



University of Pretoria

**Hotels as an Alternative Property Investment Asset Class and its
Funding Challenges in South Africa**

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(MSc) (Real Estate)

In the Faculty of Engineering, Built Environment and Information Technology
University of Pretoria
Department of Construction Economics

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Declaration

I, the undersigned, hereby confirm that the attached treatise is my own work and that any sources are adequately acknowledged in the text and listed in the bibliography.

I accept the rules of the University of Pretoria and the consequences of transgressing them.

This treatise is submitted in fulfillment of the requirements for the degree of **(MSc) (Real Estate)** at the University of Pretoria. It has not been submitted before for any other degree of examination at any other University.

Signature of acceptance and confirmation

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Date: July 2021

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Abbreviations

Adjusted Gross Operating Profit	AGOP
Broad Based Black Economic Empowerment	BBBEE
Building Information Modelling	BIM
Capital Gains Tax	CGT
Development Funding Institution	DFI
Euro Interbank Offered Rate	EURIBOR
Furniture, Fixtures and Equipment	FF & E
General Manager	GM
Gross Lettable Area	GLA
Hotel Management Agreement	HMA
Internal Rate of Return	IRR
Johannesburg Stock Exchange	JSE
London Interbank Offered Rate	LIBOR
Living Standards Measure	LSM
Meetings, Incentives, Conferences and Exhibitions	MICE
Net Present Value	NPV
Real Estates Investment Trust	REIT
Return On Equity	ROE
Return On Investments	ROI
Operator Suppliers Equipment	OSE
South African Property Owners Association	SAPOA
Strategic Business Unit	SBU
Small and Medium Enterprises	SME's
State Owned Entities	SOE's
Venture Capital Company	VCC

Abstract

Title: Hotels as an alternative property investment asset class and its funding challenges in South Africa

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Institutional investors and corporates are constantly looking to achieve double digit yields in relation to investments in traditional real estate assets. With retail, office and residential property under pressure the study set out to determine how hotels perform compared to traditional property investment asset classes in terms of investment yields during different stages of the property cycle, and whether investors (property developers and institutional investment funds) are considering the hospitality sector for investment or diversification of current portfolios. Furthermore, to determine how aligned the commercial banks, Development Funding Institutions (DFI) and Section 12J funds are with funding single hotel assets versus portfolio lending, and what their requirements are.

As an exploratory study, interviews were conducted to obtain in- depth and rich information from purposively selected respondents with experience in the sector after completing a preparatory questionnaire. Respondents included property developers, investors, financiers, tour operators and hotel operators. Results confirmed that both developers and investment funds are indeed considering hotels as an alternative investment since the yields are favourable when compared to other asset classes, yet with a longer investment horizon. Hotels required time to stabilise and at this point an

expected yield should be higher than 12.5% which is higher than initial yields for traditional commercial properties. Historically, hotels investors were very specific in their investment asset classes and usually purely focused on hospitality assets (specialist investors). This has now changed with an increase in generalist investors coming to the market with exposure in a diversity of asset classes including the hospitality sector.

Funding challenges, due to the operational risk associated with Hotel Management Agreements (HMA) is perceived by both financiers and developers or investors. Leases are the preferred income model but are seldom available in the hospitality sector and often those that are made available, may not provide the strong covenants required by financiers and developers/investors. Alternative funding is available in the form of Section 12J VCC's or from DFI's but both have their limitations as became apparent in the results. Recommendations for further research include funding challenges for a development or acquisition strategy at a single asset and portfolio level, and expansion to Sub-Saharan Africa as it impacts many investors and international hotels brands with exposure in these regions.

Keywords: hospitality assets, hotel funding, hotel management agreements, franchise agreements, leases, development funding institutions, commercial banks, section 12J.

Chapter 1: INTRODUCTION

Property development has slowed significantly in the last few years which can be attributed to an ailing economy in South Africa (Matsangou, 2019) as well as a maturing property cycle which has seen retail and commercial property investment boom far beyond economic growth sustainability. Many “traditional property investment asset classes” which include commercial, retail and residential assets have been under pressure in terms of achieving desired returns. De Loo (1995) points out that property funds or institutional investors in South Africa did not view hotels as suitable for their portfolios. Developers and property funds are now exploring alternative property investment asset classes which include hospitality, medical associated properties and student accommodation to achieve desired returns.

Institutional investors and corporates are constantly trying to achieve close to double digit yields in relation to investments in traditional property assets (Seroto, 2018). Now that these yields are difficult to achieve in this economy, many are looking at alternative property investments not previously considered, but little evidence is available when comparing average yields with these property asset classes. If one examines the Real Estates Investment Trusts (REIT's) listed on the Johannesburg Stock Exchange (JSE), there are only two REIT's solely focusing on hospitality as a property investment asset class, being Hospitality Property Fund and City Lodge. However, a recent research article by Jones Lang LaSalle (JLL) shows how hospitality investors, being listed or non-listed entities, are moving away from being specialist investors in hospitality to more generalist in all asset classes (JLL, 2018).

When looking at hospitality developments in South Africa, commercial banks have remained conservative in their risk appetite in funding hotel developments or acquisitions. Most lending has been driven by leveraging off existing portfolios that consist of more traditional property assets which are then cross collateralised, and even in this regard, is

lowly geared or leveraged. The reality is commercial banks are conservative at best when considering funding in the hospitality sector. The most notable source of funding hotels is through the Development Finance Institutions (DFI's), but there is less knowledge of the some 140 DFI's in Africa and their capabilities in funding projects (Calice, 2013:1). A further limiting factor is that most international DFI's are not mandated to fund hotel developments in South Africa due to the country's strong and independent financial system. Local DFI's are positioned to assist (Baloyi, 2011), but require black ownership representation in a development and this is often a challenge in completing a development due to equity requirements. Most international DFI's traditionally focus on assisting countries in Sub-Saharan Africa where strong development is required due to the human element of job creation and economic building.

South African investors and developers have been searching for yields outside of their traditional property investment asset classes and this is introducing new lenders to the sector (JLL, 2018). A new funding mechanism is that of a 12J Fund which is a Venture Capital Company (VCC), looking to raise capital for projects by giving tax incentives to its investors (Sacks, 2019) as per government legislation. Government has realised the need to create jobs and has created this mechanism where investors receive a tax benefit when investing in VCC's that participate in such projects (Sacks, 2019). It is not available across all sectors and only focuses on sectors that have an economic impact and look at providing jobs (Sacks, 2019). The sectors primarily "property" focused, would include the following:

Hotels, lodges and serviced apartments which fall under the hospitality sector and are defined as an immovable property that has its trade carried as a hotel keeper. This must include the following as a minimum according to Sacks (2019):

- Let out a room for short term stay
- Offer a meal served on the premises

- Provide a furnished room
- Service the rooms daily
- All guests must pay for the use of the room
- There are no times when a room is not available to guests for use – i.e. the room cannot be closed for business when an investor may potentially use it

Other property types included are **student accommodation**, **renewable energy** such as solar panels, and **mining** which includes the land rights.

12J funds are an attractive alternative to commercial banks or DFI funding, but have limitations, the main challenge being that a VCC cannot invest more than fifty million rand in a single hotel development. In addition, the 12J requires 10% shareholding in the project which is a challenge for most developers (Sacks, 2019). If one considers The Capital Hotel Group which is the fastest growing owner managed, fully serviced four-star brand (Klein, 2019) in South Africa, one will note that the Westbrooke 12J fund is partially funding this roll out, but that significant investment is required over and above the fifty million per project (Klein, 2019).

The challenge remains with commercial banks and the fact that they prefer leases, yet the reality is that there are few to no leases available. This leasing trend is more popular in South Africa than other countries (Rogerson JM, 2012:200), but is a trend that has changed significantly. Market volatility in South Africa is not well suited for this type of operating agreement (JLL, 2016). If leases are made available, they may provide excellent security to commercial banks which is required as per their credit policies, yet the operators that offer these leases are often operators with weaker balance sheets or those that are new to the industry. A fixed lease or a hotel management agreement has difference in terms of risk allocation between the property owner and the hotel operator. Fixed leases give the investor a fixed return income with little risk of variation, but with less control over the property by the tenant. Often there are specific brand standards to

be upheld and it brings about great difficulty if the landlord has full control over the property (deRoos, 2010).

A hotel management agreement on the other hand provides operators with a more active asset management approach, but most importantly in this approach the property owner would share in the operational risk. This would allow the property owner to share in the upside of the business, but risk is higher for the property investor due to the operational risk association (Sampson, 2012). This would mean that the owner has operational risk in addition to the development risk. As with traditional commercial property, the operational risk falls away once income is received based on the fixed lease. The owner would be contracted to be more involved with operational requirements such as hiring the General Manager (GM), employing the staff for the hotel, approval of budgets for the hotel, etc. The relationship is not reflective of a property owner letting to an operator, but rather that of a property owner that has risk in the operational business of the hotel. Additional risks to the owner would be that the hotel management agreements are long term, normally starting at 15 years; as well as Furniture, Fixtures and Equipment (FF & E) and Operator Suppliers Equipment (OSE) being the developer's responsibility. This is not the norm in other commercial property assets.

Hotel management agreements are seen as strategic mechanisms to expand an operator's footprint without the financial exposure of capital expenditure on real estate ownership, but risks exist for the property investor who will need to share in this risk. It is clear that fixed leases are no longer the norm in the hotel property investment asset class, and it is important to understand operational risk when discussing hotels as a property investment asset class. As confirmed by deRoos (2010) pure variable leases are typically based on turnover achieved by hotel operations, but do not measure the ability of the operator to manage expenses which would normally mitigate the owner's risk. This would be considered a variable hotel management agreement which places the risk squarely on the owner of the property. This is similarly a concern for commercial banks specific to this property investment asset class.

Hotel management agreements can be provided in the form of a fixed and variable lease. This allows a small portion of the income to be fixed, where the balance is based on operational performance and this would mean expense management is a driver for an operator. Operators know that signing a lease will be reflected as a liability on an operator's balance sheet (deRoos, 2010), whereas a hotel management agreement will not. Hudson (2010) informs that hotel operators have followed an investment strategy of being "asset-light" over the last few decades, which is a term in the industry where companies have sold off properties or interest in properties and focused on expanding with the management of hotels, using hotel management agreements or franchise agreements. Examples would be hotel brands such as Marriott, Hilton Hotels, Starwood Hotels and later, Accor Hotels & Resorts which sold off interest in hotels owned to focus on operationally profitable performances instead of more high capital focused property investment (Hudson, 2010). These operational models mean owners receive direct profits from generated profits by the hotel operators.

Hotel management agreements were one of the only ways to operate a hotel in the 1980's due to the political system of apartheid in South Africa where strong international sanctions against the country meant global hotel brands were not allowed to enter the country (Tucker, 1986). Rogerson JM (2013:59) stated that the nationalist environment isolated South Africa from the rest of the world and forced the emergence of local hotel management companies to become owner operators which is a different to the "asset light" view that had become normal in more developed markets like North America and Europe. To be "asset light" is where operators are focused on operating hotels and do not have a strategy to have ownership in the hotel as a property asset.

Most South African hotel companies remained as owner operators despite the end of Apartheid and lifting sovereign sanctions in the 1990's (Rogerson JM, 2011:343). Many of the hotel operators had exposure to casinos. Companies included Sun International and Tsogo Sun groups. Hotels were linked to casinos as there was limited availability of licenses in South Africa which allowed hotels to perform well in a less competitive

environment. With new casino licenses no longer made available, these companies had to expand with immediate focus outside of South Africa or to compete in the hotel sector directly. The need to develop and deploy profit meant that companies preferred owning their own hotels. Local owner operators are still the largest portion of hotel real estate in South Africa (Rogerson JM, 2012:200).

The second biggest category of hotel owners in South Africa are large REITS/institutions and property-owning companies that have hotel exposure. These companies are not involved in managing their own hotels. The majority prefer a lease for their hotels, to ensure that most of the operational risk is passed onto the tenant. This model is considered the norm for South African real estate investors. It is the same model used in developing or investing in offices, residential and industrial property. However, international hotel companies entered South Africa. Due to this, investors and owners have investigated the operating model of hotel management agreements (Rogerson JM, 2012). The table below provides a summary of the most prevalent hotel property ownership groups in South Africa:

Table 1.1 Prevalent hotel property ownership groups in South Africa

Name	Ownership type
City Lodge	Hospitality focused REIT
Sun International	Hospitality focused REIT
Hospitality Property Fund	Hospitality focused REIT
Growthpoint	REIT with hospitality exposure
Redefine	REIT with hospitality exposure
Attacq	REIT with hospitality exposure
Spear properties	REIT with hospitality exposure
Liberty two degrees	Pension fund with hospitality exposure
Old Mutual	Pension fund with hospitality exposure

The Capital Hotels group	Private equity – owner operator
Anew Hotels	Private equity – owner operator
Premier Hotels group	Private equity – owner operator
The Legacy group	Private equity – owner operator
Tintswalo	Private equity – owner operator
Bon Hotels	Private equity – owner operator
Onomo Hotels	Private equity – owner operator
Tata Africa Holdings	Private equity – owner operator
Village n Life	Private equity – owner operator
Abland	Developer with hospitality exposure
Blend property group	Developer with hospitality exposure
Rabie property group	Developer with hospitality exposure
Batsomi Group	Private equity – third party operated
Cavaleros	Private equity – third party operated
Platinum hospitality holdings	Private equity – third party operated
Collins group	Private equity – third party operated
Public Investment Corporation	State fund – third party operated
Airports Company South Africa	State fund – third party operated
Industrial Development Corporation of South Africa	State fund – third party operated

1.1 Background to the study

Commercial banks are becoming increasingly knowledgeable when it comes to hotel management agreements and they show positive intent to become involved with the sector (JLL, 2018). What the lenders normally look for in senior debt funding would be consistent and predictable cash flows like a fixed lease for a commercial property. Commercial banks would also require a strong balance sheet or guarantees behind the deal, be it from related companies or shareholders. Hotels are an operational business rather than just a real estate letting entity. Commercial banks, in the absence of a fixed

lease would look primarily at the “jockey” behind the deal and look to cross collateralise other assets within the promoters portfolio to provide for the hotel development. The hotel will be taken as security in addition to the existing portfolio. Valuation models are important in this aspect as it is vital to determine correct values which are relied on by the banks (Verginis & Stephen Taylor, 2004) as this asset has additional operational risk which most traditional property asset classes would not have. Traditional studies done by specialist firms such as Fernridge and Demacon are market focused and do not specifically specialise in the hotel investment space. Banks are relying on hospitality specialist companies like JLL, HTI Consulting and HVS to provide such studies and valuations. Commercial banks would increasingly rely on external feasibility reports to underpin an initial project and to advise on hotel performance over a ten-year view. These reports will encompass periodic reviews and most importantly, hotel performance details which are normally underwritten by the company providing these report (Bader & Lababedi, 2007). In addition, commercial banks would also rely on an experienced project management team, as developing a hotel is far more complex than a commercial or retail asset. This is where Building Information Modeling (BIM) is used to great effect by the project management teams within the international hotel brands. All of this is vital in relation to understanding what lending covenants are required.

Commercial banks prefer lending against acquisitions or refinancing existing assets, as this provides them with a trading history to lower the risk and assist in underwriting. This in turn is not an area where the DFI’s tend to deploy capital as it does not meet their development role which is important in ensuring the development of Africa (Phakathi, 2018). During the development phase, the active lenders largely depend on the Sub-Saharan Africa jurisdiction, the debt of the banking sector and the interest from DFI’s to be in a certain market. There are many instances where construction loans are provided off the back of lender take-outs post-construction and into operations. A 12J fund on the other hand could look at both acquisitions and developments (Sacks, 2019), but again the limit of fifty million rand as a total investment per hotel development can have a restrictive affect and is only available in South Africa.

With an increasing focus by generalist real estate investors on the sector, it seems as if there is an increase in borrowing off existing portfolios. This in turn is bringing lenders to the hotel sector who previously did not have exposure to the asset class (Evans, 2019). Over time these lenders should become more comfortable with the industry and the pool of lenders will deepen as a result and improve liquidity and lending terms. The banking sector in South Africa, but more specifically in Africa, is constantly going through change and this impacts on capital reserving requirements. These changes, albeit slow and conservative, will impact on each country's central bank which will filter through to the commercial banks and essentially affect their ability to lend, their pricing, and in some cases their solvency. The hotel sector needs to work with these lenders to educate them on the volatility that can occur through cycles and how good operators are able to manage downside risk and maximise cash flow for debt service.

Mezzanine lending is still very much in its infancy in the real estate sector in South Africa and Africa. This tends to be replaced by equity products rather than traditional mezzanine lending (JLL, 2018). Alternative lenders are not currently active in the sector. Yet there are several owner operators who have their own listed bonds to reduce the cost of debt. Through consolidation of ownership and operations, this may increase.

To summarise, the landscape of property investment in South Africa is changing. When the property cycle is at a certain stage as indicated below (Barber, 2018), then alternative property investment options or taking on investments outside of South Africa make for attractive options when desired yields are not being achieved in traditional property asset classes. This is evident from Nedbank, the market leaders in South African commercial property finance, where they have set up a Nedbank Africa team looking at deploying capital outside of South Africa. As of June 2019 Nedbank, had announced the deployment of R1billion into Centum in Nairobi which is a mixed-use development including hotels (Naidoo,2019). Hotels do provide a good alternative as part of alternative property investment asset classes, but investors and banks alike would need to fundamentally understand the operational risk and the fact that leases are not available in hotel

investments. The question is if the desired yields, Internal Rate of Return (IRR) or Return on Equity (ROE) are met with a viable project backed by a feasibility study, then what funding mechanisms are available to conclude such a development?



Figure 1: Different Stages of the Property Cycle

1.2 Problem statement

The problem statement in this study is stated as per the following:

By comparing returns achieved by hotels as an alternative property investment asset class to traditional property investment asset classes in South Africa, one could invest in hotels if funding mechanisms are available and if it is shown that yields outperform those achieved in traditional property asset classes on a long-term basis (longer than five years), specifically because hotels need two years to stabilise and thereafter the ramp up in earnings is significant. This must be compared during different phases of the property cycle.

1.3 Research questions

The research questions to be addressed are summarised below:

- How do hotels perform as an alternative property investment asset class as compared to traditional property investment asset classes in terms of investment yields during different stages of the property cycle
- If there is evidence that developers and property funds are considering hotels as an alternative property investment asset class, how aligned are the commercial banks, DFI's or 12J funds and what are their requirements to fund single hotel assets versus portfolio lending
- Finally, how do these funding challenges compare to those experienced in the rest of Sub-Saharan Africa, specifically looking at DFI funding

1.4 Research aim

The intended aim of this research is to:

Investigate if hotels outperform alternative property asset classes during different phases of the property cycle and if so, could funding institutions align their required returns of funding with the risk profile of hotels as a property investment asset class.

Limited information is available on this topic which highlights the importance of such a study. This will provide future research topics with a strong base to expand on topics related to hotels and its role as an alternative asset class in South Africa.

1.5 Research proposition

The research proposition to be tested in this study is:

Alternative property investment asset classes can yield better returns than traditional property investment asset classes during different phases of the property cycle. This can in turn give a higher IRR, leveraged IRR and ROE which should allow for adjustments in credit strategies of banks to consider alternative property asset classes more favourably for funding.

1.6 Research objectives

The research objectives to be achieved may be summarised as follows: To

- Compare traditional leases with management agreements and the underlying difference in risks

- Investigate availability of leases in the hotel sector versus hotel management agreements
- Understand different types of management agreements in hotel investments
- Understand a franchise agreement and how this compares to a management agreement
- Elaborate on joint-venture ownership models typically found in hotel investments
- Explore the funding mechanisms available for hotel developments in South Africa
- Compare commercial bank funding policies to development bank policies in hotel investment
- Investigate the use of alternative funding tools such as 12J funding and analyse this success with hotel groups
- Compare these funding challenges with those faced in Sub-Saharan Africa

1.7 Research methodology

The above objectives will be achieved by adopting the following research method:

- A literature review informed by the problem statement and research objectives
- Individual interviews utilised to ask set questions to different sectors in the market, being the financial institutions, hotel operators, hotel investors and traditional property asset class investors
- Analysis and interpretation of the survey data
- Conclusions and recommendations

There are three research types available being quantitative, qualitative and a hybrid of these methods. Qualitative research is described as exploratory research looking to provide primary research and to investigate new thoughts about a certain concept (McMillan and Schumacher, 1993). This is a more in-depth approach as it is of a primary

nature. Qualitative research is a methodology used to understand a specific topic at hand and tends to have more open-ended questions. In this case individual in-depth interviews are conducted online containing open-ended questions providing participants an opportunity to share their views on the specific topic. The interviews will allow the data collection process to be completed with more structured questions once opinions are formed by the respondent. Quantitative research typically uses statistical data by quantifying the problem statement (Creswell, 2003) and looks for explanations or patterns in the data. Quantitative research is an excellent way to validate certain variables in such a study. It is best utilised when the research is easily correlated or predictive. It is normally done in a structured format using surveys, polls or close ended interviews (Jackson, 2009). Quantitative data is best utilised when a big sample is available and can be time consuming. Reality however dictates that in dealing with this particular topic, hospitality is of such a specialised nature that obtaining a big enough sample would be unlikely.

Understanding the two methods of research available, one can also look at a hybrid method where qualitative and quantitative research is done. Hybrid methodologies have the option to use questionnaires and interviews. Known as a “pragmatic approach”, it gives the research the choice to use a method that is most suitable for the research problem without issues in any related theory (Teddlie & Yu, 2007). A hybrid approach could be used to complement findings and further strengthen the conclusions deduced from the research. It also means that bias inherent with the researcher will be minimised. Mixed research has become more popular and has gained support in recent times (Bryman, 2006:97). In this specific study a qualitative approach was best suited as obtaining a big enough sample for a purely quantitative study would be challenging. Where appropriate, qualitative data may be quantified to descriptive statistics should clear trends emerge. Existing published information will be used to substantiate findings from in-depth interviews which form the basis of the research.

1.7.1 Sources of data

The research methodology used was the following sources of data:

- **Primary sources of data**

Primary data to be obtained during the individual in-depth interview process.

- **Secondary sources of data**

Literature review of various academic journals, books and media articles.

1.8 Limitations

This study has the following limitations:

- Limited information on hotel lending from commercial banks as this is a far less traded asset compared to other traditional asset classes or compared to other regions where hotel trades in Europe and America, for example, are far more prevalent.
- Banks are negative towards hotel investment due to the oversupply for the 2010 World Cup. The existing credit policies seem to have been put in place post this cycle as well as after the financial crisis in 2008. This may deviate answers to the research, as pre-conceived perceptions are in place for credit managers at commercial banks.
- Professionals may be reluctant to disclose private information relating to existing projects, developments or deals with the fear of sensitive information being leaked to competitors or the public in general.

1.9 Structure of the study

The research report was structured as per the following:

In **Chapter 1** an introduction and background to the study is provided. In this chapter, the problem statement, research questions, and research proposition are established. The research objectives and aim are stated and follows with a description of the research methodology and data sources utilised. Lastly, possible limitations of the research project are outlined.

Chapter 2 provides a review of literature on the topic.

This is followed by **Chapter 3** which describes the data and research methods used in the study.

In **Chapter 4** statistics and interpreted data of the research are presented.

Results of analysed data are provided in **Chapter 5** which can be used to compare hotels and traditional property asset classes during different phases of the property cycle.

Finally, the study is concluded in **Chapter 6**, which is concluded with a bibliography.

