Branding/licence and marketing fees are included in the management agreement. In addition, the owner is also responsible for maintaining the asset throughout its lifecycle in the form of capital investments. For the risk taken, the owner is left with all of the net operating income of the operation, as well as the potential for real estate capital gains upon the sale of the asset.

Under a lease, the owner still owns the real estate, but grants the rights of the operation to a tenant in exchange for a rent payment (fixed, variable or hybrid). This fundamentally shifts the operating risk to the operator, who must now pay for all operating costs (suppliers/employees), as well as rent for the use of the property. In addition, the operator may be also be required to fund all or a large portion of any future capital expenditure, depending on the type of lease. The net operating income of the operation is kept by the operator. Any capital gains on the sale of the asset remain with the landlord, although the lease obligation on the property generally survives the sale of the asset.

Chart 6 briefly summarises the division of risk and responsibilities between the owner and operator under a lease agreement and an HMA.

CHART 6: LEASE VS HOTEL MANAGEMENT AGREEMENTS – DIVISION OF RISK AND RESPONSABILITIES

Management Agreement		Lease
Owner	**Hotel Operations**	Operator
Owner	**Suppliers/Employees**	Operator
Owner	**Asset (Capital Investment)**	Operator
Pays management fees to the operator for professional management of the hotel		Pays rent to the owner for the right to use and operate the hotel
Owner	**Residual Income of the Hotel**	Operator
Owner	**Operational Risk**	Operator

A further stumbling block is the willingness of lenders to provide debt financing under each type of contract. The following chart illustrates the dilemma between the interests of lenders and investors, when presented with the two different contract structures, and the implications for each party.

CHART 7: INTERESTS OF LENDERS VS INVESTORS

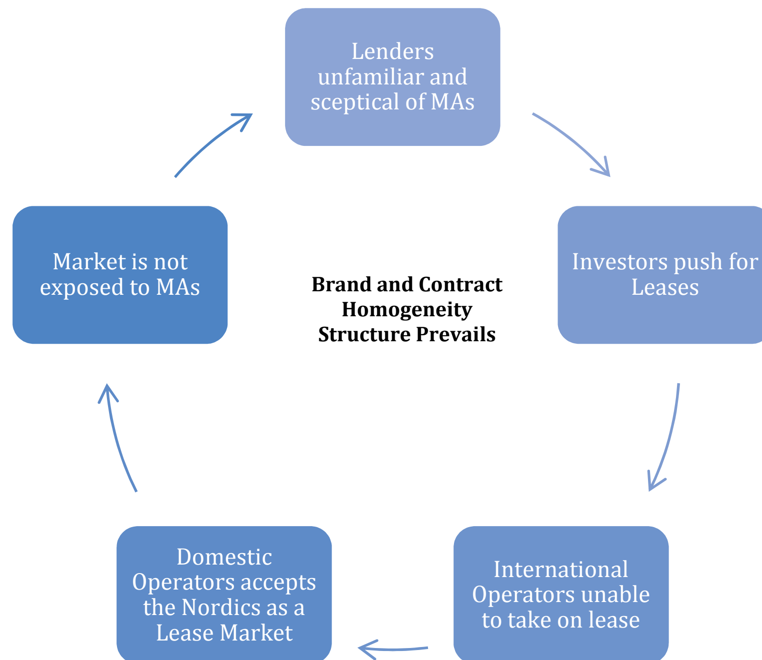
	Management Agreement	Lease
Lender Rationale	Borrower cash flow more risky, as borrower bears operational risk	Borrower cash flow less risky, as rent income more 'certain', provided hotel is not 'over-rented'
	Hotel operator selection is crucial	Minimum rent guarantee further reduces perceived risk
	Potentially more attractive debt coverage ratio as borrower cash flows potentially higher	Potentially lower debt coverage ratio as borrower cash flows more stable but potentially lower
Investor Rationale	Potential to benefit more from positive fluctuations in the business cycle	Less potential to benefit from positive cycle, however significantly less risk during downturns
	Cash to service debt potentially higher during good times but the converse is also true	Cash to service debt constant, with small fluctuations during good times
	Hotel operator selection is crucial	Lease guarantor is crucial

For the investor, the issue of whether the residual earnings of the operation (when discounted to a net present value) are likely to be higher than the rental payments from the operator over the holding period of the asset is an essential part of whether a lease or HMA is preferable, as well as the potential for capital gain upon disposal of the asset. Unfortunately, investors are often swayed in one direction by the willingness of the lender to provide debt financing based on their perception of the risk associated with each case, and the investor's own risk profile.

Although this discussion could be applied to many different markets and is continuously debated, the issue is all the more glaring in the Nordic region, which is known for high labour costs, the elevated cost of goods and high taxes, and unfortunately average rates are not high enough to compensate for the perceived operational risk. Departmental profit at full service hotels in the region averages 50%, whilst the same branded hotels in the UK or Germany run with departmental profit levels of 60% and over. Similarly gross operating profit (GOP) levels below 30% are not uncommon, whereas other regions – the UK in particular – are likely to produce GOP levels closer to 40-50%. Therefore, it can be a costly endeavour to attempt to break into the Nordic market. The result of this is that in order for a hotel operation in the region to sustain its lease payments, a fairly similar product type has evolved as the optimum profitable operation for both operator and investor/owner. In this way, regional brands such as Scandic, Radisson Blu, Thon Hotels and a handful of others have perfected their operating models and dominate the hotel landscape almost entirely.

Chart 8 illustrates this self-perpetuating cycle in the Nordic markets.

CHART 8: THE NORDIC DILEMMA



To address the perceived risk associated with an MA, hotel operators are including more 'guarantee' clauses in their agreements, intended to reduce the uncertainty provoked by the potential fluctuation in owner cash flow. Operators originally steered away from guarantees and owner priority clauses in order to protect their own liability, but they are being forced to reconsider such clauses in order to compete for prime development sites. Some examples include:

- Guaranteed levels of net operating income (percentages of revenue or amounts);
- Base fees on a moving scale – particularly for an opening property – from as low as 1% in the opening year to 2-3% by the third or fourth year of operation;
- Providing key money, particularly for prime locations and new properties and/or landmark properties;
- Subordinating fees to thresholds on total revenue and rooms revenue, and if the threshold is not achieved the fees are not paid out.

In all cases, the real credibility lies in the guarantee behind the agreement, not necessarily the stringency of the various clauses within the agreement.

A brief survey of the development pages on top international companies' websites showed that Rezidor is one of the few international hotel operators which includes lease agreements as an option on its website and provides details of the typical structure of its agreements, further indicating that many international operators still do not favour this type of operational agreement and prefer to operate under management agreements.

Conclusion

How likely is this cycle to be broken? The answer lies in another question... At what point will the regional brands no longer be able to expand within their home markets and individual properties begin to cannibalise each other's business base? There are currently around 20

Scandic hotels in the Greater Stockholm area, not including those under development. In this case, the risk implication for the investor/owner of the properties is clearly much greater than for the hotel brands, which will still have their numerous hotels to rely on. Rent payments, however, may become increasingly difficult to cover. In addition, proposed changes in the International Accounting Standards on the handling of operating leases and accounting on corporate balance sheets may also impact hotel companies' ability to tie themselves to leases.

Is the tide turning within the Nordic region as more international companies look to expand into these markets, and open up the door to a more international platform for investors and travellers alike? Watch this space.

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