

# Hotel REITs more hospitable for investors

## After weathering SARS and 9/11, trusts resuming or increasing distributions

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Canadian hotel REITs have faced an uphill slog for the past four years, hit sequentially by the September, 2001, attacks in the United States, a faltering North American economy and finally by the panic surrounding SARS, or severe acute respiratory syndrome, which erupted in early 2003.

But this year things are looking up.

All four of the hotel-owning REITs reported positive total returns for the six months ended June 30, 2005.

Investors, some of whom had seen payments from distributable profits suspended by some of the REITs, had payments reinstated or increased.

Three of the four REITs posted increased "revenues per available room" or RevPAR, the industry's benchmark performance figure, for that period. That's a far cry from their results just two years ago, when hotel bookings plummeted in the wake of the worldwide publicity surrounding SARS.

Toronto hotels took the worst hit, as their RevPAR in the first six months of 2003 tumbled 29.5 per cent below what it had been in the previous year, according to PKF Consulting in Toronto.

Still, Rossa O'Reilly, managing director and real estate analyst at Toronto-based CIBC World Markets, calls the present recovery a "restrained" one.

"U.S. tourism still hasn't rebounded, probably because of a higher Canadian dollar, discounted air fares for domestic travel in the U.S. and border tie-ups," he says.

And there is still lingering fallout from the 2003 SARS scare, he adds, since bookings for large groups are often made two years ahead. "Worst hit are hotels in the larger cities that rely on conventions and U.S. visitors -- the Legacy REIT is front and centre."

**Legacy Hotels Real Estate Investment Trust**, which has 40 per cent of its rooms in Toronto, Montreal and Vancouver, including Montreal's Fairmont Queen Elizabeth and the Fairmont Royal York in Toronto, has lagged behind others in the recovery, says Gail Mifsud, real estate and lodging analyst at Raymond James Ltd. in Toronto.

In the first half of the year Legacy's funds from operations -- one commonly accepted measure of REIT operating performance -- fell to 4 cents a diluted unit from 14 cents and RevPAR declined slightly by 0.8 per cent, she says.

After suspending its 74-cent annual distribution early in 2003, Legacy, the largest of the hotel REITs, with a market capitalization of \$641-million, has reinstated an annual distribution of 32 cents.

But the REIT is still not reaching the profit or operating margins it did in previous years, Ms. Mifsud says.

"We are lowering our full-year 2005 estimated funds from operations from 62 cents to 50 cents per diluted unit -- the third quarter, which includes summertime travel, is a critical one for this REIT."

Still, Ms. Mifsud sees the REIT as trading near the units' intrinsic value. She says investors should be patient because at around \$7 a unit, Legacy is trading very close to its book value of \$6.90, while the other three hotel REITs trade on average at 1.6 times their book value.

"This is a value play. We have an outperform rating on Legacy and based on a continued recovery in this sector, steady economic growth and a limited new supply in upscale hotels, we have a target price of \$7.50 on it, which offers a 10-per-cent total return for long-term investors."

While Legacy concentrates on luxury hotels, Vancouver-based CHIP, or **Canadian Hotel Income Properties REIT**, focuses on mid-market brands such as Delta, Radisson, and Crown Plaza that rely largely on Canadian rather than foreign guests, says Leslie Lundquist, portfolio manager with Calgary-based Bissett Investment Management Ltd.

This makes the REIT less vulnerable to tourism from the United States, which is still depressed.

CHIP reported a 5.5-per-cent gain in RevPAR for the first six months of this year, as well as 43 cents in diluted distributable income a unit -- another commonly accepted measure of REIT performance -- up 16 per cent from the 37 cents posted in the same period last year, Ms. Lundquist says.

"We like the mid-market, Canadian focus and we also like their low debt ratio; with about 30 per cent debt and 70 per cent equity, CHIP is the least levered of the REITs, which is important in a volatile industry that can go through tough times."

CHIP had a "spectacular" second quarter, with RevPAR rising by 7.2 per cent, adds Ms. Mifsud. "Their portfolio is heavily concentrated in Western Canada, in Manitoba, Saskatchewan and Alberta. As a result of the oil boom and increasing agriculture-related business, RevPAR here has been higher than in the rest of Canada."

**InnVest Real Estate Investment Trust**, which has Canada's largest hotel portfolio, with 132 properties and a market capitalization of \$590-million, also reported solid six-month results. Diluted distributable income rose by 3.6 per cent to 31 cents a unit from 29.9 cents in the previous year and RevPAR increased by 6.5 per cent.

Oscar Belaiche, vice-president and portfolio manager at Dynamic Mutual Funds in Toronto, says InnVest is a substantial holding in some of their funds. He likes it because of its 9-per-cent yield and its focus on limited-service, lower-overhead hotels, including franchise brands such as Travelodge and Comfort Inn.

**Royal Host REIT**, the smallest of the four with a market capitalization of \$141-million, came to market in 1998 at a price of \$10 and hit an all-time low of \$3.90 in October, 2003. During that period annual distributions fell to 24 cents a unit from 96 cents.

Royal Host reported a 1.4-per-cent gain in RevPAR for the first six months of this year, while diluted per unit cash available for distribution rose to 24 cents from 21 cents in the preceding year.

The REIT has increased its monthly distribution to 3.5 cents from 3 cents, or 42 cents annually, for a yield on the current \$5.70 price of about 7.4 per cent.

Some experienced investors see untapped potential in this REIT.

Deep-value investor Irwin Michael, president of Toronto-based ABC Funds, has bought more than one million units in Royal Host and now owns about 4 per cent of it. He maintains that the REIT is in transition and that at its current price of about \$5.70, it is fundamentally undervalued.

Royal Host has recently sold troubled properties, such as the Oklahoma Marina.

"We estimate Royal Host's current net asset value at \$6.50 a unit and with given management's firm intention to return the trust to its core competence in hotel ownership and management, the net asset value could easily reach \$7 a unit," he says.

The recent 18-per-cent ownership position taken by Geosam Investments, a private investment firm controlled by George Armoyan, is also seen as a catalyst for change, since he has a history of buying large stakes in undervalued companies and introducing new strategies, Mr. Michael says.

## Hotel REITs

6 months ended June 30

	Mkt. Cap (\$million)	Annual distribution	% change in rev. par
Legacy	\$641	\$0.32	-0.8
InnVest	590	1.12	6.5
CHIP	463	0.90	5.5
Royal H.	141	0.42*	1.4

\*as of Sept. 30, 2005

*SOURCE: ANALYSTS*

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