Chapter 2: THE LITERATURE REVIEW

2.1 Introduction

The key theme to this paper is to understand the performance of hospitality assets as compared to traditional property asset classes in the South African property sector. The literature presented outlines important theoretical aspects for property investment in South Africa as well as understanding important elements and limitations to making such investments, with specific focus on hospitality assets.

2.2 Brief history of the international hotel industry

The security provided by an operator to a hotel owner is far more complex than a standard lease obtained for a commercial building or retail centre for example. There is inherent operational risk which is a significant mindset change for most property developers and financiers alike. Prior to the 1950's, operators or better known as hotel management companies, owned their own hotel (deRoos, 2010). They were considered as owner operators and hence played the role of developer, landlord and tenant. This model was extremely capital intensive as the operator not only had to provide equity towards setting up operations of the hotel, but all the equity required to develop the property.

During the 1950's the model changed where instead of being focused on hotel owner operators there was a separation between property company and operating entity, effectively giving birth to the Property Company – Operating Company relationship and separating the functions of each aspect. According to deRoos (2010), these early hotel management agreements were heavily in favour of the operator and gave independent hotel owners little to no recourse should the operator not have performed. They were

burdened with the operator until such time that the hotel management agreement had lapsed. The 1980's real estate crash was the turning point where several court cases were contested during bankruptcy hearings between hotel owners and operators (deRoos, 2010). In most instances the court subsequently ruled in favour of the property owner.

2.3 Understanding differences in hotel management agreements and leases

Hotel management agreements have since evolved and is the preferred model for both hotel owners and operators. The main reason for this is the separation of interest as hotel owners prefer to focus on the property development or investment aspect of their decision, whereas hotel operators focus on fee generation for the operating entity and on growing their hotel brand. They tend to not want to focus on injecting capital expenditure (Capex) into big property projects (deRoos, 2010). The main functions for a hotel management company when they have a hotel management agreement in place with a hotel owner, is to operate the hotel and provide operational expertise with pre-determined methods whilst leveraging off their brand to bring clients to their hotel via booking systems and loyalty programs. This running of the hotel is done for a fee which is pre-agreed with the hotel investor or owner (Sayce, 1995; Harper, 2008; deRoos, 2010).

The intention of the agreement is to ensure maximum profit for both the operator and the hotel owner. This places operational risk of profit and loss on the owner which can affect the asset value either positively or negatively. The effect of the asset value is dependent on operating effectiveness of the hotel operator and market conditions (Bader & Lababedi, 2007). This model is a worldwide trend and is becoming more popular as both the operator and property owner can benefit. However, the property owner is at high risk depending on the performance of the hotel operator. This is a challenge for funding purposes, as well as for listed property funds that require fixed rental income as opposed to the variable income received with a hotel management agreement.

There is a difference in risk association and difference within the provision of hotel management agreements. In many instances, hotel owners do not want to take all the risks associated with a hotel management agreement and would prefer some sort of fixed income base. It has emerged in certain parts of the world where hotel management agreements are provided with a minimum income guarantee (deRoos, 2010), which is normally provided within the first five years of operations. The trend in South Africa for these guarantees is to provide the hotel owner with a guarantee of between 3% and 4%, with the benefit of additional variable income. In this instance the hotel operating company has more risk in the hotel and will trade off the provision for this risk with either a longer term for the hotel management agreement or a higher fee for managing the hotel.

2.4 Evolution of the hotel management agreement and the hospitality sector in the South African context

The introduction and evolution of the hotel management agreement has changed the hotel investment outlook in South Africa and historical context must be given when discussing this. Tucker (1986) stated that international sanctions against South Africa during the Apartheid era meant that local hotel groups had to be created to service the country and they were largely successful as there was no real competition from international brands and/or hotel owners. This also meant though that there was no need to follow any emerging trends. The Southern Sun group dominated the industry in the 1970's with the company growing quickly with 24 hotels by 1974 after being created in 1969 (Rogerson CM, 1990).

Rogerson CM (1990) states that although Southern Sun dominated in the initial period, other South African hotel groups emerged with the most prominent groups being the Protea Hotel Group and City Lodge which began in the mid 1980's. Most of these were owned and effectively operated by the same company. There was no separate relationship between the property company and operating company where a hotel

management agreement or franchise agreement was put in place. When apartheid ended in the 1990's, the only group to start looking at hotel management agreement and franchise agreements was the Protea Hotel group (Rogerson JM, 2013). The South African hotel sector is unique in its structure due to the attributes of the apartheid isolation era. A good example being the higher number of leased hotels in comparison to global norms, where globally the trend was that the majority of hotels are operated on the basis of an agreed hotel management agreement (Rogerson JM, 2012), with the only exception being that of Germany where leases are common due to the stability of the country. The trend is changing in South Africa to be more in line with international standards. The growth of tourism and international participation by companies in South Africa has meant that South Africa has had to adapt to hotel management agreements. Big hotel brands provide much larger international distribution networks and loyalty programs which require specific hotel management provided by international hotel operators. According to Rogerson JM (2012), the hotel sector has developed post the abolishment of the apartheid with a bigger focus on larger hotels which need specific and specialist management.

Table 2.1: Number of rooms by different size category (1990 vs. 2010)

Year	1-50 rooms	51-250 rooms	More than 250 rooms
1990	15,658	18,566	7,526
2010	15,412	45,398	12,442

Source: Rogerson (2012)

In the South African context, slow growth and interest from institutional investors for hotels as an asset class is a challenge. According to an interview conducted by Rogerson with Deborah Sampson (2012), hotel management agreements is where the perceived risk is higher for the hotel owner. A study by De Looer (1995) shows that the majority of

institutional property investors in South Africa did not see hotels as a suitable asset class for their portfolios (De Loor, 1995). This is an important aspect in understanding the perception of the sector.

Most hotel owners in South Africa are private property companies and not institutional investors (Nelson, 2012). There are REIT's that own hotels within a portfolio, but this is often a function of a hotel being part of a mixed-use development, an opportunistic development, or acquisition rather than being the core focus of the REIT. This would include REIT's like Redefine who are retail and commercial property focused, but do own hotels like the Protea Marriott in Loftus Park, Pretoria. Others include Atterbury and Attacq who have hotels in their portfolio in the Waterfall precinct. Again, another indication of a hotel being part of the bigger property portfolio (Atterbury Property Holdings, 2016). The Attacq property group is aligned with their policy of lease agreement and being a stable income earner. The group is one of the few developers that have managed to negotiate a fixed lease on a new hotel being completed in October 2020 with City Lodge (Cokayne, 2019).

Rogerson JM (2012) states that "South Africa shows patterns and differences with regards to hotels as an asset class compared to advanced economies, such as relatively poor levels of understanding of hotels by institutional investors, a perception that there are higher levels of investor risk in hotels compared to other traditional property classes, knowledge gaps in relation to appropriate monitoring or benchmarking of the hotel property market, and a failure to establish boundaries between hotels as property or a business in the mind of an investor".

Several authors with understanding of the South African hotel sector confirm that the sector is maturing and beginning to display closer correlation to global trends. The industry changing quickly and strong hotel sector growth on the African continent has brought in a wave of global hotel operator interest. This would include operators such

as Radisson, Accor, Hilton, and now Marriot through their acquisition of Protea Hotels. South Africa has been a key gateway to Africa for these global players and their presence will increase the appetite for investment from global players in this sector. This shift will have an impact for hotel owner in Africa with specific attention to increased participation, meaning that institutional investors have to adapt by looking at this as an investment asset class as part of their portfolio or for private investors to focus on building a significant enough portfolio to either look at listing or to sell to a fund (JLL, 2018).

2.5 Property investment fundamentals

Property is an important aspect of the global economy and general financial and sovereign fiscal system, which means the aspect of value is a requirement to ensure that the broader financial systems is calculated correctly. Gilbertson & Preston (2005) present the following reasons for correctly valuing property:

- Financial institutions utilise property as security for loans
- Residential or retail investors
- Pension funds with savings invested in property
- Economies reliant on stable financial sectors
- Shareholders invest into companies that are themselves then vulnerable to takeover if not regularly and correctly valued in terms of balance sheet valuations

As part of the South African economy, the figure below indicates the size of the property sector and the sectoral market sizes (Nedbank Group Commercial Property Finance, 2019:5).

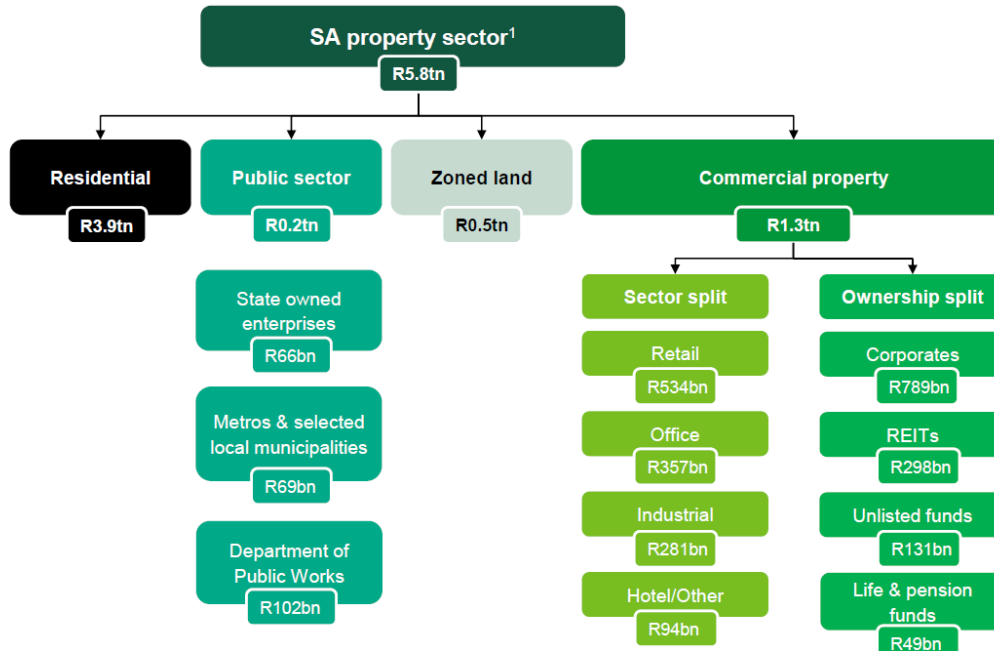


Figure 2.1: Commercial property marketing in South Africa

Institutional investors such as listed REITs are set to deliver a total return (share price movement and distribution) of 13% - 14% (Penny, 2018). This as a comparison is well aligned to institutional investors as well as corporate investors' desire of achieving IRRs north of 15%. Most property asset classes considered for the developments or acquisitions are traditional asset classes such as commercial, retail or residential developments (Seroto, 2018).

Newell and Seabrook (2006) detect a high correlation between hotels and other real estate sub-sectors in the United States of America suggesting that compared to other real estate sub-sectors, hotels have inferior diversification benefits. They further argue that hotel real estate has a relatively short track record as compared to traditional real estate, which raises doubts from investors and thus limits capital flows from investors. However, given the need of international tourism, hotel properties are an important property investment sector. Newell and Seabrook (2006) define the main factors influencing hotel investment decision making as financial (weight of 37.0 percent) and location (29.9

percent) factors. These were followed by economic (14.5 percent), diversification (12.0 percent) and relationship (6.6 percent) factors. This sees three levels of importance in the factors influencing hotel investment decision making.

The South African economy is in a difficult position with GDP growth revised by the World Bank to below 1% for 2020 and this is mainly due to electricity supply concerns (Naidoo, 2020). This in turn has meant that commercial property acquisitions or developments are difficult to find at the desired yields as businesses or retailers are placed under pressure to pay rentals at rates previously expected by landlords. This is noted in the central business nodes like Sandton where gross commercial rentals have not increased substantially from R200 to R205 per square metre between 2014 and 2018 (Makhoba & Ramokhoase, 2019).

Further pressure will be seen in the retail space with retailers feeling the results of the economy not growing at the desired rates. This means rental expenses, being the biggest expense for any retailer, is being challenged with landlords, yet annual trading densities have decreased across all retail property sectors (MSCI, 2019) which are categorised as per the following:

- Neighbourhood centres
- Community shopping centres
- Small regional shopping centres
- Regional shopping centres
- Super-regional shopping centres

Rent reversions are becoming more frequent, escalations are no longer agreed at levels above inflation, and retailers are re-inventing their businesses to minimise gross lettable area (GLA) required for the space. Vacancy rates have also increased in this property

asset class which has further put pressure on the sector. The figure shows the trend of increasing vacancy within super regional malls in South Africa (SAPOA, 2019:12).

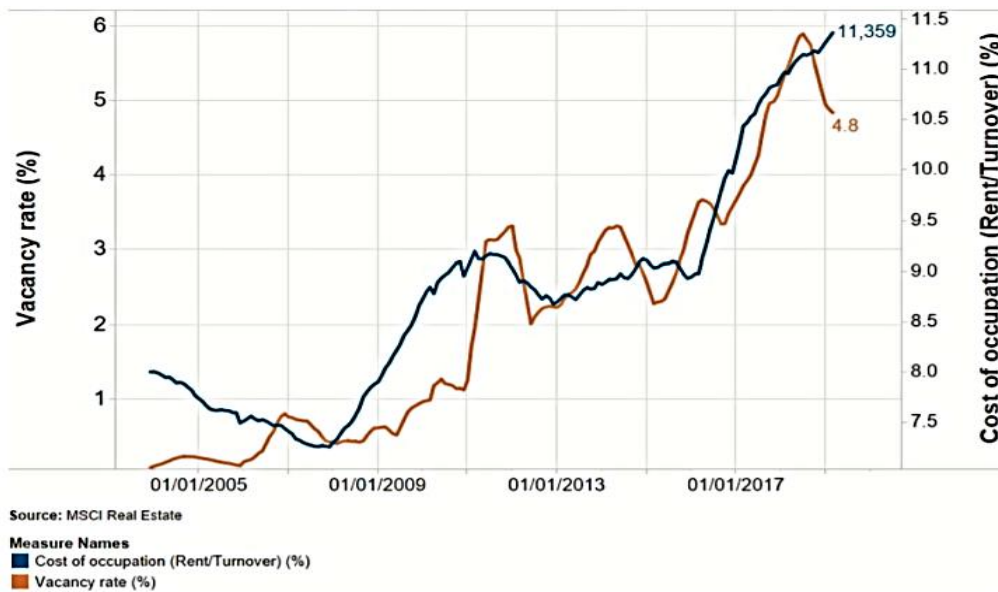


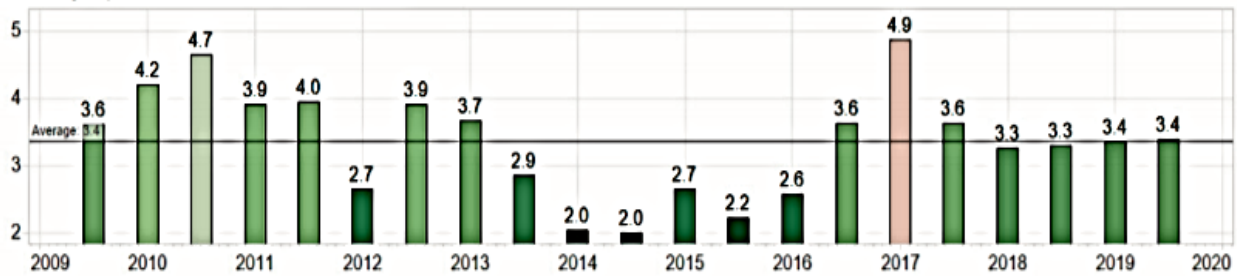
Figure 2.2: Vacancy rate – super regional malls

One sector in the market that has shown a robust nature in assets is the industrial sector. Fortress property fund is one of the dominant owners in industrial and logistics property with a portfolio of 75 879 square metres of industrial space and 1 434 659 squares metres of logistics space as at 31 December 2018.

It is one of the traditional property asset classes that has shown resilience and growth in the last few years as compared to the other traditional property asset classes (Stevens, 2018). Below is a figure further demonstrating the resilience of the industrial sector in terms of vacancy rates remaining constant for the last five quarters (SAPOA, 2019:3).

Industrial Vacancy Rate

Vacancy %; 2009/06/30 to 2019/06/30



Industrial Base Rental Growth

Annual Growth %; 2009/12/31 to 2019/06/30

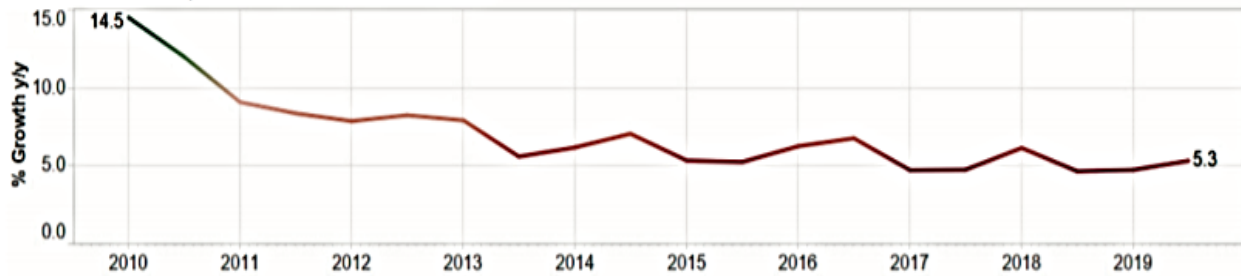


Figure 2.3: Vacancy rate – industrial property

2.6 Generalist versus specialist hotel owner

With the challenges in the current South African economy and traditional property asset classes not performing as well as expected, many investors are looking at alternative property investments previously not considered, (JLL, 2018), but little evidence is available on comparing average yields with these property asset classes. If one examines the REIT's listed on the JSE, there are few specialist REIT's focusing on hospitality as a property investment asset class. However, a recent research article by JLL shows how hospitality investors, being listed or non-listed entities, are moving away from being specialist investors in hospitality to more generalist in all asset classes (JLL, 2018). Research has shown that in 2014, 38% of investors in hotels were hotel only investors (specialists) whilst the remaining 62% were multi-property investors (generalists). As of 2018 the percentage of hotel only investors (specialists) dropped to 29% whilst the multi-property investors (generalist) increased to 71%. This shows a trend that alternative

investments like hotels are becoming more of a key focus to developers and investors alike (JLL, 2018). With continued pressure to deploy capital at scale, investors are seeking alternatives to fulfill their return requirements, particularly at this late stage of a long global real estate cycle. The positive outlook of the travel and tourism sector as well as continued growth in hotel operating revenues in Sub-Saharan Africa continues to push investors towards hotel real estate. Generalist investors are often able to better unlock debt due to their strong existing relationships and more diverse balance sheets (JLL, 2018).

The eventual end of the current global real estate cycle may lead to a pullback of generalists from the hotel sector. However, regionally it is expected for this trend to continue due to the attractive currency hedge that hotels can provide in many parts of the continent and the long-term fundamentals. According to JLL (2019), in the past five years, an estimate 70% of global hotel investments were made by generalist property investors and not investors that traditionally specialise in hospitality. The figure below illustrates this trend (JLL, 2019:7).

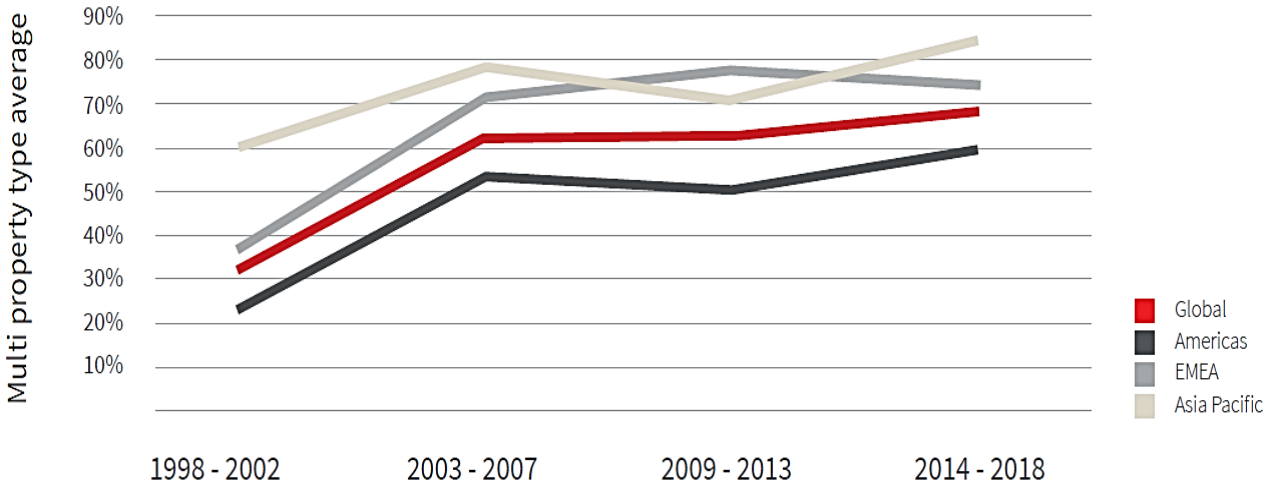


Figure 2.4: Hotel acquisitions by generalist investors

Similar fundamentals are driving this trend in Sub-Saharan Africa. Saturation in other real estate sectors and more balanced management agreements are however driving this trend at a regional level, rather than the current stage in the global cycle.

2.7 Funding of hotels in South Africa and Sub-Saharan Africa

When looking at hotel developments or acquisitions in Sub-Saharan Africa, commercial banks have remained conservative in their risk appetite for funding (JLL, 2019). Over the past few years lenders have not shown much change in their approach with lending to single hotel developments, and still look at leveraging off existing portfolios which would include well established hotels with consistent cash flow or more traditional property assets. These assets are then cross collateralised to fund a new hotel acquisition or development. In this regard, it is lowly geared at no more than 60% LTV.

According to JLL (2018), one of the main reasons for leveraging off an existing portfolio is the operational risk associated with the hotels. Commercial banks rely on consistent cash flows for debt serviceability such as income received from leases, but this is increasingly difficult to obtain in the market in Sub-Saharan Africa. DFI's and commercial banks are however becoming more knowledgeable about hotel management agreements, but still look at mitigating risk with more consistent income streams from the asset. It is due to this that there has been an increased trend for mixed-use developments which would include a component of retail, commercial, hotel and branded residence in one development site (JLL, 2019).

Global trends have shown that mixed-use properties are the only asset class that grew in 2019 compared to 2018 in terms of global transaction volumes. This is illustrated in the figure below (JLL, 2019:14).

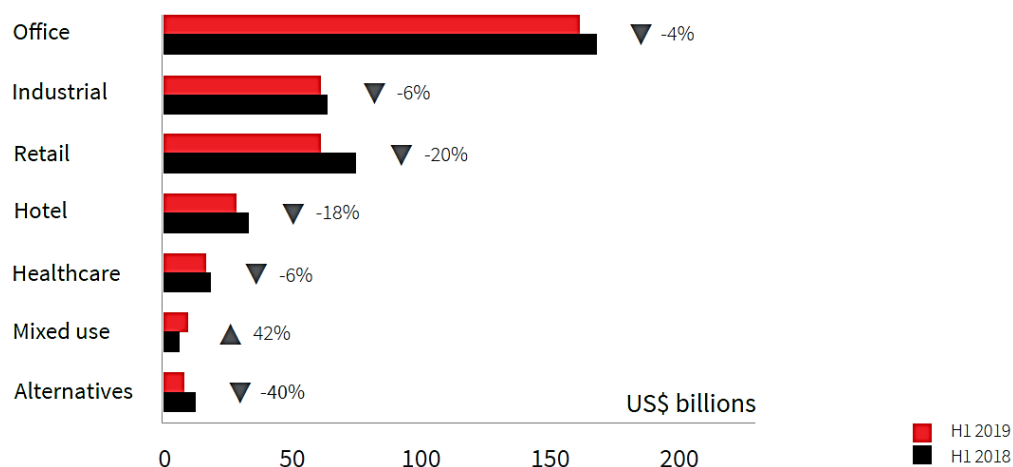


Figure 2.5: Global transactions by sector

The benefit of a mixed-use development is that once it is ready to take to market, it can provide income streams that mitigate much of the risk for the lender. Kane (2004:1) states that leases from the retail and commercial spaces provide consistent cash flows akin to a stable income asset, whereas the branded residences can be sold on a pre-sales basis and a full cash sweep can be taken from these sales and be provided as equity into the hotel development. The most notable source of funding hotels in Sub-Saharan Africa is through the development finance institutions (“DFI’s”), but there is less knowledge of the some 140 DFI’s in Africa and their capabilities for funding projects.

In addition to this, most prominent commercial banks in Sub-Saharan Africa take no risk during the construction phase of a hotel development and would in fact only look at leveraging off a hotel for an investor post completion of the hotel. The main concern for funding during the construction phase is failure to complete due to time delays, overruns, difficulties in procurement and lack of quality contractors that can build to international hotel brand standards (JLL, 2019). In contrast, DFI’s would only look at funding hotel developments, whether it be a greenfield or brownfield conversion. According to Massa *et al* (2016), the main focus for DFI’s is still the development of economies in Sub-Saharan

Africa and sustainable job creation, keeping in mind that the investment decision should still be sound.

Cross border debt is difficult to manage. Both commercial banks and DFI's will have some form of local currency funding, which is an expensive option compared to USD/EUR denominated debt that is linked to the London Interbank Offered Rate (Libor) or Euro Interbank Offered Rate (Euribor). JLL (2019) explains that most large property and specifically hotel projects or acquisitions in Sub-Saharan Africa will have majority USD or EUR based debt, normally with a spread of between 400 and 600 BPS on the Libor rate. Tenors tend to be between 7 and 10 years. Lenders will look at hard currency denominated loans for hotels in Africa even outside of countries which have their currencies pegged to hard currencies, due to the hard currency denomination of room rates. This denomination of room rates provides a hedge between the lending currency and room revenues, which reduces risk to the lender as well as lowering pricing for the borrower. The difficulty however is the interest rates of local funding which can easily be close to 20% in most African countries. Below is information of prime lending rates of major countries in Sub-Saharan Africa as at the end of September 2019.

Table 2.2: Prime lending rates for selected countries in Sub-Saharan Africa

Ghana	27.80%
Angola	17.50%
Nigeria	15.80%
Tanzania	15.27%
Cameroon	13.70%
Ethiopia	13.10%
Kenya	12.47%
South Africa	10.00%
US linked interest rate	6.20% - 7.20%

Source: JLL (2019:15)

This makes the debt yields high and would present an opportunity for mezzanine funding as often the capital stack is not completed due to the gap between USD/EUR based senior debt, local currency senior debt and equity. Mezzanine funding in Sub-Saharan Africa in the hotel space is still very much driven by equity type products instead of traditional mezzanine funding. There is a high level of demand for mezzanine funding to complete the typical capital stack of a project, but it is something that is not yet available in Sub-Saharan Africa (JLL, 2019). Alternative lenders are not utilising this space at the moment and many owner operators need to circumvent this problem by creating their own P/E style fund in order to enter the market (JLL, 2019). Sub-Saharan Africa is not as liquid as mature markets and funding can be a challenge for new entrants into the market. It is due to this that funds are being created to enter the market on a portfolio level such as Onomo Hotel Group joining forces with CDC Group and for example the Qatari based fund manager, Kasada.

JLL (2018) provides a report on the number of funds that have been created or consolidated in the years between 2014 and 2019 which has been a trend for investment into the hotel space in Sub-Saharan Africa due to the lack of competitive funding opportunities (figure 2.6 below). Most Sub-Saharan countries are aware that the hospitality industry is a great source of job creation and economic development (Fredericks, 2018). The funding challenges present stumbling blocks for hotel development, but governments are seeing this as an opportunity to obtain investment from developers and investors alike through tax breaks in the form of incentives, tax deductions, exemptions and tax rebates. A good example would be the 12J tax incentive scheme in South Africa which is positioned for investors that receive tax credits when investing in hotel acquisitions or developments through a qualifying Venture Capital Company (“VCC”).

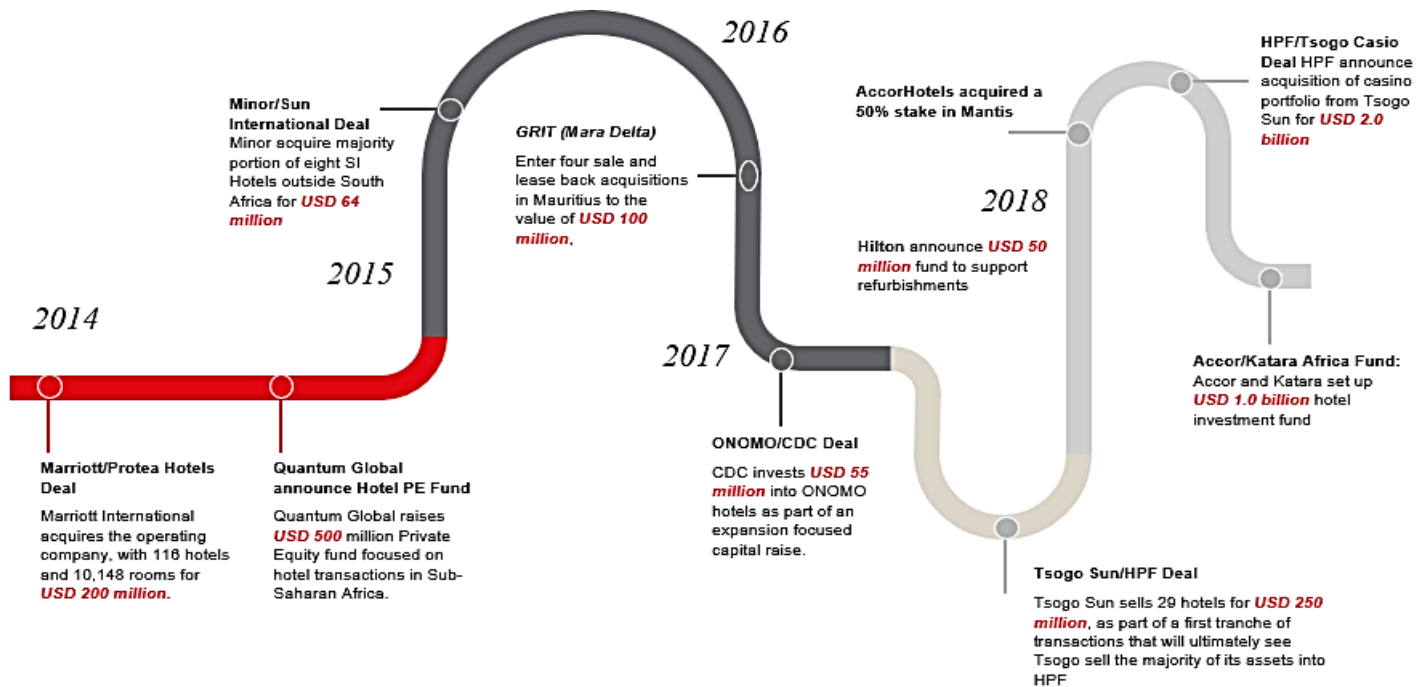


Figure 2.6: Consolidated hotel funds since 2014

This is not meant as a funding tool for developers, but rather a tax incentive mechanism for investors to receive their tax credit by investing in hotel assets. This has come to good use for projects where there is a shortfall of funding or where a project may have a problem with the last source of equity. There are certainly challenges in hotel investment in Sub-Saharan Africa, but it remains the biggest continental market in terms of opportunities for the next generation of new hotels (Seigler, 2020). JLL (2019) states that many parties including developers, investors, operators and governments are looking for funding solutions. The biggest opportunity remains in filling the gap where so many projects fail in financing a hotel development or acquisition.

2.8 The role of Section 12J in hotel funding

Section 12J is an incentive created by South African Treasury (specific amendments to Section 12J of the Income Tax Act) in encouraging South African citizens to invest in the local economy in higher risk products, but with the benefit of a tax deduction (Sacks,

2019). This tax deduction is allowed if investments are made an approved Section 12J Venture Capital Company known as a VCC.

This provides a good mechanism for developers to provide a product to the market and sell on a similar pre-sales model to that of a residential sales model. To illustrate, if an individual investor that is on the highest tax bracket or trust invests R1 million in an approved VCC, the investor will get a tax credit of up to R450 000 at the end the financial year. If a South African registered private company invests R1 million in a Section 12J VCC, the investor will receive a tax credit of R280 000. The additional benefit for a company is that no dividends withholding tax is applicable when annuities are paid as these annuities are paid company to company which is effectively tax free (Sacks, 2019).

Investors will therefore receive a return on the full market value being the 100% investment with only 55% exposure if an investor is an individual or trust, or 72% exposure if the investor is a South African private company. Should the individual investors be on the highest tax bracket, the following will apply as indicated in table 2.8 below:

Table 2.3: Summary of tax benefits for each type of investor

Description	Individuals/Trusts	Corporates
Initial investment	R 1 000 000	R 1 000 000
Tax relief (in the tax year of initial investment)	(R450 000)	(R280 000)
Net investment (risk capital)	R550 000	R720 000

It is imperative to note that Treasury created the mechanism of the Section 12J tax deduction for investment in higher risk businesses with the intention of job creation and effectively investing in Venture Capital type businesses (Hogg, 2019). To understand in

what business a Section 12J VCC can invest, is to understand what business they cannot participate in, as legislation provides guidelines on which sectors are prohibited (Sacks, 2019). A Section 12J VCC would need to understand whether the below elements exist and if it is the case, then investing will not be allowed:

- The gross asset value of the invested company exceeds R50 million or R500 million in the instance of a junior mining company;
- The invested company revenue has more than 20% earned in investments;
- The invested company has most or more than 50% of its operational earnings outside of South Africa;
- The invested company is involved in one of the defined impermissible trades. This could be **firstly**, any trade in respect to that of immovable property except for the case of a “hotel keeper”. This could be further defined as serviced apartments, student accommodation or hotels which will all meet the definition of a “hotel keeper”. **Secondly** any services provided in the financial sector such as banking, insurance, hire-purchase agreements. However, this does not prevent a Section 12J VCC from investing in technology within this sector. **Thirdly** any services in terms of financial or advisory services which may include legal advice, tax advice, stock broking services, consulting services, auditing services or accounting services. **Lastly** no trade involving with gambling, liquor, tobacco, arms and ammunition is allowed.

The intention in the act is that there is an opportunity to make use of a Section 12J VCC if the investment does not fall within the above list. As noted by Sacks (2019), Section 12J VCCs can invest in businesses with a gross asset value of less than R50 million (R500 million in the case of mining companies). Below is a list of the most notable qualifying businesses that form part of the existing Section 12J market (Sacks, 2019):

- Mining and contract mining businesses;

- Agriculture businesses;
- Franchises;
- Hotels, lodges, student residences and B&Bs;
- Manufacturers;
- Renewable energy businesses; and
- General SMEs.

From an investor's perspective, there are two main limitations:

The first is to retain the tax deduction where an investor must hold share in a qualifying 12JV for a period of no less than 5 years. If there is a disposal prior to this period then the investors would be liable for the pay back of the full initial tax deductions, with no interest or penalties.

The second is when an investor exists in a qualifying S12J VCC where the capital gains cost (CGT) has a base cost of zero. It therefore means the investor will pay CGT on the investment amount as well as the capital growth on the investment.

From a developer's perspective, the Section 12J provides a competitive way to sell developments to the South African market. These projects provide significant boosts to investors' return on investments (ROI) as well as cash on cash returns (Sacks, 2019). In addition to the investor benefiting from a significant ROI boost, developers still benefit from Section 12B deductions. Section 12J is an extremely attractive tool to developers looking to diversify into serviced apartments which is a longer stay product compared to that of a hotel. Cohen (2019:[2]) states in order to qualify for a Section 12J it must not fall within the definition of "impermissible trade" under Section 12J (1) B of the Act which states the following:

“impermissible trade” is “any trade carried on in respect of immovable property, other than a trade carried on as a hotel keeper”.

Immovable property investments made by Section 12J VCC do not fall within this ambit except in the case where it is seen or deemed as a “hotel keeper”. The question is to define what is considered a hotel keeper as many initial Section 12J VCC’s tried converting longer stay residential developments and packaging them into Section 12J products which was deemed to be impermissible (Sacks, 2019).

Effectively, a “hotel keeper” is defined as “any person carrying on the business of hotel keeper or boarding or lodging housekeeper where meals and sleeping accommodation are supplied to others for money or its equivalent”, Sacks (2019:[3]). The above definition with the binding requirement by the South Africa Reserve Services to meet the term of “hotel keeper” in terms of the Act, the developer of investee company must ensure the following requirements are met:

- rooms service available all day
- room to be furnished
- meal service on offer on the hotel premises
- let out a room for a short-term stay
- guest must have the option to pay for the use of the room
- room available to let for a short stay

The above definition would therefore mean that investment opportunities qualifying in the ambit of a Section 12J would include a broader category of property:

- Hotels

- Student accommodation
- Lodges
- Guesthouses

Cohen (2019:[2]) has stated that the new limits of Section 12J investments will increase capital flights out of South Africa, where this form of investment was previously keeping wealth in the country. An add on effect would mean potential jobs lost due to opportunities not being fulfilled due to more difficult capital raises (Hogg, 2019) The limits introduced by Treasury meant that a cap of R2.5million per investor was allowed in a Section 12J investment. Prior to this cap, large value investments were made by South African taxpayers into Section 12J investments. Assets under management doubled in one year from R3.7bil to R6.7bil as illustrated below (Jooste, 2019). One would assume the Treasury would be encouraged by the amount of capital invested in Section 12J investments, as the investment vehicle was introduced to provide equity funding to small and medium enterprises (SMEs) through an upfront tax incentive for taxpayers who invest. If taxpayers invested R100, they could claim up to R45 back from the SA Revenue Service and generate a return from the full R100 invested (if invested wisely). There is a clear short-term upfront cost to the fiscus, but the Treasury should gain through long-term sustainable tax revenue collected from the SMEs that receive the funding. Below is a snapshot of the percentage of capital raised per Section12J in 2019:

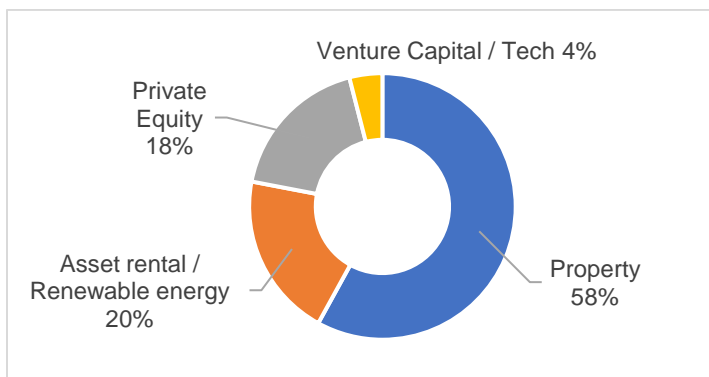


Figure 2.7: Section 12J capital raised in 2019

At the end of the 2019 tax year, the following statistics were available on the Section 12J:

- 120 active funds
- R3.7billion invested in Section 12J which was nearly double to that of 2018
- R1.6billion raised by funds promising hospitality exposure in 2019
- Liquidity for 800 – 1,000 new hotel rooms from the 2019 capital raise

The 2019 Taxation amendment bill which gazettes the single investors or trust to R2.5m per individual investment cap and R5m per company per annum was done to curb “abuse” where holiday homes were turned into a Section 12J company. The SA Revenue Services discovered this and refined the legislation. This will consequently reduce the amount of private sector investments in SMEs, likely resulting in more capital leaving South African shores and fewer jobs created (Cohen, 2019). Sacks (2019) states that further unexpected amendments relate to the time frame in which the Section 12J investments must invest investors’ capital. Up until this amendment, a fund manager had three years in which to deploy investors’ capital, failing which the Section 12J investment would be non-compliant with the legislation. Treasury has now extended this time period to allow the fund manager four years in which to invest funds under management into qualifying investments, effectively allowing the funds to withhold on capital for longer without deploying it into the system.

This amendment comes as a surprise as several of the larger Section 12J investments have failed to invest a significant amount of capital under management into SMEs. While preventing non-compliance is desirable, this amendment may adversely affect investors in Section 12J investments that invest capital at a slow rate, as their capital may be idle for longer. Investors in Section 12J investments that have failed to invest funds timeously will thus likely earn a lower return from their investments (Smith, 2020). Even more concerning is that it is likely that investors in these funds will be required to hold their

investment for longer than expected due to the investment taking longer to generate the anticipated returns.

Future investors should therefore be mindful of the total percentage of capital invested by the Section 12J investment into qualifying SMEs before making an investment. If appropriate steps are taken towards timely investment, this amendment will likely not seriously affect investors. The Section 12J incentive has created a new SME investment class that is only now starting to flourish, and is completely supported by the private sector, both from an investor and funder perspective as well as from an asset management perspective. Hopefully the introduction of these amendments will provide the Treasury with the confidence it needs to extend the incentive, which is scheduled to end on June 30, 2021. Francois van Zyl, a partner at 12Cape, a Section 12J investment fund that owns the newly opened Latitude Aparthotel in Sea Point, Cape Town, says the prospective growth in tourist arrivals in Cape Town will increase the demand for serviced holiday villas and self-catering apartments. He sees the hotel as an example of how the Section 12J company plans to deploy investors' capital in future.

2.9 The role of Development Funding Institutions in Sub-Saharan Africa

African Private Equity and Venture Capital Association (2018) cites that Development Funding Institutions (DFI's) are not maximising their potential to deploy capital into Africa as many are withholding excess capital and a significant number of projects are waiting to be vetted for investment. The reasons for this are due to the complex investment process which is riddled with arduous steps that involve manual due diligence procedures and deliberation. This despite the enhancement and accessibility to technology innovation in the region. Another stumbling block in Africa is that most DFI's outside the borders of South Africa do not have mandates to invest in South Africa, yet DFI's such as the Industrial Development Corporation have strict Broad Based Black Economic Empowerment (BBBEE) policies which exclude many developments on this basis which

can be capital intensive. The IDC would be a perfect solution to development funding as they have a dedicated Tourism Strategic Business Unit (SBU) which focuses on the investment in hospitality in South Africa with niche products looking at the following:

- High impact tourism ventures
- Tourist attractions
- Niche product offerings
- Hotel developments

DFI's investing in Africa are focused purely on development and not acquisition of hotels. This is mainly due to the development and economic impact such a hospitality development would have on the country in which it has invested, often citing job creation impact as a main driver. Not all countries share in access to investment from DFI's as domestic credit increases per with capita in relation to the strength of the economy. Upper-middle income countries such as South Africa, Namibia, Cabo Verde, Morocco, Tunisia and Mauritius all achieved access to domestic credit above 50% of their GDP. They will have more levels of private or domestic funding for development from local commercial banks than DFI's. However, lower levels of economy in poorer countries will have greater growth prospects which is where many DFI's have a significant impact.

In addition, and very similar to DFI's, are sovereign wealth funds of which there are 15 such funds (Santiso, 2014) as of 2014 with the largest being the Libyan Investment Authority. These wealth funds can be used to invest in structural transformation. A good example would be the targeted investments in hospitality by the Angolan sovereign fund. DFI's continue to have a role to play to fill the gap of pension or property funds investing in the hospitality sector. CDC which is a wholly UK government-owned DFI announced in 2017 that EUR 46 million will be invested in ONOMO hotels which will have a development pipeline of 20 hotels across 20 African countries by 2022 (Adepoju, 2017). A further report by Manders (2015) shows that between 2009 and 2014, 14 DFI's across

22 African countries invested USD 328billion in African infrastructure which was four times the amount of capital that the private sector contributed during the same period.

2.10 Alternative asset classes to hotels and their performance

2.10.1 Commercial real estate - Offices

With the abolishment of Apartheid and sanctions being removed against South Africa, many multinational companies entered the market in South Africa post the first democratic election in 1994. This saw the GDP of South Africa average at 3.6% over the period between 1994 and 2009 with the lowest GDP at 0.5% in 1998, in anticipation of the commodity crisis, whilst the highest was 5.6% in 2006 (Trade Economics, 2019). This would mean with these growth rates that there was a boom in new office space required in terms of Gross Lettable Area (GLA) entering the market. With the 2009 global financial crisis, businesses around the world were most affected with many closing operations. Emerging markets were initially most affected as many investment funds focused on investing in haven countries such as the United States of America (McCauley, R. N & McGuire, P, 2009). The main reason for this was to disinvest in what was considered a higher risk investment even though at that stage South Africa had an investment grade of A3 according to Moody's and BBB+ from Standard & Poor's and Fitch which meant South Africa was above investment grade.

At this stage many new master plans had been developed with new P-grade and A-grade office parks being built around the country with the relocation of the traditional CBD business to newer, safer destinations. This included the development of Sandton and Rosebank from the Johannesburg CBD, Umhlanga Ridge from the Durban CBD and to a lesser extent Somerset West from the Cape Town CBD.

Cape Town had a turnaround during this time with a CBD upliftment program which saw reinvestment in the CBD with many businesses migrating toward the Victoria and Alfred Waterfront and Foreshore area. This meant a boom in office rentals and new office developments in key primary nodes around the country. Since the global financial crisis, South Africa had Jacob Zuma as president which coincided with corruption allegations, growing fiscal deficit, unstable power supply and continual slide in business confidence as indicated below (Trade Economics, 2020):



Figure 2.8 Business confidence

The GDP in this same 10-year period between 2010 and 2020 (Trade Economics, 2019) averaged at 1.8%. This has meant the slowing of business growth and confidence of doing business in South Africa and without these strong indicators, the growth has slowed significantly in new office space required in terms of GLA entering the market. Johannesburg is the largest municipal economy in South Africa, contributing one third of the country’s GDP and is a good indicator of existing performance in this property asset class. 2020 yields in Johannesburg for office spaces were between 8% and 9.5% for both 2019 and 2018, with rentals remaining the same at between R220 – R260 per square metre for prime locations. Development pipeline has reduced from 375 808 square metres in 2018 to 297 505 square metres in 2019 (Makhoba & Ramokhoase, 2019).

Sandton is however the key driver in Johannesburg and the inclusion of single tenant P-grade buildings like Discovery, Ernst and Young and Sasol to name a few, has meant that there has been an increase in pressure in terms of vacancy in office space in the Sandton node as well as the greater Johannesburg region, and further pressure has been placed on more intense rental reversions (Makhoba & Ramokhoase, 2019). This trend is not bound to Sandton only as it has been similar in other major metropolitan areas throughout the country. The economy has been struggling to breach 1% growth for the last 3 years with State Owned Entities (SOE's) being fraught with corruption allegations (Trade Economics, 2019). With country wide pressure on office space the vacancies, this has meant that tenants have the power when re-negotiating lease terms with landlords (Makhoba & Ramokhoase, 2019). The average rental rates have seen a steady increase for Grades A and P by 6.9% while the Grade B lowered by 3%. The figure below (SAPOA, 2006, 2009 and 2014) shows the vacancy rates and rental per square metre for the major metropolitans in the country with comparisons over the last ten years.

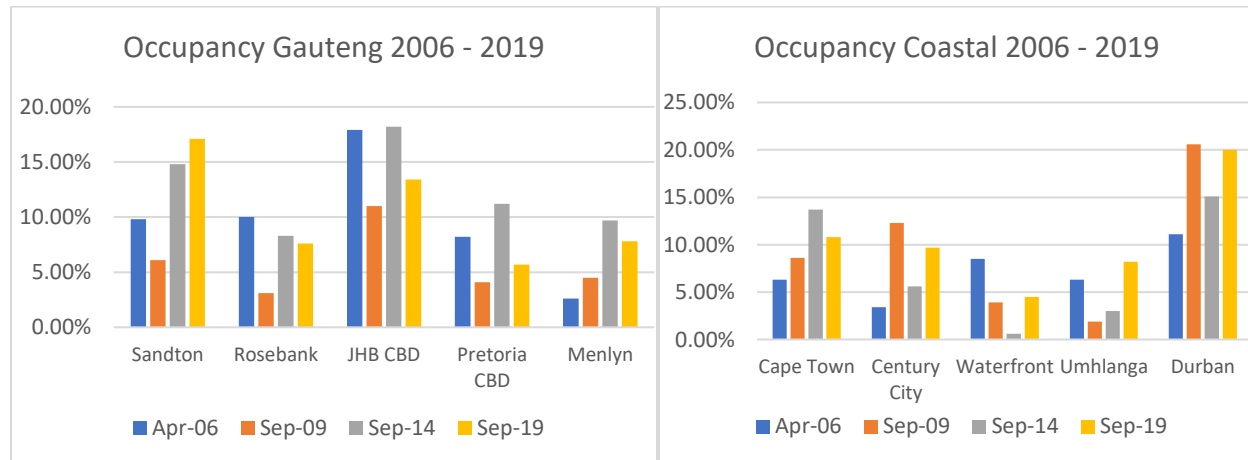


Figure 2.9: Vacancy rates 2006 - 2019

Table 2.4: Rates commercial offices, prime nodes in South Africa

	Sandton		Rosebank		JHB CBD	
	P-Grade	A-Grade	P-Grade	A-Grade	P-Grade	A-Grade

Apr-06	N/A	R75.00	N/A	R65.00	N/A	R34.00
Sep-09	R133.50	R126.25	N/A	R110.00	R100.00	R65.00
Sep-14	R195.00	R145.00	N/A	R163.00	N/A	R75.00
Sep-19	R225.00	R140.00	R261.00	R180.00	N/A	R93.00

	Cape Town		Century City		Waterfront	
	P-Grade	A-Grade	P-Grade	A-Grade	P-Grade	A-Grade
Apr-06	N/A	R60.00	N/A	R95.00	N/A	R95.00
Sep-09	R130.00	R95.00	R115.00	R99.50	N/A	R142.50
Sep-14	R185.00	R113.00	N/A	R128.00	N/A	R165.00
Sep-19	R185.00	R150.00	R210.00	R155.00	R200.00	R205.00

	Pretoria CBD		Menlyn	
	P-Grade	A-Grade	P-Grade	A-Grade
6-Apr	N/A	R33.00	N/A	R82.50
9-Sep	N/A	R48.00	N/A	R116.50
14-Sep	N/A	R65.00	N/A	R130.00
19-Sep	N/A	N/A	R205.00	R180.00

	Umhlanga		Durban	
	P-Grade	A-Grade	P-Grade	A-Grade
6-Apr	R85.00	R65.00	N/A	R55.00
9-Sep	R85.00	R117.50	N/A	R95.00
14-Sep	R85.00	R135.00	N/A	R70.00
19-Sep	R175.00	R150.00	N/A	R100.00

Source: SAPOA (2006), SAPOA (2009) and SAPOA (2014)

Commercial offices will still drive premium rates and developers will still achieve desired returns for offices in premium locations, but further indications show that office vacancies in Sandton have reduced and can be attributed to office-to-residential conversions (Makhoba & Ramokhoase, 2019). This may be further illustrated as per the figure below (SAPOA, 2019:13) is an indicator of the decline in development activity in the commercial office sector.

OFFICE DEVELOPMENT UNDER CONSTRUCTION SQUARE METERS; 1990/03/01 to 2019/06/01

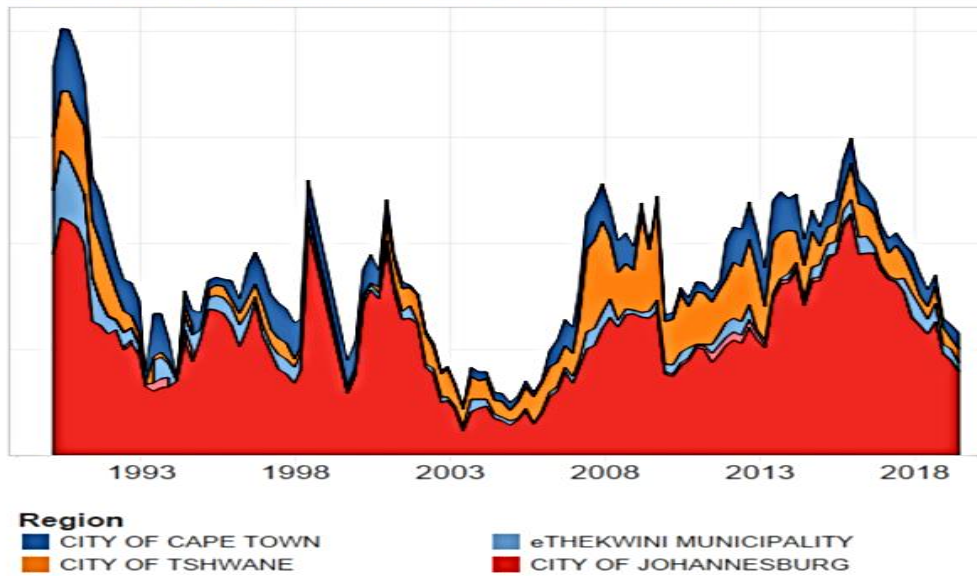


Figure 2.10: Office development under construction

2.10.2 Commercial real estate – Retail

During the Apartheid era, many of the retailers were not allowed to enter previously disadvantaged communities due to safety concerns (du Toit, 2010). Many retailers looked to enter these markets up to and post 1994, which meant an increase in retail development in rural communities (du Toit, 2010) as they were under-served at this point in South African history. Trading density by late 2007 had grown steadily with super regional shopping malls at trading densities of R26 000 per square metre in terms of turnover. Retail sales in South Africa exceeded R1 trillion in 2017 spaced over 24 million square metres of retail space (Prinsloo, 2018:2). This is evident in retail trading density over the last ten years as indicated below (MSCI, 2019:1), which has seen growth in all classifications of the retail sector.

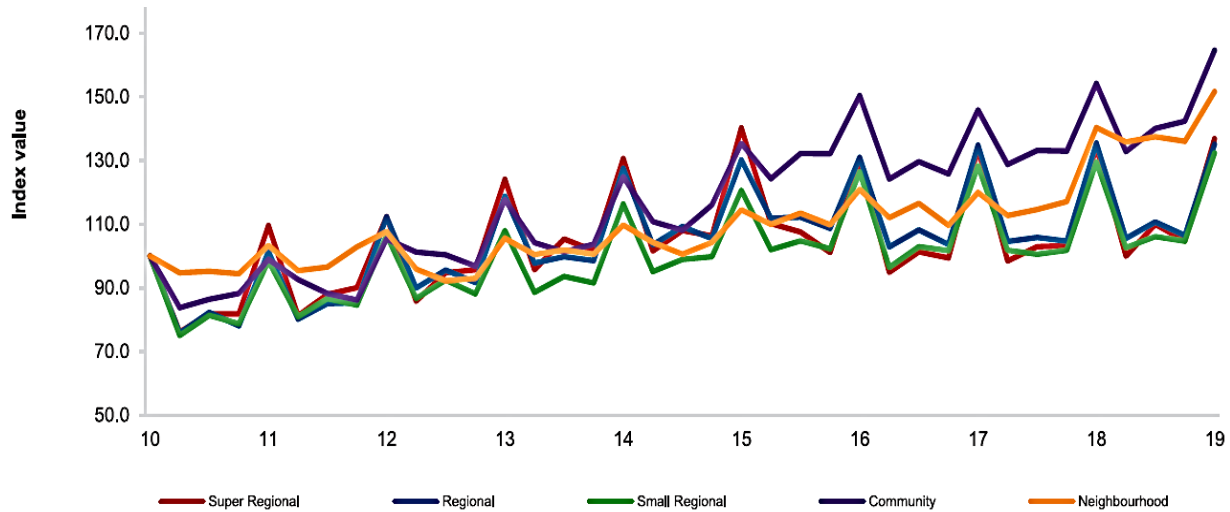


Figure 2.11: Trading densities in the South African retail sectors

With the global financial crisis in 2008 and 2009, spending power for the consumer in South Africa was under pressure. During this time super regional malls and regional malls performed best in terms of trading densities per square metre as consumers were more attracted to department stores and larger malls had far greater numbers of these types of tenants (Prinsloo, 2018). South Africa from 2015 grew to have the fifth highest number of retail centres globally with 1942 retail centres equating to 23 million square metres at the time in 2015 (Prinsloo, 2016:1). In terms of GLA this ranked as having the 6th highest number of square metres in retail space as compared to other destinations. There was a growth in the number of retail centres from 1053 centres in 2007 to 1942 by 2015 (Prinsloo, 2016:4).

Table 2.5: Retail centre size per country

No	Country	No of centres	GLA m2 (Mil)
1	USA	115438	701.9
2	China	3800	250.0
3	Canada	3517	54.6
4	Japan	3096	46.4

5	South Africa	1942	23.0
6	UK	1672	28.4
7	Australia	1508	22.2
8	Italy	962	15.4
9	Malaysia	924	13.5
10	France	746	15.8

Source: International Council of Shopping Centres (2015)

The retail sector represents 15% of the total GDP of South Africa with the sector employing 1 million people. The future of retail centres is dependent on the impact of online shopping. This is the fastest growing retail market in developed markets such as Europe and North America (Prinsloo, 2018). Sales for online shopping was expected to reach EUR 250billion in 2017 and USD 400million in the USA retail market for the same period. South Africa is still relatively small with the market only being R 8.9billion per annum. Prinsloo (2018:3) states the main driver for the increase in online shopping is the increase of ownership of smartphones from 13% to 29% of the population as of 2017. This is illustrated in Figure 2.12 below.

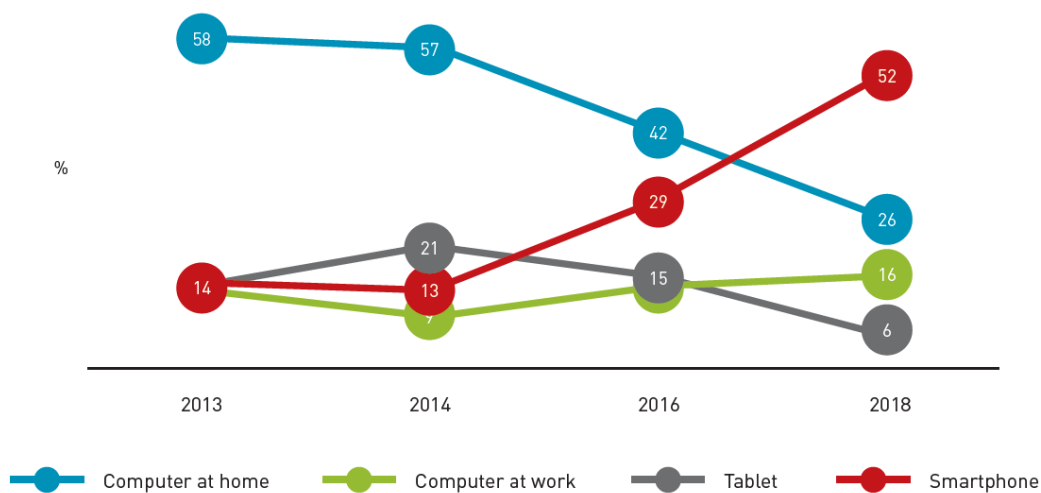


Figure 2.12: Online shopping

Research by Prinsloo (2016:3) indicates that the amount of online shoppers has also increased with the amount of monthly transactions. In 2013 it was noted that 41% conducted online transactions on a monthly basis, whereas in 2018 this number increased to 54%. Such online shopper do on average of three transactions per month at a value of R1 350 per transaction. Millennials are more active online and do four to five transactions per month. Millennials transact more frequently, but the spend per basket is lower at R1 280 per transaction. In the past, social media platforms like Instagram was not important in terms of source of information. As of 2018, research shows that 33% of online shoppers rely on Instagram as an important source of information or as an influencer (Prinsloo, 2018:5). More millennials use features on Instagram for shopping trends such as photo-sharing. Instagram only has 400 million users which is almost one fifth compared to Facebook, but generates 15 times the level of engagement. Instagram is regarded as the world's most powerful platform (Galloway, 2018).

Online reviews are becoming an important aspect of the decision whether to buy online. Amazon is one of the most trusted companies based on the number of reviews followed by Google. The 2018 survey indicated that 64% of online shoppers are strongly influenced by online reviews. Only 17% indicated that they are not at all influenced by online reviews. Online users in the hospitality industry already pay much attention to reviews on TripAdvisor and Booking.com. The future of retail marketing will be influenced by online reviews and the visual effects created by Instagram. Prinsloo (2016:3) notes that convenience is still the main reason for shoppers purchasing online and this has not changed since 2013, as demonstrated in figure 2.13 below. Research indicates that 43% of online shoppers note this as the main reason for shopping online. Non-online shoppers are mainly older people, earning less than R20 000 per month and are mainly in middle to lower Living Standards Measure (LSM) groups (Prinsloo, 2016). With the strong youth dynamics in South Africa, online shoppers have followed characteristics as below:

- 50/50 female to male split
- Aged between 25 – 49 years

- Earning more than R30 000 per month
- LSM 10 and 10+

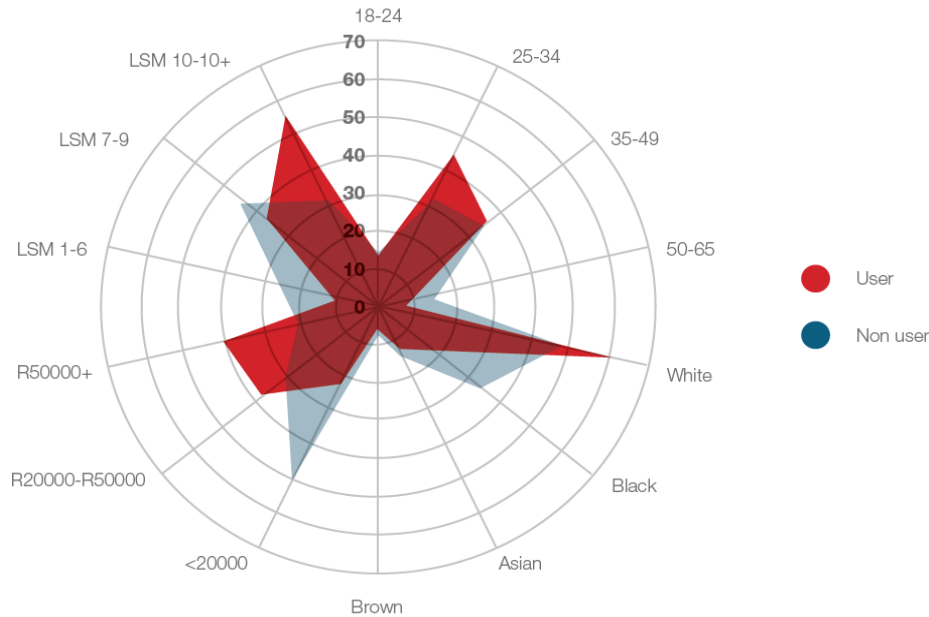


Figure 2.13: Split of online user and non-users

All these changes will have a major impact on the planning of an omni channel strategy by retailers in future. Shoppers confirm that online and in-store shopping will remain important as shoppers in South Africa still look to feel and touch products (Prinsloo, 2016). This clear preference for shoppers has meant that some online retail platforms are also moving to brick and mortar. Retail in future will mainly be driven by convenience and experience. Mobile devices are key for online shoppers to compare prices and to find the nearest available store to purchase products. Marketing initiatives will therefore mainly focus on social media by developing application software to complement retailers. This means millennials will become the next customers and will be key for the future. Estimates of online shopping in South Africa by 2023 show that online shopping can grow to approximately R40 billion by 2023 with current levels at approximately R22.5 billion (Prinsloo, 2018:18). Nevertheless, retail remains an important asset class as many South Africans simply do not have access to data to shop online, and if they did, not all rural

areas are serviced with retail centres. The trend is however increasing to online shopping and retailers are fast adapting as they have done in the United States and other developed countries in the world.

2.10.3 Commercial real estate – Industrial

Industrial property has been more resilient to the economic challenges faced by South African developers compared to other commercial assets (API Property Group, 2019). Industrial properties are concentrated in specific industrial areas with these areas having space availability for expansion. Retail property is strongly linked to the consumer whereas industrial and warehousing space is linked to the economy of the country with specific links to the manufacturing sector (Prinsloo, 2018). The industrial sector in 2019 was observed as being stable albeit with challenges with an unstable grid and volatility of the local currency. Despite this, the industrial sector has been resilient and has outperformed other commercial asset classes.

Industrial properties driving premium rates are those that are either multi-purposed or specified in the high end-technology space. Location is key with good performing industrial assets close to ports or airports still demanding premium over location situated away from these transport hubs (Bales, 2020). Over the past few years the industrial property sector has outperformed the office, retail and leisure property sectors and according to Bales (2020) one could attribute this to the following factors:

- Location of the site
- Accessibility and road systems
- Age and condition of the buildings
- Modern building materials (for example, asbestos roofs will likely have to be replaced shortly)

- Loading and offloading areas by large interlink trucks. This was an increasingly important factor in 2019
- The flexibility of the premises (specialised premises have a smaller chance of being rented out if a new tenant needs to be found)

The need for warehousing due to increased online shopping and the need for support to retailers has seen a big drive towards warehousing assets (Prinsloo, 2018). API Property Group (2019) state that other factors which may have improved the sectors' performance, are discussed below.

Industrial productions are driven by construction demand as well as other forms of fixed investment (API Property Group, 2019). In Q4 of 2018 the country slipped into a technical recession, but demand in industrial property was bolstered because of the increase in construction sector demand by 2.3% specifically due to the rise in non-residential buildings (API Property Group, 2019).

2.10.4 Commercial real estate – Alternatives

When discussing alternative property asset classes, the first that comes to mind is that of medical services which is rapidly changing. One of the main developments being the specialisation medical centres such as same-day surgical centres. Over the past few years the growth in private medical centres, each with its own specific or a few specific purposes has risen. More medical schemes' expenditure is being utilised in these new types of medical centres due to the higher rates of utilisation. This gives medical schemes more motive to increase their expenditure at these types of institutions than traditional hospitals (Econex, 2013). The surgery sector within medical services is underdeveloped in South Africa in comparison to the more developed countries with South Africa seeing

their day hospitals having 17.54% of the market share in comparison to the 82.46% of the general hospitals (Goss-Ross, 2018).

Focusing on the comparison between hospitality as an investment and student accommodation, one can assess the current market for each and draw comparisons between the key performance indicators which an investor will use as the basis for decision making. These are the ROI per square metre, average vacancy rates as well as growth prospects for each type of development. Student accommodation is considered a highly profitable sector of investment, especially in recent years due to the influx and growth in the number of students attending tertiary education institutions. The number of new, purpose-built student accommodation is set to top 500 000 beds within the coming years (Rawson, 2019). However, due to the very nature and purpose of these properties, the demand is area specific as well as competitive with regards to cost, features and services. The additional number of students attending tertiary education institutions each year is indicative of and explains the occupancy rates of over 97% (Unknown, 2019).

These investments, as previously stated, are area specific and are only feasible and scalable at locations surrounding these institutions. This is limiting in nature in comparison to the hospitality sector which has an abundance of locations and points of interest to be of service to customers. Student accommodation is seen as a cost driven sector with high levels of competition due to the different requirements for the customers. However, hospitality is a versatile form of lodging which gives it the dynamic range in terms of product and profitability. This does give the investors in hospitality the attribute of innovation and diversification to improve their bottom line. Whereas in a sector with almost entirely cost-conscious customers, this may not always be possible. This sector niche is considered as being stable, as the profitability of the sector is not greatly affected by external market factors (Smith, 2020).

Due to the dynamism and versatility of the hospitality sector, it is a good form of alternative investment due to the potential earning abilities. The high-end of the market is not as affected by direct-to-consumer online booking sites as this mostly affects the low-end of the scale (PWC South Africa, 2019). The outlook for the 5-year period from 2018 to 2023 is a good return of 5.8% compound annual rate, which is higher in comparison to an estimated 4.6% inflation rate in 2021. This is an aspect of the trade which could appeal to the knowledgeable investor as they would understand the possibilities within the hospitality sector. During a growing economy and market, the hotel market can profit more from a growing economy at a faster pace and it can do this throughout the year. Student accommodation leases and customers largely coincide with an educational institute's academic year.

Data centres are now considered a maturing asset class and is further recognised by the United Nations due to internet access being a catalyst to basic human rights (UN, 2016). The advances in technology has meant a greater need for data centres which has increased significance in including as portfolio enhancing and in the context of suitable alternatives property investment (McIntosh et al., 2017). The data centre REIT market has experience rapid growth which sees data centre REIT's in the United States of America expanding by 80% in marketing capitalization between December 2015 and July 2018 (NAREIT, 2018). Self-storage has also gained in popularity with specialist South African REIT Stor-Age having grown its share price by 41% as compared by the JSE's listed property index of 1.8% for the same period from June 2020 to June 2021 (IOL, 2021).

2.11 Residential Property

Although residential property does not fall within the ambit of commercial property, it would be prudent to include a section on this asset class. The residential property market has slowed down over the past few years and this is despite the increasing trend of office-

to-residential conversions which has been occurring recently. Flat vacancy rate was up to 7% in Q1 of 2019 as opposed to 5.5% in Q1 of 2018. Flat rentals grew by 4,5% which is down from the 2018 figure of 5.7%. (Cameron, 2019). This is indicative of an over-supply in the residential sector which was analysed in 2018 by Rhodes & Associates whose studies indicate that the developers of new apartment buildings are unable to find enough buyers to sell all the units and are thus becoming landlords (Cameron, 2019).

As of 2018, Gauteng suffered from the highest vacancy rate which was 9.3% with Kwa-Zulu Natal and the Western Cape seeing figures of 6.5% and 5.7% respectively. The extent of this sudden rise in the vacancy rates and the over-supply is emphasised by the fact that the number of square metres of flats and townhouses in South Africa was up 58% year on year from January 2019. Most of the risk of investment in the residential market is seen on the high-end of the price scale. Conversely, the market for hospitality is a highly fluctuating market which can be adjusted as the market adjusts. South African hospitality companies have targeted alternative clients to entice more revenue, as well as foreign tourism. One of these techniques as discussed by PWC South Africa (2019) is referred to as MICE (meetings, incentives, conferences and exhibitions). This is an example of the versatility of the sector as well as the versatility of the clientele which can be serviced with a singular space. A hotel is dynamic in its attraction of clientele. This would include conference venues, exhibitions and even shopping areas which is not afforded to other potential investment options.

2.12 Fourth industrial revolution

This is essentially a combination of technologies on a physical, digital and biological level and therefore tertiary sectors are required for delivery, manufacturing and servicing of industries (API Property Group, 2019). A changing environment, a weak economy, and the need to adapt to the transformation in demand, are all factors that have forced

property developers to showcase their agility. Due to the need for warehousing, manufacturing, factories and machinery, industrial property has been able to remain resilient against the economic downturn.

2.13 Imports and exports

Growth in the import (specifically) and export industry increased demand for industrial properties specifically for warehousing. API Property Group (2019) research shows there is a clear correlation between the trend of wholesale and retail trade sales in comparison to imports. This means that the increase in imports and exports as shown below (SARS, 2019), resulted in the need for increased storage, logistics and warehousing services in South Africa.

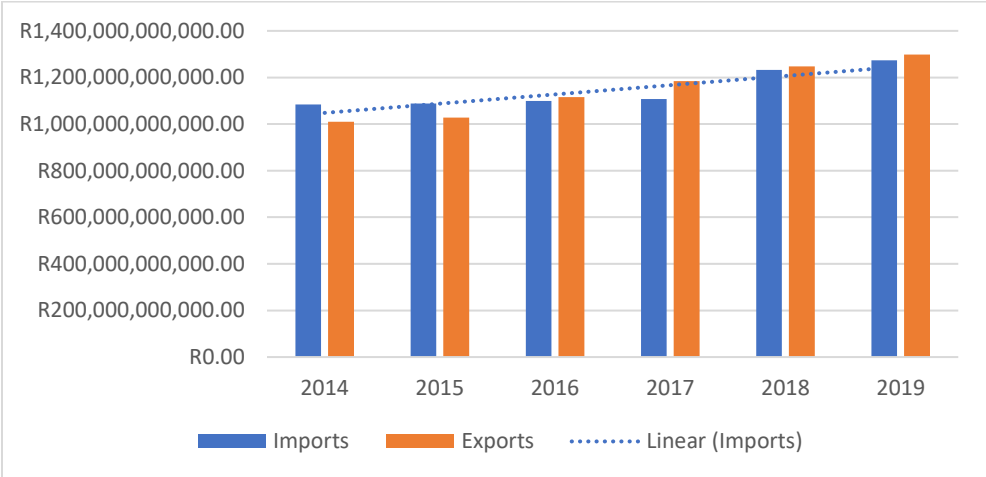


Figure 2.14: South African imports and exports

According to trade economics data, South Africa's Absa Manufacturing PMI fell to 44.3 in February of 2020 from 45.2 in the previous month. This represents a seventh consecutive month of contraction and is at the quickest pace since August of 2009. Nevertheless,

industrial assets are still performing well and showing resilience to the market. This contraction would mean manufacturing activity decreasing significantly and would imply low level of inventory and resultantly less storage space would be required in the current economic climate.

Aside from demand for hard and light industrial accommodation, the manufacturing trend suggests that there is little growth in domestic demand for storage and logistics accommodation. However, commercial and industrial zoned services land has had no notable reduction in prices and has instead maintained an easy and steady trend. This trend is set to remain the same especially for the commercial and industrial investment properties, with good leases in place which assist in sustaining their market value. The expansion for industrial development as conversion from agricultural land into serviced land, will further drive prices. The risk of holding agricultural land is high and will therefore increase the price of zoned land.

2.14 The Property Cycle

In understanding developers, REIT's and fund managers' ROI requirements, one needs to be cognisant of where in the property cycles the current market falls. Below is a diagram of the different property cycles (McCarthy Group), which will be discussed in more detail together with understanding of return expectations.



Figure 2.15: The property cycle

According to White & Gray (1996) the success of property development is the extent to which a property investor's objections are met. These may be in the form of the following; maximising yield, beating inflation and the service of the public need. South Africa is currently experiencing a correction in the property market. The financial yield of a development or property investment can be measured by the following methods:

2.14.1 Initial return

According to Megginson *et al* (2007) many companies look at first year return on a project based on the rate of return the investment will make on an accounting basis. This is referred to as a hurdle rate. These initial return calculations can be done in two steps:

- Identify the net income for each year of its investment life
- Measure the CAPEX required to the project in each year of its investment life

This is then calculated by dividing the net return by the book value of the assets on a year-on-year basis. This is then comparable to ROI (return on investment). Most property-owning entities will establish a minimum rate of return which needs to be earned before funding such a project or acquisition. A key measure in this calculation is the valuation of the asset. The flaw with such a measure of rate of return is that it must be measured against other similar investments to have an objective approach to the investment (Megginson *et al*, 2007).

2.14.2 Payback Method

This method considers the maximum acceptable payback period for such a project. The payback period measures the period in which it takes for a project to generate enough cash to recover its cost. The calculation is the investment cost divided by the cash flow per period. Megginson *et al* (2007) notes that despite these apparent virtues, the payback method suffers from several serious problems. Firstly, the payback cutoff period is simply a judgmental choice with little or no connection to shareholder value maximisation. Secondly, the way that the payback method accounts for the time value of money, is crude in the extreme. The payback method assigns a zero percent discount rate to cash flows that occur before the cutoff point. Thirdly, using the payback period to control for project risk is equally crude. Finance teaches that riskier investments should offer higher returns. If it is true that riskier projects have longer payback periods, then the payback rule simply rejects all such investments even if they offer higher returns in the long run.

2.14.3 Net Present Value

This method is effectively when one takes the sum of the cash inflows and outflows, discounted at a rate consistent with the project's risk. If this Net Present Value (NPV) exceeds zero, then the project is feasible. The cash flows in each year may be positive

or negative, though one usually expects projects to generate cash outflows initially and cash inflows later (Megginson *et al*, 2007). The net present value (NPV) is simply the difference between the present value of cash inflows and the present value of cash outflows (White & Gray, 1996). With a positive NPV the project can be accepted, and it should be rejected if the NPV is negative. There is one other subtle drawback to the NPV rule, being a drawback that results from the inability to incorporate the value of managerial flexibility when calculating a project's NPV. What is meant by using the term managerial flexibility are options that managers can exploit after an investment has been made to increase its value (Megginson *et al*, 2007).

2.14.4 IRR (Internal rate of return)

According to White & Gray (1996), the Internal Rate of Return (IRR) is defined as that rate of return which will make the present value of future cash inflows equal to the present value of the initial investment cost and other cash outflows. According to Megginson *et al* (2007), the most popular and most intuitive of the above alternatives, is known as the IRR method. The IRR of an investment project is the compound annual rate of return on the project, given its up-front costs and subsequent cash flows. Once the IRR is calculated, it should be compared with a prespecified hurdle rate established by the company. The hurdle rate represents the company's minimum acceptable return for a given project, so the IRR decision rule is to invest only if the project's IRR exceeds the hurdle rate. A company should set the hurdle rate at a level that reflects market returns on investment that are just as risky as the project under consideration. Therefore, the IRR method, like the NPV method, establishes a hurdle rate or a decision criterion that is market based, unlike the accounting based and payback approaches that establish arbitrary thresholds for investment approval. In fact, for a given project, the hurdle rate used in IRR analysis should be the discount rate used in NPV analysis. (Megginson *et al*, 2007).

Several advantages make the IRR one of the most widely used methods for evaluating capital investments (White & Gray, 1996). Firstly, the IRR makes an appropriate adjustment for the time value of money. Secondly, the hurdle rate itself can be based on market returns obtainable on similar investments. Because market rates vary, based on the risks of different instruments, companies can similarly choose different hurdle rates for projects with different risks. Thirdly, because the “answer” that comes from an IRR analysis, is a rate of return; and its meaning is easy for both financial and non-financial managers to grasp intuitively.

Finally, the IRR technique focuses on cash flow rather than on accounting measures of income. This buyer’s market environment is evident during a distressed sales market scenario with an oversupply of stock which will take time to clear out. This will become evident with the bank’s bad debt to book ratio and how this has increased or compared year-on-year. According to the estate agency affairs board, the housing price index is a good indicator. With this growth rate seemingly dropped and only becoming visible again when the oversupply has been dealt with, the growth potentially initiates another property cycle with a positive capital growth cycle in nominal as well as real terms. The following symptoms are present in the current cycle which indicates a slump:

- High percentage of distress sales
- Availability of credit (bonds or mortgages) limited
- High bond or mortgage stress levels
- Low sales volumes
- Below historical levels price growth
- Uncertainty about market values of SA property

The South African property market has, during the last 50 years reacted differently from the boom-bust scenarios experienced elsewhere in the world. The 2010's property plateau will most probably be longer than the 6-year span experienced during the 1990's and this span will be determined by the inflation rate and logically its effect on our currency. The biggest difference between the plateaus of the 1990's and the 2010's is the remedial effect the growing black middle class will have on the property market. In today's market, the impact of our ailing economy and global conditions will play a role in the growth expectations in the market. The reality is that there is a current slump in the market which is attributed to many factors such as regular energy cuts, low business confidence, increased pricing pressures on lease to turnover ratios and other factors. This coupled with the recent downgrading to junk status of the economy has meant that our cost of capital has become more expensive and therefore places more pressure on returns (Eager, 2019). The historical hurdle or ROI rates expected from property developers would be between 15% and 20% depending on asset class. This may come under pressure in the current market in South Africa.

2.15 Covid-19

Covid-19 has had a significant impact on the hospitality sector which is arguably the most affected industry in 2020-21. At the time of the first level five lockdown in South Africa on the 15th of March 2020, occupancies had already dropped globally affecting hotel performance. This significant drop in occupancy is illustrated in the table below.

Drop in Occupancy (9-15 March 2020)									
70% or greater		60% - 70%		50% - 60%		40% - 50%		20% - 40%	
Italy	93%	Slovakia	70%	Israel	59%	Myanmar	49%	Portugal	39%
Lebanon	77%	Slovenia	68%	Estonia	58%	Philippines	49%	Morocco	39%
South Korea	75%	Vietnam	67%	Cambodia	57%	Senegal	47%	Lithuania	39%

Greece	75%	Romania	67%	Poland	56%	Kenya	46%	UAE	37%
Kuwait	73%	Singapore	66%	France	55%	Sweden	45%	Ivory Coast	37%
China	72%	Bahrain	66%	Hungary	55%	Malaysia	45%	Ethiopia	33%
Croatia	71%	Saudi Arabia	65%	Switzerland	55%	India	44%	Turkey	33%
		Czech Rep	64%	Serbia	55%	Oman	43%	Finland	32%
		Japan	64%	Thailand	53%	Laos	43%	Canada	28%
		Georgia	61%	Denmark	51%	Tunisia	43%	USA	27%
		Austria	60%	Spain	50%	Sri Lanka	43%	Maldives	26%
		Belgium	60%	Netherlands	50%	Egypt	43%	Qatar	26%
		Bulgaria	60%	Germany	50%	Ireland	41%	Russia	25%
						Ukraine	41%	UK	23%
						Ghana	41%	Latvia	23%

Table 2.6: Drop in Occupancy due to Covid-19

Source: Fjallman (2020)

According to JLL (2020) the consensus was that there would be a rebound in the second half of 2020, but that this may be further delayed in Sub-Saharan Africa due to a second wave which is currently impacting the continent, as well as the delay in procuring vaccinations. The severe impact of travel restrictions, event postponement and cancellations, as well as individual travelers being negatively impacted by the pandemic, has meant that hospitality and tourism has been the most affected. Without a doubt, COVID-19 will have an impact on the sector as travel restrictions mean that the hospitality sector is most affected. This has been confirmed by the number of travelers arriving in, and departing from South Africa as can be seen below. Numbers supplied by Stats SA (2020) indicate that Arrivals of Foreigners are down by 90,4% and Departures down by 89,6% while arrivals by SA Residents decreased by 83,8% and departures by 82,2%.

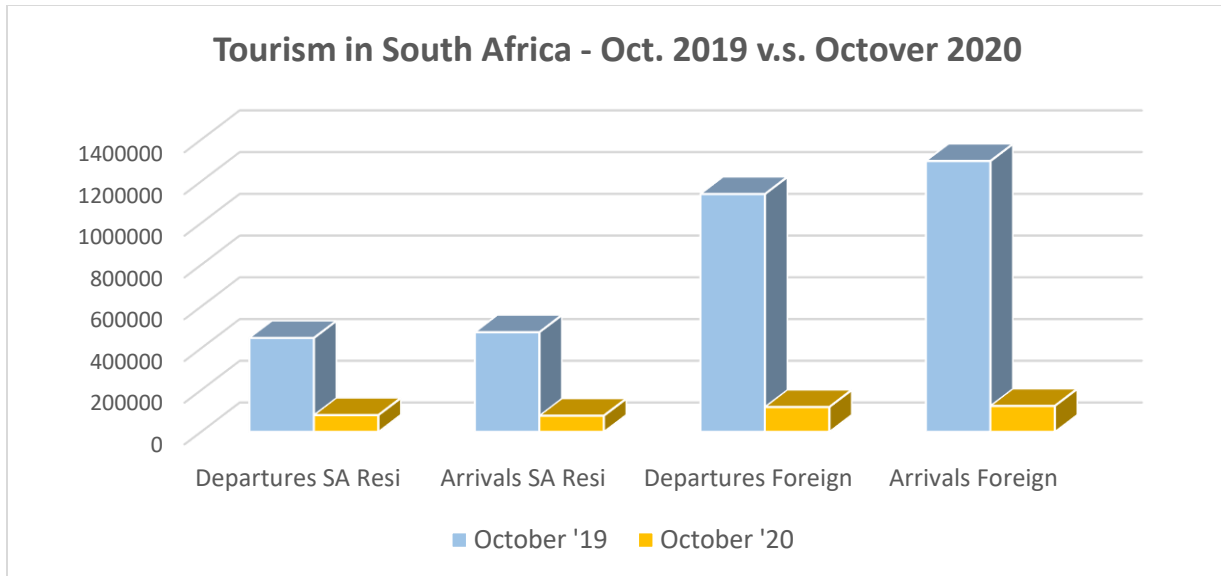


Figure 2.16 Tourism in South Africa

With the global economy shrinking at an estimated 4.4% in 2020 according to the International Monetary Fund, it will also mean less disposable income for corporates which will affect the MICE (meetings, incentives, conferences and exhibitions) business of corporate hotels (JLL, 2020). Household disposable income will have declined which will have an impact on the leisure market with less overseas and local travelers going on vacation. It is difficult to predict the level and pace of recovery as the response time to dealing with Covid-19 will have a direct impact on the recovery in the sector. Research by Allan, R (2020:3) out of China which was the first country to be affected, has already shown recovery to levels pre-pandemic which is encouraging for lagging countries like South Africa.

The problem on predicting the recovery is that there is no direct timeline on when it will end (Emanuel, 2020) and the longer this is protracted, the more severe and sustained the slowdown will be. The map below (Hoyt *et al*, 2020:3) is a strong illustration of how Africa has impacted by the pandemic with Reuters confirming that as of the 22nd of January 2021, South Africa is the country with the highest newly reported infections per day, as

well as deaths per day (Reuters, 2020). A strong indicator of the current second wave as shown in figure 2.17 below.

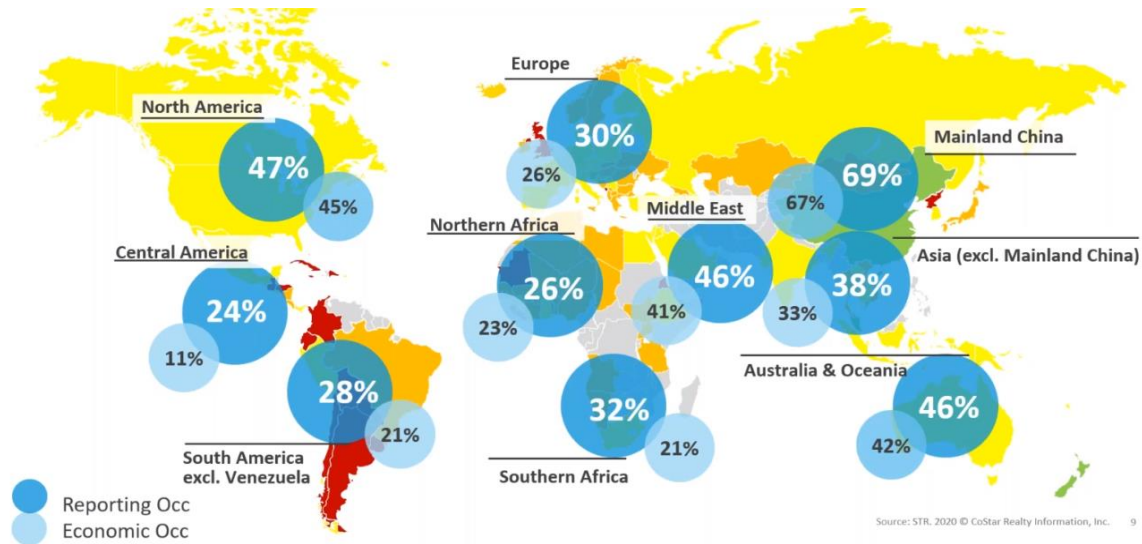


Figure 2.17: Impact on occupancy due to Covid-19

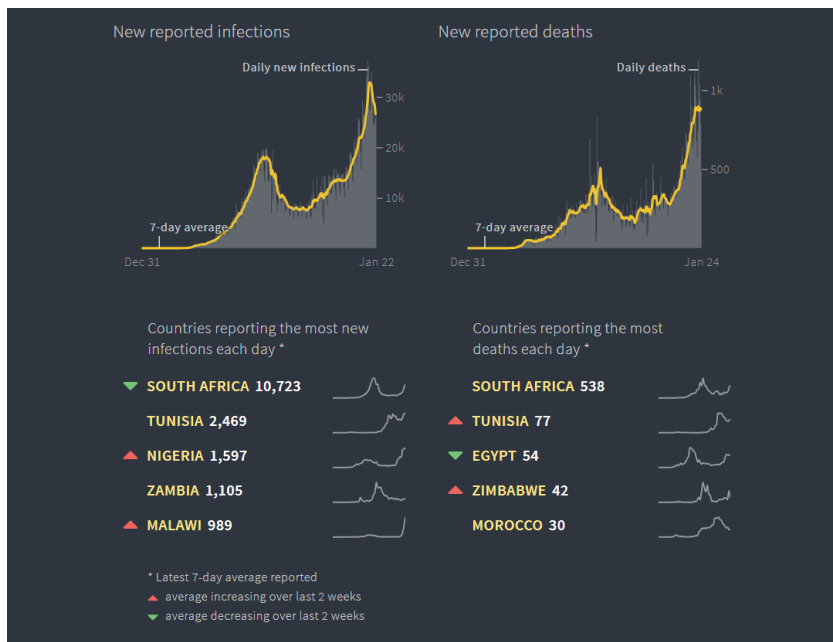


Figure 2.18: Infection rate of African countries

2.16 Summary of the hotel industry in Sub-Saharan Africa and the funding impacts

The literature does present a strong case that opportunity lies in the hospitality sector as it is the smallest in terms of market size compared to other sectors and provides an alternative when traditional commercial assets are struggling to gain traction in the market. The literature also links the need to understand hotel business fundamentals in make the informed forecasts and investment decision, an important part of this being the understanding of differences between franchise agreements, management agreements and leases. This need to be considered in relation to the evolution of the hotel sector, globally and in South Africa. Important are hotel management agreements which are becoming increasingly aligned with global trends (Rogerson JM, 2013).

Most of the developers, pensions funds or REIT's would indicate that variable income is not within their preferred mandate when investing in commercial property. Financing is a challenge as traditional banks prefer hotels funded off an existing portfolio of properties that have a stable income stream (JLL, 2019). Development funding institutions are also difficult to access due to their rigorous entry criteria which eliminates several potential developers from accessing this funding. Investigation would need to define which institutions are able to fund hotels and at what levels for future demand in the sector. These are the fundamental challenges faced by developers when entering the hotel market and remain a concern for past and present developers. ROI fundamentals exist in the hotel market, but ROE hurdles are difficult to meet due to the equity required for the funding of hotels.

The hotel industry in Sub-Saharan Africa's hotel market is rapidly growing with more capital and equity markets entering the continent. A better understanding of the sector has introduced new players to the market. The fastest growing markets are arguably those outside of South Africa which are less mature markets. Supply in these markets is

growing with supply entering these markets being very pronounced. This is the hallmark of any frontier region and has characterised the evolution of almost all hotel markets. Investors are looking beyond the attractive demand fundamentals that characterise the region, to carefully consider the supply landscape. A critical point is the disparity that exists within markets in Sub-Saharan Africa. In almost every major market across the region, hotels that are well located and able to align their product to the demand fundamentals, with a suitable distribution system, are comfortably outperforming their competitors. This trend is important, as even in tough markets, there are still opportunities. South Africa is attracting increased liquidity for hotels as other asset classes come under pressure in a low economic growth environment.

Stronger market fundamentals make this an easier proposition and in East Africa, improved trading in Addis Ababa is seen off the back of positive political reforms. The pace at which this command economy opens to the rest of the world will be key to its success. Kampala and Entebbe are performing well, with strong demand prospects. Nairobi's recovery from oversupply was more subdued in 2019, due to the impact of the tragic Dusit attack in January 2019. The longer-term prospects for Nairobi are excellent and several knowledgeable investors are prepared to look beyond the short-term challenges. Dar es Salaam and Lusaka are performing poorly, with Lusaka having attracted an unsustainable level of new hotels. West Africa has several exciting hotel markets. Dakar is performing well, with strong demand conditions and a diversified economy. Abidjan has been a strong performer over the past decade. Performance has recently been more subdued due to the impact of new supply of hotels and the upcoming elections in 2020, with many companies waiting for the outcome before considering their approach to the country. This is not unique to the Ivory Coast, but a common theme in Africa when the outcome of an election is not a foregone conclusion. Fortunately, the growth of democracy is becoming more common. Lagos offers opportunities for acquisitions. However, development cost levels are not conducive to new entrants in the short-term.

Accra is a market to watch having seen a year of strong growth and an excellent destination marketing campaign in the form of the “Year of Return” during 2019 (Busari & Siaw, 2019). The Indian Ocean resort markets such as Mauritius and Seychelles have had less demand and are likely to see some performance pressure in 2020. That said, performance is still consistent and strong, and the deeper capital markets still make for attractive investment prospects. Emerging Indian Ocean markets such as Zanzibar and Madagascar are likely to see growth through 2020. As the region matures, with more focus on the sector from institutional and international capital, investors that are knowledgeable, innovative and able to disrupt the sector are well placed to succeed. New concepts such as serviced apartments, combo and lifestyle hotels are leading some of this disruption and innovation.

Chapter 3: DESIGN AND EMPIRICAL STUDY

3.1 Introduction

Chapter 3 details the research approach used for this study. Research methodologies are initially presented in the chapter followed by a justification of the chosen methodology for the study. The research design of the study is discussed in detail later in this section which will include the sampling method used for data collection, research instruments used, and the data analysis method used.

A major limitation to the study was the lack of readily available performance data for the hospitality sector in South Africa. The most likely source to obtain returns published is from the MSCI South Africa annual report property index which provides performance on property returns on a cumulative basis since inception in December 1994. Hotels as a property asset class makes up 0.6% of total property asset classes with sector specific returns not made available. Returns are indicated in the below table.

Table 3.1 Annual property index returns

Year	All Assets ⁽¹⁾	Standing Investments ⁽²⁾	Non-operating Investments ⁽³⁾
2020	-3.10%	-3.00%	-4.80%
2019	7.50%	7.70%	5.00%
2018	9.70%	10.10%	7.70%
2017	11.00%	11.80%	7.90%
2016	10.70%	10.50%	11.20%
2015	12.40%	12.90%	10.50%
2014	12.40%	12.90%	9.60%
2013	15.70%	16.10%	12.40%
2012	14.40%	15.20%	9.00%
2011	10.90%	10.60%	11.40%

Source: MSCI (2020)

The index methodology used for the table above can be summarised as follows:

- ¹ All Asset performance measures every direct property investment in MSCI's index database comprised of all property sectors, ownership structure and interests
- ² The Standing Investment index subset is based on completed and lettable properties only, described as operational properties
- ³ The Non-operating Investment index subset is constructed from those properties not included in the Standing Investments index subset, which can be referred to as non-operational assets.

It would be difficult to compare the performance of this index to that of the hotels subset due to limited participation of only 0.6% as an asset class as compared to the R 400.75 billion asset value of the total value of all property asset classes.

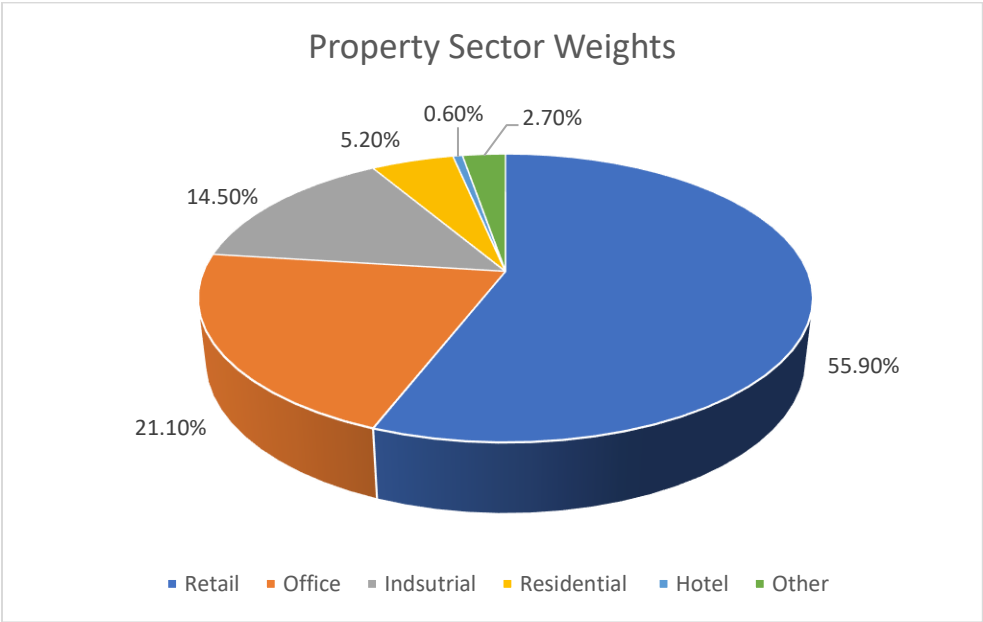


Figure 3.1 Property sector weights

Newell and McGreal (2015) investigate hotel investments and their contribution to commercial real estate at a global, regional, and country specific level between 2007 and 2014. This is done by assessing 174,000 real estate transactions worth over \$4.35 trillion of which hotels transaction made up 8.8% of global real estate transaction activity. This clearly shows that hotels are a stronger asset class globally as compared to a regional level in South Africa. As discussed by Manning et al (2015), real estate research has historically focused on traditional forms of real estate such as offices, retail, industrial and residential property asset classes. Recent statistics from American Hotel and Lodging Association (2013) indicate that there are approximately five million hotel rooms and 50,000 hotels in the United States of America. Even in this developed economy, Manning et al (2015) describe this asset class as being under researched.

3.2 Research Methodology and Methods: Brief Overview

The research problem and skills of the research should be the determining factor of the research methodology used (Leedy & Ormrod ,2005). Another school of thought by Heppner & Heppner (2004) is that the researcher takes time and thinks about the method selection as this will have an impact on the course of the entire study as well as any findings. The research methodology used as the general research strategy provides the framework of how the research will be carried out and identifies the specific methods used (Howell, 2013). This is described as systematic theoretical positioning. It does not look to provide solutions, but rather it looks to assist the research with a paradigm outcome. A research paradigm informs and guides how research should be conducted on people's assumptions about the nature of knowledge. These methods tend to provide how certain results are formulated. Methodologies implemented correctly will aim to provide research findings relevant to the problem statement. The tools used are the research methods provided to the researcher to obtain this data.

3.3 Research Methodology

As briefly indicated in Chapter 1 there are three predominant types of research methods namely qualitative, quantitative and mixed methods (Hanson *et al*, 2005:224).

Qualitative – this method is described as exploratory research which looks to signal new beliefs, emotions, perceptions, ideas or thoughts regarding a specific topic (McMillan and Schumacher, 1993). This research is normally carried out with the idea of asking open-ended questions and is unstructured or less structured in its questions. It can take the form of focus groups, one-on-one interviews or participant observation. This research tends to be in smaller sample sizes and data is subjective, giving opportunities to be interpreted by the researcher. The advantage of this research method is it is relatively short in nature to conduct and requires fewer participants. It can also be more in-depth limiting it to finding a “generalist” view on the data. These types of insights can be limited to subjective understanding (Creswell, 2003).

Quantitative – this method is used when looking for patterns or predictions through quantifying the problem statement and producing some statistical analysis of the results (Creswell, 2003). This form of research aims to confirm, validate, establish or decline relationships between variables that are easily found in the study, normally those where generalised findings are interpreted (Howell, 2013). This type of research has findings that are relatively predictive and correlate in some way. Quantitative research approaches are structured and are usually done in surveys, opinion polls, interviews, Q and A and close-ended questions (Jackson, 2009). The samples with this method tend to be larger compared to qualitative research.

Mixed – this research approach includes both qualitative and quantitative research methods (Creswell, 2003). A mixed method could for example use a questionnaire as well

as a focus group. This method is often viewed as more of a pragmatic approach as it provides the researcher with the opportunity to use the research method that is best suited for the specific research problem without becoming distracted in theoretical elements of the study (Teddlie & Yu, 2007). Instead of viewing quantitative and qualitative as opposing methodologies, rather view them as complementary to each other. By utilising both methods, the research has the ability to use strengths of both methods and inherently cancelling any bias or favouritism to any specific source or method. Rossman & Wilson (1985:627) argue that there are three reasons to use mixed methods:

- “Enable confirmation or corroboration of each other through triangulation
- Provide richer data through more complex data analysis and comparison
- Initiate new modes of thinking by attending to paradoxes that emerge from the two data sources.”

Mixed research methodologies have more support now and have become a common approach to research studies (Campbell & Fiske, 1959), and are now considered as the third research methodology. Below is a table with characteristics of the two approaches:

Table 3.2: Characteristics of idealised quantitative and qualitative approaches

Dimension	Quantitative Approach	Qualitative Approach
Design	Experimental	Non-experimental
Setting	Laboratory	Field
Data Collection	Instruments (e.g., electronic or mechanical devices, tests, questionnaires)	Collection of “narratives,” either already existing (e.g., diaries), or new (e.g., interviews)
Data Type	Numerical (ratio, interval, ordinal)	Descriptive (e.g., interview protocols, written records, videos)
Analysis	Descriptive and analytic statistics	Analysis aimed at revealing meaning
Generalisation	Focus on testing hypotheses	Focus on generating Hypotheses

Source: Campbell, D.T. *et al* (1959)

This study is mainly based on the qualitative research methodology as it aims to understand and describe new ideas on the research problem statement but would include elements of quantitative research to support the notion of it being based on a mixed methodology. Johnson *et al.* (2007) defined the mix of methods as “the class of research where the researcher mixes or combines quantitative and qualitative research techniques, methods, approaches, concepts, or languages into a single study.”. The research questions are exploratory in nature and therefore support the qualitative analysts (Leedy & Ormrod, 2005).

The study's aim is to have an in-depth understanding of the research topic which will be done by conducting in-depth interviews with participants that will have flexibility in answering open-ended questions. The researcher has the ability to work directly with participants and has the capability of conducting face-to-face interviews. The in-person interaction will be in the form of a questionnaire with an unstructured interview. Data will be collected from the interview which will be cross sectioned with data collected in a quantitative manner. The data collected from secondary research will add depth to the study. Solid qualitative research is well complemented with quantitative data, but this can only be established by directly talking to the participants to allow them to share their information in an impartial manner.

3.4 Principles of qualitative research

The basic principles of qualitative research can be defined with the five basic principles:

Research question: The questions are more investigative in nature in trying to understand the intentions and purposes of the respondent

Philosophy of research: The researcher focuses on the respondents' direct experience with their world and will proceed through stages of the following:

- Recording participants' narratives
- Description of what they say in terms of discipline-based concepts
- Explanation of what this means for theory in the particular discipline

Method of data collection: People's experience of the world and their relationship to it can best be investigated by allowing them to describe these phenomena as experienced

by themselves. In other words, some kind of narrative of the people being interviewed is needed. The dominant form of narrative is the interview, although the extent of its dominance varies from discipline to discipline.

Roles of researcher and subject: The people who are often referred to in quantitative studies as “subjects” then become partners with the researcher in the reconstruction and understanding of their own experiences. These people are referred to as “participants” or “respondents.”

Data analysis: The fundamental task of analysing the data is to interpret the narratives and to understand their meaning. As a rule, the researcher makes a protocol of respondents’ narratives and uses these (a) to describe the situation of the participants and (b) to understand the implications of the narratives for relevant theory.

Research Design

When discussing research design a framework encompassing six dimensions is available for both quantitative and qualitative research methodologies. This framework would include the following:

- Design – is it experimental, quasi-experimental in nature or is it an ex-post-facto or non-experimental design
- Setting – real life versus laboratory
- Data collection procedures – special apparatus, tests, questionnaires, observation schedule or interviews
- Data type – ratio/interval, ordinal, nominal, non-numerical data or narratives
- Analysis type - statistical analysis or meaning based analysis
- Strategies of generalisation – hypothesis testing or hypothesis generation

The two approaches are well understood. This study takes the approach of a non-experimental design, backed with secondary quantitative research to support any conclusions. The elements to good research and the framework to answering questions are described below:

- Reliability which refers to the likelihood that the findings would be duplicated by different researchers working with different participants. Reliable findings will likely be replicated and the opposite for unreliable findings. The importance of this aspect is that unreliable findings cannot be used for generalisations
- Internal validity which refers to the likelihood that relationships among variables are genuine and not due to any other factor such as any cause-and-effect relationship the participants may have
- External validity is when research involves the extent to which the findings continue to apply in new settings that are unlike the circumstances in which the study took place, especially real-life settings

This and other research studies do have certain elements within the studies that will:

- Optimise the reliability of the study by ensuring the findings are genuine and not preconceptions of a researcher
- Optimise internal validity by ensuring as best as possible that the findings compare to genuine relationships within the variables
- Optimise external validity by showing that the findings can be applied to other settings

Keeping all of this in mind, it must be noted that there is a relationship between the dimensions of a research study which refers to the table below:

Table 3.3: Dimensions of research, reliability and validity

Dimension	Reliability	Internal Validity	External Validity
Design			
<i>True experiment</i>	Highly favourable	Highly favourable	At risk
<i>Quasi-experiment</i>	Favourable	Favourable	Lower risk than experiment
<i>Ex-post-facto</i>	Favourable	Favourable	Lower risk than experiment
<i>Non-experimental</i>	At risk	At risk	Highly favourable
Setting			
<i>Laboratory</i>	Highly favourable	Highly favourable	At risk
<i>Real life</i>	At risk	At risk	Highly favourable
Data Collection			
<i>Instruments, tests, questionnaires, etc.</i>	Highly favourable	Highly favourable	At risk
<i>Narratives</i>	At risk	At risk	Highly favourable
Data Type			
<i>Numerical</i>	Highly favourable	Highly favourable	At risk
<i>Descriptive</i>	At risk	At risk	Highly favourable
Analysis			
<i>Statistical hypothesis testing</i>	Highly favourable	Highly favourable	At risk
<i>Content analysis</i>	At risk	At risk	Highly favourable

Source: Heiman (2001)

The present study gathered data from the hotel business community that have access to data, either directly or indirectly. The study does not look to implement any sort of intervention, but is non-experimental in nature so that the participants are not manipulated or controlled in their responses (Heiman, 2001).

3.5. Sampling in qualitative research

In this research study, use has been made of purposive sampling which is subjective sampling and takes the form of non-probability sampling. The researcher uses his or her own judgment in choosing participants from the population to participate in the study. The selected sample are members involved in the hospitality sector in different fields of specialisation. These would include influential decision makers across different sectors of the industry, as described below:

- Hotel Operators
- Hotel Owners and Investors
- Hotel Owner Operators
- Hotel Financiers
- Hotel Section 12J Financiers
- Hotel Property Consultants specialising in the field of hospitality

Some of the participants are prominent hotel chain owners and therefore represent a significant group in this industry. According to Salant, Dillman and Don “Occasionally... a census is the only way to get accurate information, especially when the population is so small that sampling part of it will not provide accurate estimates of the whole” (Salant *et al*, 1994). However Field (2005) states that “it is more suitable to use a sample group if the population is (1) large and (2) homogenous in nature”. The sample in this study was intentionally selected from a heterogeneous group of hotel industry professionals to include various core focus areas or fields of expertise for each of the sub-groups in question. The subgroups were selected for homogeneity and therefore individuals who have prolonged working experience, were included. As the focus is on occupational capabilities in the hotel industry, more specifically related to financing structures, the research questions and sub questions were allocated to groups of specialists from the various sectors within the industry. This was done in order to better describe and provide

understanding in the sub questions through the significant depth of their collective experiences.

During data analysis, a serious attempt was made to prevent cognitive biases from contaminating the data. This was done with an awareness of risk of biases to avoid these pitfalls by discussion and review between participant observers as well as research study leader and researcher. The homogeneity of the sub groups within the heterogenous population and the resources available for this research (time, finance, and labour) suggests that utilising a questionnaire and interview approach was most suitable for this study.

3.6 Research Instruments

In this study an approach was taken of using a questionnaire that is more entrenched in quantitative research. The questionnaire is used as a guideline for questions presented to the participants with open ended answers being encouraged by the researcher in order to develop themes from the responses. The questionnaire was provided to the participants beforehand. They were not asked to answer in written or email format, but rather to use the questionnaire as preparation for the structured interview. In this way the questionnaire became a discussion guide that served both a preparatory function as well as a structure for the interviews that followed. The researcher then met with the participants and conducted the interview to ensure a higher response rate and to engage deeper discussion of any aspects not clear from the initial answers provided. This increased internal validity as opinions of other participants could be shared and compared to obtain the complete spectrum of the in-depth meaning of each answer.

No instruments are used to measure any variables presented in the study. This would include examples such as demonstrated competency, understanding of hotel

complexities within the business). An instrument was therefore designed for the purpose of the study. This instrument was not validated externally which is viewed as a limitation to the study. The limitation is in regard to reliability and validity of the instrument and its potential results. The current study looks to provide initial exploratory findings in a sector or area of research with little to no existing research.

Additional to this, the interviews were schedule to take place in April 2020 which unfortunately coincided with level four lockdown. It was considered to move the study to a more quantitative approach, but as news came that South Africa would enter level three lockdown the opportunity came to meet with clients to conduct face to face interviews. The richness of data far exceeded the risk associated to changing the study to a quantitative research study.

3.7 Framework for the questionnaire and interview

Chapter 5 presents the results of the study, but prior to this it would be important to present the basis for determining the questions used in the questionnaire and framework or discussion guide for the interviews.

The questionnaire is not based on any case study, but rather used as a pre-emptive to the one-on-one interviews to be held at a later stage. In forming the questions, Youngman (1978) lists the types of questions as follows:

- Open
- List
- Category
- Ranking

- Quantity
- Grid
- Scale

The questionnaire is more exploratory and therefore, most of the questions are qualitative research methodological approaches. It is due to this that most of the questions are open-ended to ensure themes and concepts are freely discussed. Each question is used in an open and exploratory way, but there are certain questions that are aimed at obtaining different responses. The questionnaire or framework that served as a discussion guide for the structured interview is provided in Annexure 1 along with an indication of the types of questions included.

3.8 Interviews

The purpose of the interviews is to encourage respondents to reveal their construction of reality (their internal picture of the world) as openly and fully as possible. In order to achieve this, researchers should use all skills available to lead interviews and encourage people to reveal their thoughts. The interviewer is expected to lead the interview, although to different degrees depending upon how structured it is, and to prevent respondents from digressing, but not to assume too active a role, for instance by behaving as though the interview was a casual conversation between two acquaintances. These considerations mean that interviewers should:

- Use appropriate language (e.g., they should not use specialised psychological jargon with laypersons);
- Avoid leading or tendentious questions that put words into respondents' mouths;
- Avoid going into details of the research;
- Avoid entering into private conversation with respondents during the interview;

- Ask occasional “check” questions to be certain that an answer has been understood and that the respondent is being consistent in answering;
- Check the understanding of respondents’ answers by asking appropriate follow-up questions.

3.9 Types of Interviews

Even though it is outlined that the research approach taken was a mixed research approach, the interviews merit more attention due to the qualitative nature of the study. There are five interview types namely the following:

- Open Interview
- Semi-structured interview
- Structured interview
- In-depth interview
- Group interview

The selected interview type for this study is the structured interview. This interview type is highly structured with a question and answer exchange. The researcher will enter the interview with specific questions that have answers usually derived from earlier research findings. The questions are asked aloud from a questionnaire that the researcher has worked from prior to the interview. All participants get asked the same questions, in the same order using the same process unless a participant offers relevant answers that may deviate from the set questionnaire. Some questions can be open ended, and the researcher may even offer specific alternatives from which the respondent can choose. Frequently, the respondents’ statements need not be written down verbatim by the interviewer. Due to the structured nature of the questions, only certain “key” words or phrases are interesting to the researcher.

This interview allows for prior quantitative research to be conducted with the development of questions based on these themes. These interviews yield pre-structured information which is less time consuming to conduct and easier to analyse. These interviews can be conducted without physical contact via telephone or email, but this was not the chosen form for this study as there were many open-ended questions that yielded different themes and data that could not be analysed without being in the presence of the participant. However, there is a danger that structured interviews may become little more than spoken questionnaires. According to Jorgensen (1989), the data sets are less rich, more superficial, and more difficult to interpret. Structured interviews are also prone to the effects of factors like yea-saying (agreeing with whatever the interviewer asks) or social desirability (giving answers that seem to the respondent to be what the right sort of person would say).

3.10 The analysis of qualitative data

Qualitative content analysis usually begins with a written document such as the recorded questions used in this study. The questions and answers derived from the interview can be transcribed from video or audio recording. The analysis of narratives from an interview is much richer in primary data than those obtained by means of quantitative studies. Conducting the analysis is challenging, must be collected and analysed in a systematic and organised fashion that could be reproduced by another researcher, if desired.

3.11 Theory in Qualitative Data Analysis

Emergent issues or themes can be found without reference to theory which can be referred to as a *tabula rasa* approach. The advantage of this approach is that there is no specified content analysis or main focus by participants in advance. This is discovered

during the interviews by the participants themselves. This is a great example of the dynamics of this approach. The best way to look for emergent issues from the participants is to start the interview without any pre-formulated ideas or to at least behave as if this is the case. Ideas that become relevant during the study are identified and used to structure the content analysis. A theory guided analysis is effective where qualitative research is conducted and guided with existing theory. One way of doing this is to define in advance the ideas that are expected to emerge and check in the analysis whether these did actually appear, and in what form these appeared. The analysis then takes on some of the characteristics of hypothesis testing. As Strauss & Corbin (1998) pointed out, the initial theory may be not existing formal theory as it is found in the relevant literature, but the researcher's own intuitive or naïve theory emerging from personal experience with the theme questions. The latter was used in the study.

3.12 Securing the Data

The audience of the completed study included a mix of participants involved in the hospitality industry in South Africa. The raw data will be secured stored with access only available to the researcher and supervisor. Electronic forms of the data will only be accessible via a secured password. The data will either be destroyed after two years of completion of the study or six years after the study publication. This is in accordance with general practice.

3.13 Ethics

No anticipated risks were assessed for the participants of the study. Instruments used were non invasive and were kept anonymous which remove any concerns that may have been forthcoming from the participants. All participants were informed of the nature of the research prior to the interview and they were informed that this was a voluntary process.

No anticipated risks to the researcher were perceived. The University of Pretoria guidelines on ethics and processes were followed by the researcher.

Chapter 4: PRESENTATION OF RESULTS

4.1 Introduction

This chapter will provide the qualitative analysis, along with some quantitative analysis (in the form of basic descriptive statistic) of the data obtained during the interview which was undertaken in support of the questionnaire provided to the participants. It will present findings and the respondents' understanding of leases, franchise agreements and HMA's for hotels; funding mechanisms and challenges for this asset class and a comparison of the different types of financiers in this sector.

The questionnaire was sent to a list of targeted respondents from different fields of specialisation in the hospitality sector. The sample is considered sufficient in terms of size and characteristics with the results described in tables and figures with key themes discussed within the text in this chapter. The results are discussed in greater depth in chapter 5, with the view to answering the research questions. Data was analysed using thematic content analysis and conclusions drawn by means of systematic and objective analysis and prioritization of the constituent elements or themes.

4.2 Sampling and Data collection

This research made use of purposeful sampling. There were 25 interviews conducted in total with each interview lasting approximately 60 minutes. The semi-structured nature of the interview meant that interviews were guided to gain as much information as possible with open-ended questions and a selection of other question types as provided in Annexure 1.

4.3 Preparation for the interview and data analysis

The participants for the interviews were contacted beforehand and agreed to be interviewed. The questionnaire was sent to them via email before the interview was carried out. This allowed for them to prepare beforehand with respondents answering the questionnaire in preparation for the interview. Respondents provided written consent and were assured that their identity was protected and that they would remain anonymous. Detailed notes were taken during the interviews to refer back to answers after the interviews. Thematic content analysis was adopted as the qualitative method for identifying, analysing and recording patterns or themes within the collected data. A coding system was implemented for purposes of analysis that summarised the priorities and main themes, concepts or ideas in the data at an individual unit of analysis. Twenty-five participants completed the face to face interview. The demographic characteristics of the sample are summarised below:

Table 4.1 Demographic Characteristic

Gender	N	%
Male	20	80%
Female	5	20%
Status of involvement in Hospitality		
Tour operator	2	8%
Hotel operator	3	12%
Hotel owner operator	5	20%
Hotel owner	5	20%
Hotel financier	4	16%
Hotel S12J financier	2	8%
Specialised hotel property consultant	4	16%
	25	100%

The research sought to explore the dynamics of the hotel industry and to determine if hotels outperform alternative property asset classes during different phases of the property cycle, to understand the funding mechanisms available and their required returns, aligning the risk associated with hotels as an investment asset class. The questions were developed to structure the research into the categories presented in the results section (4.4 below) thus answering the research questions (Chapter 5).

4.4 Results

4.4.1 Involvement of the participants in the hotel industry

What role does your company play in terms of property development or acquisitions in the hospitality sector in South Africa and/or outside of South Africa. If none, why is it that hotels/resorts are not considered as an appropriate property investment asset class in your property portfolio.

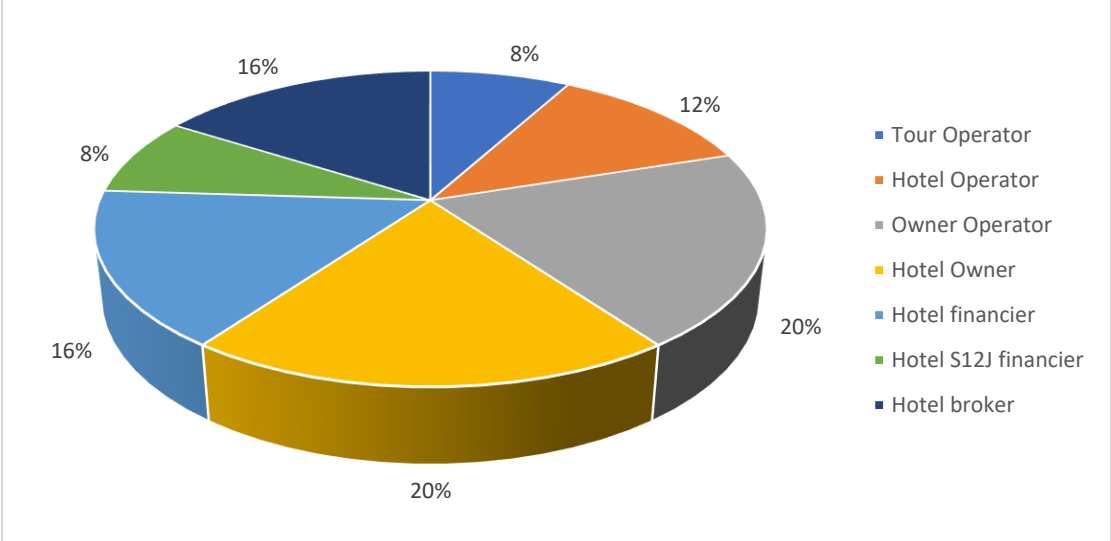


Figure 4.1 Level of involvement in the hotel industry

The pie chart above displays the level of involvement in the hotel industry. The breakdown of the level of involvement in hotel development or acquisition was as follows:

- **Tour Operators** tend not to get involved with the development or acquisition of hotels as they promote hotels for tours post completion of a hotel development. For example, the normal process would be that a hotel owner and the tour operator would promote a destination to source markets directly, through trade shows or any other form of marketing. Tour operators tend to focus on the leisure space and have a lead time of 18 months to book a hotel. Their most significant involvement for a hotel development would only be to promote a new hotel that is coming into the market. Key risk for a tour operator is to ensure a new hotel or resort is completed before sending tours to the hotel/resort.
- **Hotel Operators** are more involved during the development stage as this is the key time to sign HMA's with a hotel owner. Hotel operators look to increase their management fees and the best way to do this is to include new builds to their portfolio as new builds are built to suit and are done so according to their specific brand standards. General time of involvement is from the development phase where plan approvals are in process. In general, they get involved 18 – 24 months prior to completion of a hotel development and would assist with technical services to ensure the developer builds the hotel to be operationally efficient. Hotel operators do get involved in acquisitions, but this is normally where a new buyer is looking to replace the operator of a hotel being sold.

Hotels operators on an HMA or lease basis are rarely available on vacant possession and when available on vacant possession, this tends to be due to poor performance of a hotel. Hotel operators do not want to be the management company taking their name off the building as this poses reputational damage to their ability to manage a property. On rare occasions, hotel operators would be involved in taking over an existing hotel on the expiration of an HMA or lease of

the existing hotel operator. HMA's or hotel leases tend to be longer with typical terms ranging from 15 – 25 years. There are certain performance thresholds that operators need to adhere to, and should they fail, only then will the HMA or lease be terminable. The likelihood for a hotel operator to come to its term and be replaced is low at best as they would have to have performed above these performance tests in order to remain as the hotel operator for the duration of the HMA or lease term. The owner would generally be satisfied with such performance and it is not common to change a hotel operator that is performing well.

- **Owner operators** are involved in both developments and acquisitions. Whereas hotel operators and hotel owners traditionally have separate roles, in this case the hotel owner is the operator. It is a capital-intensive position to take as it involves equity and debt raising for a new development or acquisition, as well as working capital requirements for the hotel operation. Owner operators tend to be involved in hotel ownership initially until the brand is established, where the property investment is sold to become what is called “asset light”. To be “asset light” is where an operating entity earns management fees from the operation of hotels with limited exposure to the ownership structure of the hotels which are managed.
- **Hotel owners** are involved with both developments and acquisitions, and tend to focus their primary negotiation on HMAs, franchise agreements or leases. The financial risk lies with the hotel owner and not the hotel operator which is why detailed attention is given to negotiating the appropriate contract for the hotel being built or acquired. Hotel owners are still driven by IRR's, ROE and DSCR calculations as these impact the investment returns. Underlying covenants vary if an HMA, franchise agreement or lease is signed. This is key for financing abilities as well as returns achieved. Hotel owners tend to have more involvement with the operation of the hotel especially if they have signed an HMA or franchise agreement. A hotel owner with a lease will treat the property investment in the same way as a traditional commercial property where there is little involvement in operational activities.

- **Hotel financiers** are involved with the funding of both developments and acquisitions. They play the role of traditional lender to a developer or to facilitate an acquisition for an existing or new client. Hotel financiers have the role of facilitating these developments and acquisitions on the back of understanding variable cash flows which dominate the income earning type when compared to traditional commercial, retail or industrial properties.

- **Hotel S12J funds** tend to be involved with both developments and acquisitions, but acquisitions take a different meaning in the sense that they are not necessarily in the form of a Share Purchase Agreement, but rather stock given to the S12J to raise capital. This is similar to selling residential stock on a pre-sales basis where capital is raised amongst its investors should the returns meet certain hurdle rates. S12J funds are fund managers that raise capital to fund a hotel development or acquisition. They often facilitate the role of mezzanine funding in the hotel space.
- **Hotel consultants** are specialised brokers and tend to be involved in developments and acquisitions of hotels. In fact, most brokers facilitate initial roles such as feasibility studies, market studies, operator selection processes and promote the full value cycle of a hotel from inception to completion. These roles include the following:
 - Feasibility study
 - Market study
 - Operator Selection
 - Debt and Equity Advisory
 - Valuation
 - Asset Management
 - Asset Disposal

Two of the participants indicated that hotels do not form part of their existing property portfolio. These would include Tour and Hotel Operators. Both advised that their

involvement is on providing services in exchange for service or management fees. The reason Tour and Hotel Operators do not own hotels is due to the capital-intensive nature of the business. The counter argument being that Tour and Hotel Operators can own the entire value chain, but this in turn exposes them to high risk as has been seen with the collapse of Thomas Cook and the impact on TUI which own the hotel management company, the hotels, airline and tour operating business. Hotel brokers tend not to own developments or hotels, but they are involved specifically with hotels and consider this work or brokerage as being part of their portfolio. For the sake of this research study, the hotel brokers spoken to specialise in the hospitality sector.

Are hotels/resorts part of your existing property portfolio or is it a consideration for the future?

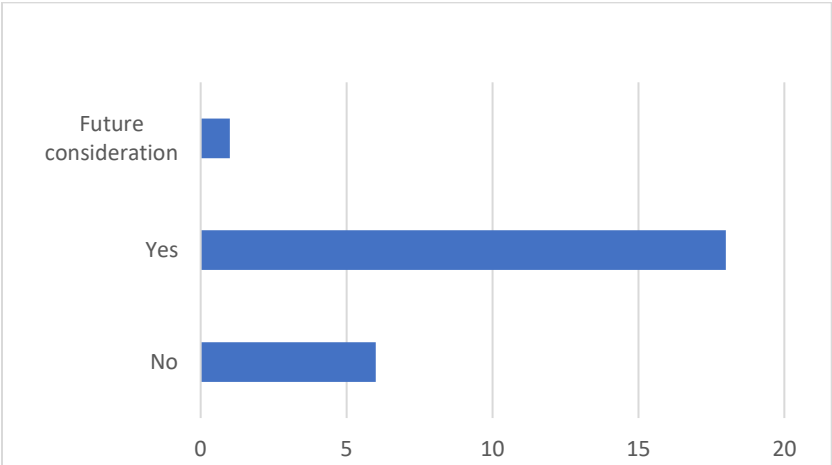


Figure 4.2 Hotels as part of an existing property portfolio

The above shows the involvement of hotels as part of the portfolio of each participant. Hotel brokers have no property portfolio in the sense that they do not own or have any hotels under management. Should this be removed then the number of “No” responses reduce to two. Most of the research participants have hotels in the form of ownership, operational involvement or financing. The breakdown of the level of involvement in hotel ownership is summarised as below:

Not part of existing property portfolio	6 (24%)
Hotels part of existing property portfolio	18 (72%)
Future consideration to form part of property portfolio	1 (3%)

If you do have hotels/resorts as part of your property portfolio, what percentage of the entire portfolio would this account for?

The percentage of those participants that answered that hotels form part of their property portfolio seem to lie at either extreme of the area chart with 8 of the 18 respondents stating they have between 0 – 20% as part of the entire portfolio, and 6 of the 18 respondents stating they have between 81% - 100% of hotels as part of the entire portfolio. Only four respondents stated having between 21% - 80% of hotels as part of their entire portfolio.

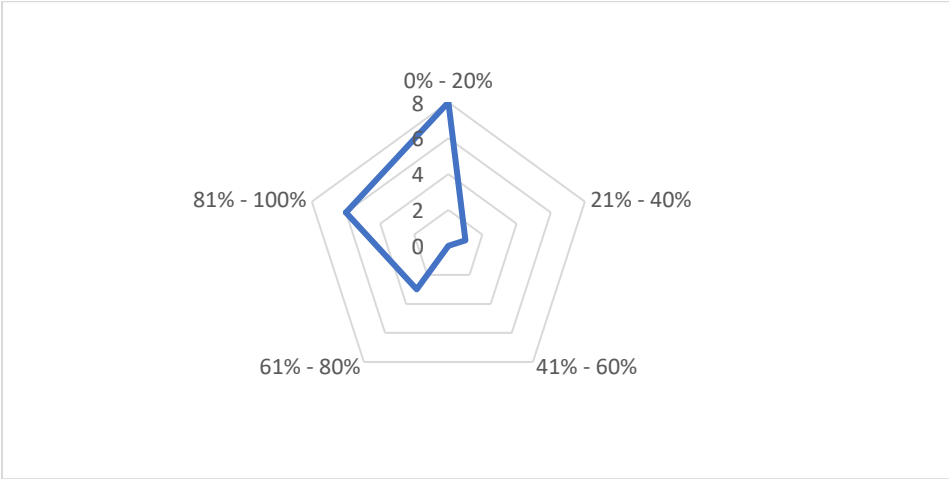


Figure 4.3 Percentage of hotels in the portfolio

4.4.2 Compare traditional leases with management agreements and the underlining difference in risks

Could you provide your understanding of the differences between a hotel management agreement and hotel lease, which you would prefer and why?

All participants answered that they understood the difference between an HMA and lease agreement. Based on the responses (transcription attached in Annexure 2), the main themes for two types of operational contracts to manage a hotel are as follows:

- The landowner carries operational risk if the hotel operator does not perform
- The hotel operator takes financial risks if the hotel does not perform and cannot meet its lease obligations
- Leases are signed for a fixed term and guaranteed income
- HMA's mean that the property owner takes management and operational risk which is out of their control
- Landlords are not as involved when a lease is signed as it is about the covenants in place of the hotel owner and the fixed income payable on a monthly basis
- With an HMA the landlord is more involved due to the shared risk in operating the hotel

In terms of preferences, having a hotel operator provide a lease with fixed income outweighs that of an HMA with leases accounting for 56% of the options chosen and HMA's accounting for 36%. A hybrid model only accounted for 8% which is effectively being an owner operator where the risk for both the property and operations of the hotel lies with one party.

The table below divides the options in terms of preferences and the reasons as to why they were preferred:

Table 4.2 Lease and HMA preferences

Lease	HMA
Fixed income	Flexibility in operating a hotel
No operational risk	Less financial risk
Easier bank financing	Ability to ride out low years of performance
Pre-determined yield for developments	Separation of ownership and operations
Operators flexible as landlord not as involved	More involvement from the owner in running of the hotel

If you had to rank in preference, being 1 the most preferred and 3 the least preferred, which “hotel management agreement” would you prefer for a hotel opportunity:

- Lease where the operator takes the risk, but covenants may not be as strong.
- HMA with a base guarantee and incentive fee which shares the risks between property owner and operator.
- HMA with no guarantee where the property owner takes all the risk but benefits on the upside and better terms.

The responses received on the ranking of preferred operator model are indicated below:

Table 4.3 Ranking of preferred operator model

	Rank 1	Rank 2	Rank 3
Lease	5	6	14
HMA with base guarantee	11	12	2
HMA with no guarantee	9	7	9

Points were allocated from highest to lowest based on the ranking criteria. The points allocation would be as follows:

If ranked as first option or preference - 3 points were allocated

If ranked as second option or preference- 2 points were allocated

If ranked as third option or preference - 1 point was allocated

The results from these points for rankings indicated a low preference to leases where the overwhelming majority preferred an HMA. HMAs that included a guarantee were preferred to HMAs without, as set out below:

Table 4.4 Comparison of leases, HMAs with and without guarantees

	Average	Rank
Lease	14	3
HMA with base guarantee	20	1
HMA with no guarantee	17	2

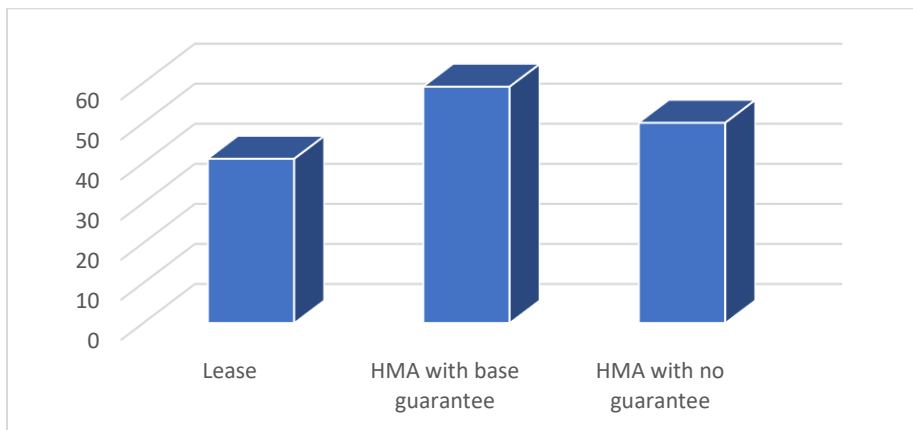


Figure 4.4 Operator agreement rankings

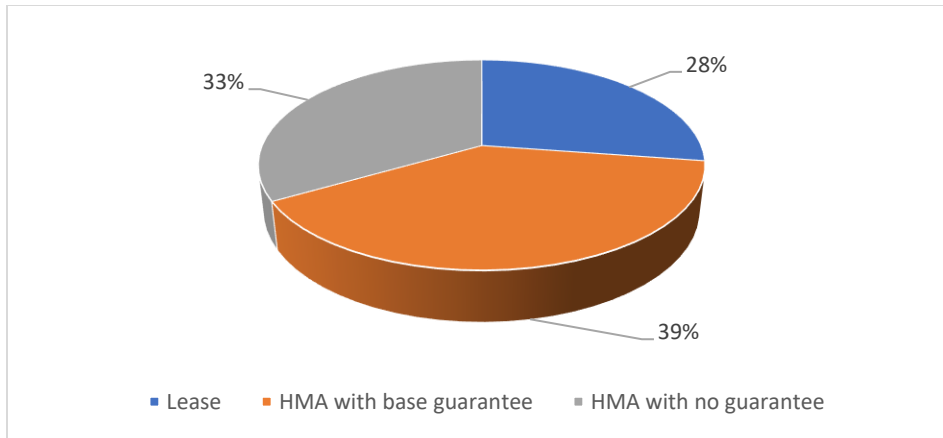


Figure 4.5 Spread of operator contracts

This pie chart shows leases having a preference of only 28% of the operational options available, with HMAs with guarantees being the preferred operating agreement with a total of 39% of participants preferring this option. Respondents favoring leases were those from an investment viewpoint. These included hotel owners and financiers. The two more favoured approaches of an HMA with or without guarantees were from respondents that had hotel operation exposure. These included tour operators, hotel operators and owner operators. HMA's with guarantee can be seen as the mean for operational risk when comparing leases and HMA's without guarantees.

4.4.3 Investigate availability of leases in the hotel sector versus hotel management agreements

Have you ever sourced a lease or tried to source a lease for a hotel development or acquisition opportunity?

The below table provides information regarding the attempts that each participant has made in trying to source a lease for a new hotel development or acquisition opportunity.

There is an overwhelming percentage of 68% of respondents that have tried to source a lease for a hotel. If the tour operators who do not tend to be involved in hotel development or acquisitions are excluded, then this percentage increases to 74%.

Table 4.5 Sourcing of leases by participant

	No	Yes
Tour Operator	2	-
Hotel Operator	1	2
Owner Operator	0	5
Hotel Owner	2	3
Hotel Financier	2	2
Hotel S12J Financier	1	1
Hotel Broker	0	4
	8	17

Most reasons for attempting to source a lease include the following:

- Leases are favourable, but tend not to exist as developers and owners normally require a 1.3 to 1.5 times rental cover which often makes bidding uncompetitive compared to those underwriting operational earnings
- Long term leases from a hotel operator would secure a property for a longer period, but most escalate at CPI and are not ideal for smaller groups and boutique hotels where the operators often provide leases. Leases are better suited to larger groups
- Leases are more suitable with a JV ownership on the property where the risk is shared. This would fall more within the owner operator model
- Leases are limited as they are negotiated at a very low level especially if no risk is taken by the property owner

Do you use a leasing broker for your properties, or do you have your own internal leasing division?

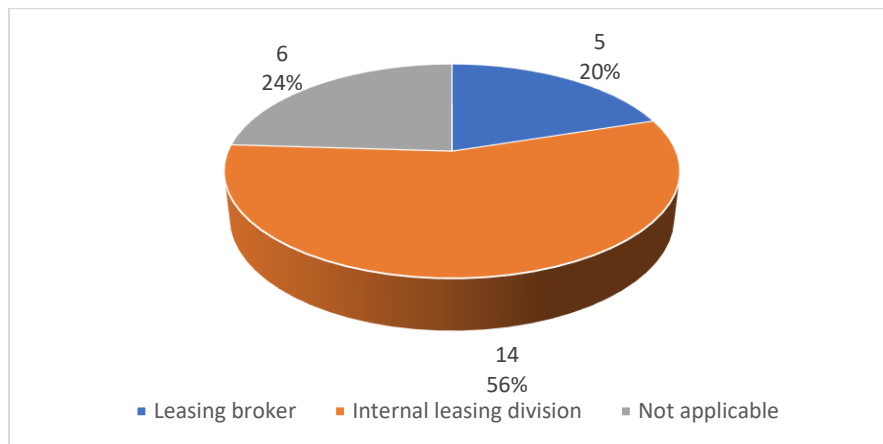


Figure 4.6 Sourcing of leases

The overwhelming majority of participants do try to source leases themselves instead of using a specialised leasing broker. Of the total response to this question, 24% of the respondents do not require this service either because they are hotel brokers themselves or are tour operators and this does not form part of their main function within the business. If tour operators are removed, the percentage of participants that have tried or try to source leases, increases from 56% to 74%.

4.4.4 Understand different types of management agreements in hotel investments

Do you know the different types of hotel management agreements and if so, please elaborate on your knowledge of them?

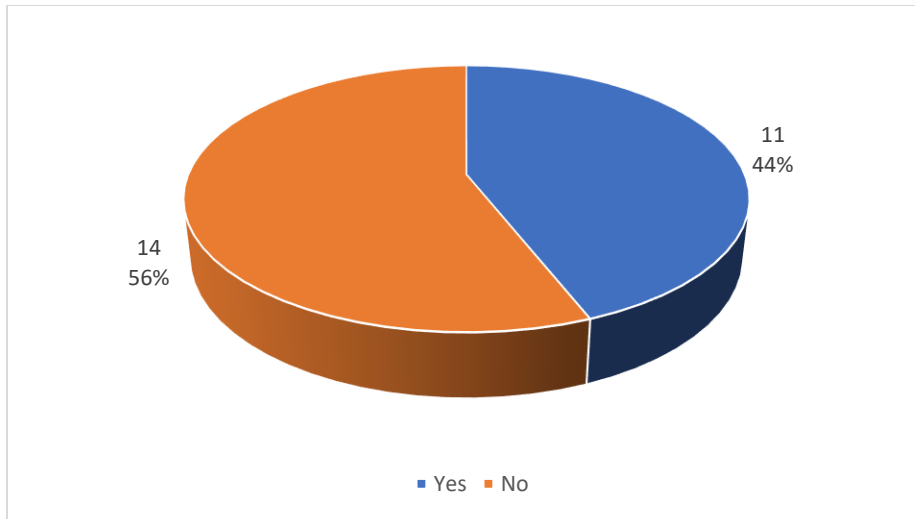


Figure 4.7 Difference in HMAs

The number of respondents that knew the different Hotel Management Agreements was 12% less than that of the respondents that did not know the different Hotel Management Agreements. The most common differences as elaborated include the following:

- HMAs are in the form of HMA with no guarantees versus HMA's with an underlying form of a guarantee, similar to a fixed and variable lease
- Certain HMAs have set terms and fees, where other HMAs are performance based
- HMAs can differ significantly in terms of the following:
 1. Length of term of the HMA
 2. Base fee levels
 3. Incentive fee levels
 4. Performance terms
 5. Owner guarantees
 6. Priority terms

- HMAs can be signed with a white label operator and the franchise agreement signed with a brand owner. A white label operator is where a property owner appoints a third-party to operate on behalf of the owner
- A franchise agreement is where an owner manages the hotel itself and subscribes to a franchise to benefit from branding, distribution, loyalty programmes, brand standards
- Hybrid agreement “Manchise”. A hotel management agreement, which allows the hotel owner to change to a franchise agreement after 3-5 years of operations
- Some hotel management agreements with strong performance guarantees with a high cap on operator payments, are considered “in between” a hotel management agreement and lease agreement
- Franchise fee equates to a percentage of revenue and loyalty programme fees
- Management agreements tend not to have a guarantee on performance. Management fees are a percentage of revenue, with incentive fees a percentage Adjusted Gross Operating Profit (AGOP).

4.4.5 Understand a franchise agreement and how this compares to a management agreement

Would you consider a franchise agreement where you could owner manage a hotel/resort off the systems of an international hotel brand, similar to having an internal leasing division for other traditional property asset classes?

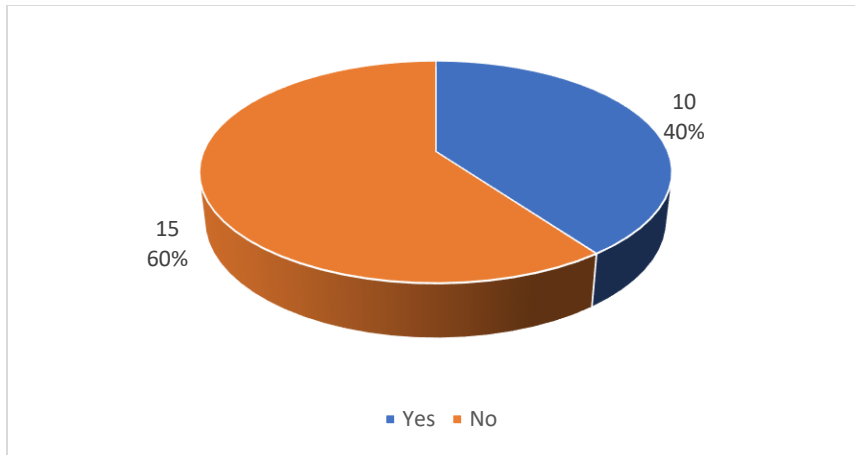


Figure 4.8 Consideration of franchise agreement

A total of 60% of the participants agreed that they would consider a franchise agreement in operating a hotel. Many agreed that in the South African hospitality sector, there is a lack of quality franchise operators that are approved by International Hotel Brands. Most of the owner operators that respondent preferred to continue expanding their own brand before looking at operating other hotels in the form of a franchise agreement. Other benefits would be the ability for the hotel owner to appoint the key positions in the hotel. This would allow greater control over operations and strategy and maintaining a strong focus and pressure on performance. Additionally, the hotel could be sold unencumbered of management and potentially of brand, as franchise agreements are easier to terminate than HMAs.

4.4.6 Elaborate on Joint-Venture ownership models typically found in hotel investments

When the property cycle is of such a nature that traditional property asset classes (commercial/retail/industrial) are under pressure to achieve desired returns/yields, would you consider more non-traditional asset classes such as hospitality assets?

Of the sample size, four respondents advised this question is not applicable to their line of work. Of the remaining respondents, only two responded in the negative and remaining respondents confirmed they would look at hotels if traditional asset classes were not performing. This equates to 76% of all respondents with most common comments as follows:

- Some do not consider this an alternative asset class as they are long term holders and will outlast the property cycles. Hospitality is chosen specifically due to its best optimal use of an individual site in an area
- Volatility is a concern and depends on global factors such as unrest, natural disasters and political instability. If a product is however in a unique setting, this would almost render it “disaster” proof
- Core is to manage an asset well. Hospitality assets have the operational ability to outperform the market
- Hospitality is an excellent opportunity to develop a portfolio and diversify, but funding is the limitation
- Mixed use developments are the focus for property development and hospitality is a key element to this strategy of portfolio diversification. A mixed use development encompasses diversification which is welcomed by investors and banks
- Hospitality is part of diversifying a portfolio, but each deal is done on its own merit
- Hospitality is an alternative to the current oversupply of commercial assets. This provides diversification to the market
- Hospitality assets provide operational opportunities to outperform the market where other assets do not
- Hotels need to be included in a portfolio in order to be considered diversified. This is regardless of property cycles. Hotels have benefit in having direct exposure to operational earnings which can be earned more quickly than other assets.
- Hospitality has too much operational risk with possible challenges due to macro economics which is out of the control of the property owner

Do you know of hospitality brokerage firms in South Africa or outside of South Africa that can assist with leasing or operator selections? Please compare this to the leasing brokers you know in the more traditional property asset classes like industrial/retail and commercial.

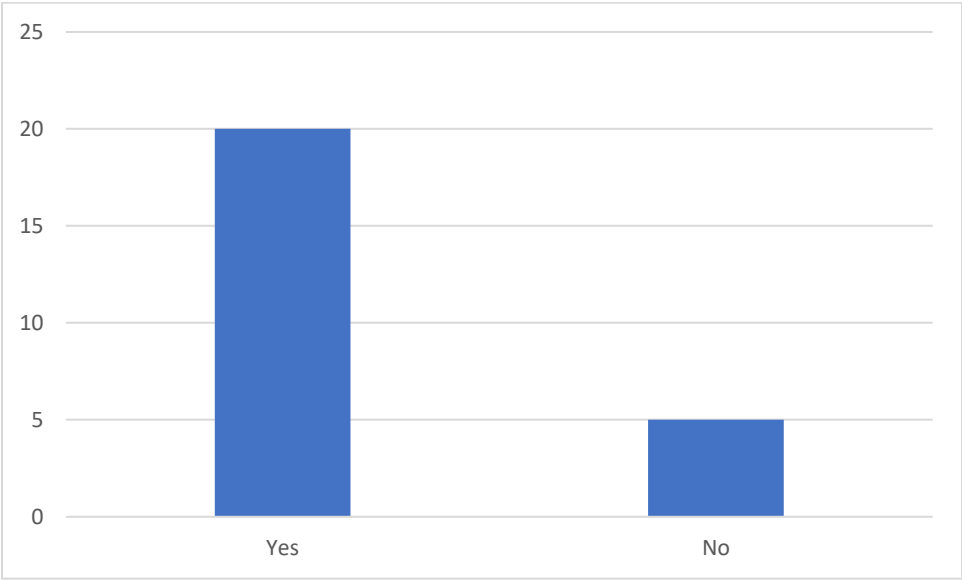


Figure 4.9 Knowledge of hospitality brokerage firms

Of the 25-sample size, 20 respondents knew of hotel specialist brokerage firms with all but one respondent able to name two or more firms that specialise in the hospitality sector. The main theme with the respondents that knew of specialised hotel brokers is that it is far more specialised than brokers in traditional asset classes. There are not as many as in the traditional commercial property space and this is because of the complexities around variable income levels, operational risks, volatile market conditions and in-depth knowledge required in the market.

4.4.7 Explore the funding mechanisms available for hotel developments in South Africa

If considering a hotel as a development opportunity, could you elaborate on the funding mechanisms you would consider?

For this response, funders and Section 12J respondents were removed as they are the funding mechanisms to new acquisitions or developments in the hotel industry. Combined respondents in Section 12J funds and financiers equated to 6 respondents with the remaining 19 respondents providing the following feedback:

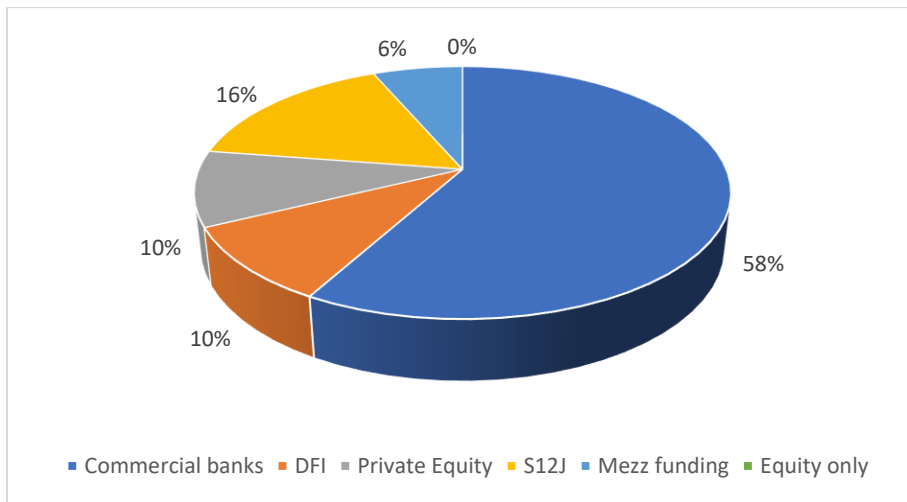


Figure 4.10 Funding for hotels

Key considerations:

- No respondents looked at funding fully with own equity

- The IDC was the only Development Funding Institution (“DFI”) mentioned by respondents that used DFI funding
- A lease agreement is required for lending by commercial banks. Leases are not obtainable in this sector which means low LTV and often high owner equity contributions
- If leases are obtained, it is often from operators that are not well capitalised and discounted heavily by the commercial banks and DFI’s
- Portfolio lending is key in the hotel sector where other assets are leveraged to fund a hotel acquisition or development
- Combination of commercial funding, with S12J in support and mezzanine/PE funding if required, should cash flow allow

If you have or have tried funding a hotel development/acquisition, could you describe the financiers you approached – traditional commercial banks, development funding institutions or section 12J

The participants had an option of one or a combination of three potential finance options being traditional commercial banks, development funding institutions or section 12J funds. The results can be summarised as per the graph below:

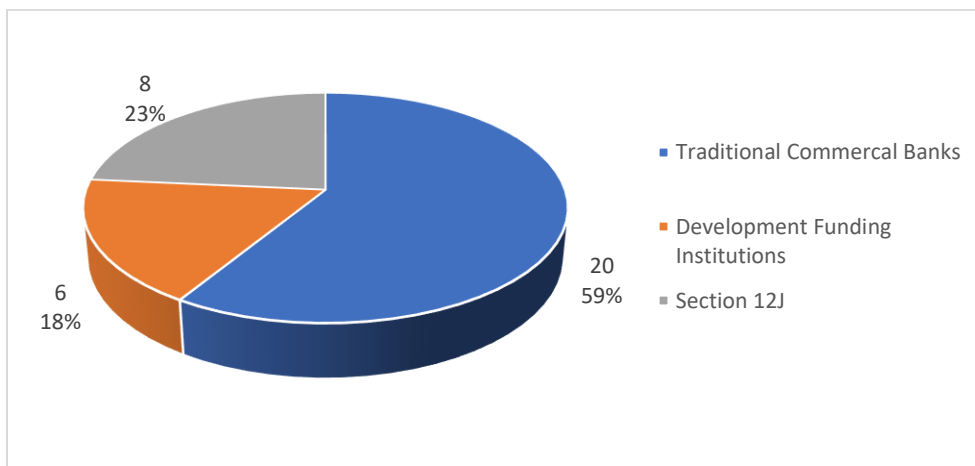


Figure 4.11 Funding options explored

Some key themes from the results are detailed as follows:

- There is an overwhelming preference to use traditional commercial banks, but with limited success. Most traditional commercial banks require leases which are difficult to obtain. The LTV's offer is limited to 50% and knowledge of the sector in general is unsatisfactory
- Many traditional commercial banks required a portfolio of non-hospitality related assets to provide funding for a hotel acquisition or development
- One respondent mentioned the desired use of Private Equity or Pension funds
- One respondent advised they only use their own equity

4.4.8 Compare Commercial Bank funding policies in hotel investment to development bank policies

What challenges did you find or are you aware of the Development Funding Institutions?

The responses to this question were easily grouped as all respondents had a similar experience with DFI's. The groupings and allocation to each are set out below:

- High level of owner's equity required
- BBBEE requirement a challenge
- Funding for developments only
- Inflexible lending terms
- Funding is expensive
- Long decision-making process
- No experience with DFI's

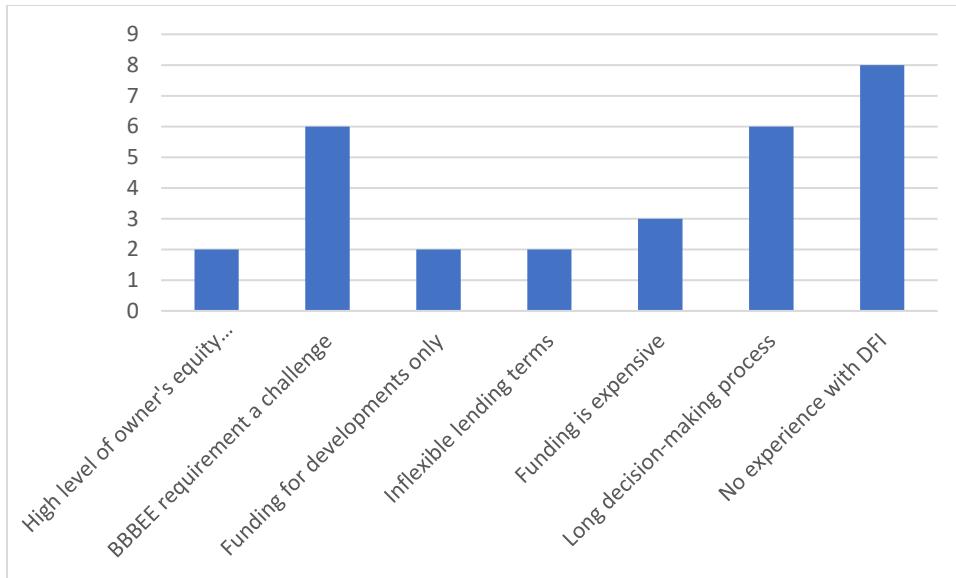


Figure 4.12 DFI Challenges

Of the total responses received, 28% advised they had no experience with DFI's. If these are removed the two biggest challenges that make up 57% of all responses were the 1) long decision-making process and 2) BBBEE requirements being a challenge. To summarise, the top 3 factors in order from highest to lowest in terms of DFI challenges to financing hotels, if those without direct DFI experience is removed, would be ranked as follows:

1. Long decision-making process
2. BBBEE requirement
3. Funding is expensive

Development Funding Institutions outside of South Africa are not allowed to invest in South Africa. Do you think this would make a difference if they could participate in South Africa?

Of all the participant, only one responded advising it would not make a difference due to lack of quality supply in South Africa. All other participants agreed it would make a difference and cited the following reasons:

- DFI's entering South Africa would mean more competition from well capitalised DFI's
- DFI's would have hard currency entering South Africa, which would drive pricing down and make it more competitive
- Less BBBEE restrictions as pure DFI funding is about community upliftment. There is no BBBEE agenda outside of South Africa. Focus is rather on community development
- It will bring different sources of funding into South Africa
- If DFI's enter the South African market, all banks would need to become more competitive with their pricing and general terms
- It could provide a more streamlined process instead of the existing drawn out process currently experienced

4.4.9 Investigate the use of alternative funding tools such as 12J funding and analyse its success with hotel groups

What is your understanding of the Section 12J and its relation to the hospitality sector?

By removing respondents that are S12J experts, the following statistics are available in terms of knowledge on the S12J:

- Of the 25 respondents, two were excluded as they were S12J fund managers
- Of the remaining 23 respondents, six had no knowledge of the S12J tax benefit

- This accounts for 26% of the remaining respondents
- The remaining 17 respondents were knowledgeable about the S12J tax benefit.

The most common themes from the interviews were as follows:

- It is a Venture Capital Company for investment in the hotel industry, be it acquisition or development
- More developmental funding sources that could provide additional access to funding (tax benefits to funder)
- Section 12J and the tax rebate benefit can provide a discount of between 28% to 45% on investments in Hotels; Student accommodation; Lodges; Guesthouses; and Serviced apartments
- Small avenue to raise capital of R50m for hotel development. The cap of R50m limits the scope to raise capital and comes with operational concerns around liquor licenses
- Fees to run these S12J companies are high and this is from developers' fees and administrators' fees. The underlying assets show no growth with the only return coming from the tax break itself
- They are a useful platform for small hotel developments. It is capped at R50m so not ideally suitable for hotels over say 75/80 rooms
- Competitive funding for the hotel industry, but unlikely to continue as Treasury will soon shut down its use in property sector. There is a deadline for 2021 where government needs to decide whether to extend this allowance in the Income Tax Act. Many believe this will not be extended

Would you consider the Section 12J as a funding mechanism for a hotel development or acquisition opportunity?

- Of the 25 respondents, two were excluded as they were S12J fund managers

- Of the remaining 23 respondents, six had no knowledge of the S12J tax benefit
- This accounts for 26% of the remaining respondents
- Of the remaining 17 respondents, two advised they would not use the S12J as a funding mechanism for the purchase of hotels or development. This equates to 12% of those that have knowledge of the S12J, whereas an overwhelming number of respondents said they would use the S12J. This accounts for 15 of the remaining 17 respondents which equates to 88%.

What do you see as the limitation to a Section 12J scheme?

The most common themes with regards to the limitation to a Section 12J scheme is as follows:

- S12J considered high risk in the short term as the current SARS policies will change to recover more taxes as South Africa slips deeper into a deficit
- Section 12J VCC's restricted in investing in a potential investee company, as no more than 20% of their raised capital can be invested into the investee company. FAIS approval is difficult to obtain as one must have a person who fits the criteria to be a "key individual" in terms of FAIS, which requires experience in the industry and further study
- Treasury, in review of the Section 12J portrays uncertainty with tax laws. In its current format, it is difficult, expensive and takes long to establish
- The R50m cap for investment is a limiting factor
- The inability to sell liquor is an operational concern
- Investors investing in a Section 12J are requesting guaranteed exits which are still proving to be a challenge
- The minimum period to hold an investment is 5 years and is difficult to imagine this in the current South African economic context

- Scalability due to the R50m is a hinderance
- The capital gains tax in year 5 could be greater than the benefit received in a 5 year investment. Investors will incur capital gains tax on the full investment amount including the growth. The base cost of the investment is reduced to zero
- Hotels generally only become profitable in year 3. The intention of the Section 12J is to provide a debt relief or a tax relief, while the asset is generating profit. This does not happen in the first three years
- Sourcing a lease from the hotel operator to guarantee a yield to the Section 12J fund is a challenge. Another solution is to have the developer guarantee those yields, which would increase the risk associated with a development or acquisition

4.4.10 Compare these funding challenges with those faced in Sub-Saharan Africa

Knowing the interest rates and returns in the South African context; then comparing to interest rates and returns in the hospitality sector in Sub-Saharan Africa – what is your preference in investment destination for hospitality and why?

Of the 25 participants, 14 answered they would only look at investments in SA. This equates to 56% of the respondents. The main themes from this question are ranked below in terms of highest to lowest:

- Political Stability and predictability – many only looked at South Africa due to relative political stability. Other countries may offer better returns, but politically unstable
- Better Returns in Africa - Africa has better returns than South Africa and is less competitive
- Risk return mismatch - the concern with hotel investment in South Africa is primarily the currency – hotels generate local currency which has not held well

against USD and EUR over the past 5 years. Preference would be to invest in politically stable countries with links to hard currency. This allows for USD or EUR based earnings, with staff being paid in local currency. In certain countries, USD or EUR based funding is also much cheaper than funding in local currency

- Ease of concluding business – still far better in South Africa than in Sub-Saharan Africa
- Prime Travel Destinations - strong air access is key and normally assists in travel to prime travel destinations. This would include strong long-haul destination airports like South Africa, Ethiopia, Egypt and Kenya
- Functioning debt market - South Africa is preferred due to a strong functioning debt market. In Africa, equity funding is required which is a more expensive form of capital

As can be seen with the above questions, open-ended answers are required which enables an exploratory one-on-one interview with the participants, which is in line with the outlined qualitative methodology approach. The grouping of questions relates to answering specific research objectives which is sub categorised within each group of respondents.

Chapter 5: INTERPRETATION OF RESULTS

5.1 Introduction

The previous chapter identified the emergent themes which were the result of research conducted through an interview process. It presents findings, key trends and interpretation with respect to the research questions in the first Chapter 1. This Chapter also provides a framework and basis of findings that could be used for future studies in this field.

5.2 Knowledge of leases in the hospitality industry and comparison of HMA's

The research shows that all of the respondents understood the difference between leases and HMA's, but unless they were directly involved with the hotel industry, there was little knowledge of the underlying risks. What is clear is that all respondents are aware that leases are extremely rare in the hospitality sector, even though it is the preferred option. Hotel operators have a greater understanding of the risks associated with leases compared to hotel owners and developers. Most operators prefer to manage a hotel for an owner on the basis of a HMA.

Developers, investors and property owners have adapted to the evolution of operator agreements, specifically when considering the evolution of tenure structures between the hotel operators and hotel investor. The research shows that such structures are divided into two groups of tenure agreements which can be described as follows:

- Fixed leases which are in place to guarantee an amount of income and normally increase with inflation. This agreement type is referred to as a Fixed Income Tenure Agreements ("FITA"). This is scarce in South Africa and Sub-Saharan Africa

with fewer new developments being concluded on the basis of a FITA. FITA are often available in more stable countries where volatility is considered low.

- Variable Income Tenure Agreements (“VITA”), a term to include variable leases as well as Hotel Management Agreements. VITA is the basis of the majority of agreements in the hotel sector.

The profile of hotel owners in South Africa is not dissimilar to the broader property investor community, with more generalist property investors becoming involved in this sector. This increased in 2018 from 62% to 71% in 2019. With the current economy in South Africa, this trend is expected to continue in future as investors and developers continue to look for yields beyond what is currently achieved with traditional property asset classes.

The results revealed that investors and developers have or have had exposure to hotel investments or developments. More experienced investors and developers have had more exposure and know understand the difficulties in finding leases or HMA's with guarantees. Considering that many investors are fairly new to the sector, they still had a high exposure rate for an asset class that is not as often invested in, specifically in South Africa as compared other asset classes. Mooya's (2015) survey found that “other property types” including hotels are the second most valued asset class in South Africa after residential property assets. This is significant in the context of this study, as it confirms that investors and South African commercial are responsible for valuing a wide range of property asset types, each with their own unique traits.

The exposure of South African investors and developers to provide the first level of insight in the hotel sector. However, the encumbrance of a hotel under a fixed lease does not necessarily meet the desired investment criteria for an investor as laid out in Chapter 2. On the basis of a fixed lease for a hotel, it is essential that covenants of the lease that are key to obtaining such a contract which is difficult in the sector. The second part of the

study shows that interest and understanding of the risks associated with a HMA is increasing.

Interesting to note is the fact that most respondents who have previously invested in a hotel, have always looked at obtaining a lease with all but one respondent having failed. There is therefore a high portion of the participants that have still, after failing at obtaining a lease, continued with an acquisition or development on the basis of a HMA. It is often the case that tenants that offer a lease do not have strong enough covenants for both the investor or financiers if funding is required for the acquisitions or development of a hotel. This is however considered one of the only ways for an operator to increase its hotel portfolio size to increase hotels under management.

5.3 Compare traditional leases with management agreements and the underlying difference in risks

Many of the respondents were well versed in the risks associated with different operational contracts. The main theme being that with a lease, the operational risk is with the operator whilst with a HMA the operational risk is with the owner. It is because of this risk that 56% still favour a lease as an operational model for a hotel investment. The majority of respondents understood that financial obligations with a lease are with the hotel operator and it is because of this that financial covenants and strength of balance sheet is very important. Landlords that have a lease with a hotel are not as involved with the operations of the hotel. When a lease is signed it is imperative to understand the covenants that are in place to ensure the operators have a supportive function to cover fixed lease amounts payable on a monthly basis. With a HMA the landlord is more involved due to the shared risk in operating the hotel.

56% of respondents, being developers, owners or investors, confirmed that they have internal departments dealing with leases. This would be in line with the fact that the

majority of respondents would prefer a structure of a lease for the management of a hotel. However, as the results indicate, this is not the preferred option for hotel operators and is scarce in a volatile market such as South Africa.

When respondents to the research were asked if they knew the difference of the HMA's available, a small percentage of 12% of respondents knew that there were different HMA options available. This highlights the lack of understanding of the different contracts available to investors that are provided by hotel operators. Many investors and developers that are considered generalist in terms of property development have had more exposure to lease contracts than management contracts. Feedback from the respondents indicated the need for hotel consultants that specialise in contract negotiation as these are seen as far more complex and vast in terms of the number of contracts signed. Where a lease agreement is one document between landlord and tenant, international hotel operators could have up to five contracts depending on the scheme. This typically includes the following:

- Hotel Management Agreement
- License and Royalty Agreement
- Technical Services Agreement
- International Services Agreement
- Residential License Agreement – this is for service apartments which are often part of a hotel. There will be additional agreements to the Residence License Agreement, but are more of an ancillary nature

Despite the complexity of these contracts, 56% respondents still advised they have internal departments that deal with these negotiations. The nature of these contracts is vital when considering investment returns, whether it be for an acquisition or development. Hotel operators are paid fees for services provided to operate the hotel. An inexperienced investor will not know the market related fees to operate a hotel or terms

and conditions of the contract to ensure they are fair. HMA's are often long term in nature and most have a 15-year minimum term. This is a long-term relationship and highlights the need for a well negotiated contract fair to both parties.

5.4 The role of a franchise operator

Franchise agreements are also an alternative to hotel owners which is common in mature markets such as the US or European markets. It is not uncommon for more than 50% of internationally branded hotels in these markets to be operated on a franchise basis and this should be a similar trend in the future in South Africa and Sub-Saharan Africa, as it becomes the preferred method of operating a hotel from the international brands. The positive with a franchise agreement is that an owner could benefit from the marketing capabilities of an international brand, whilst utilising the skills of a white label operator that has the mindset of running hotels as cost effectively as possible. The current limited number of white label franchise operators is a challenge to many of the respondents, as well as the international hotel brands that do not necessarily look to take the risk of operating a hotel but would rather get paid fees for the use of a brand name.

Most respondents that were not hotel brands or owner operators, understood the concept of a franchise operator but were not aware of the different types of franchise options available. Discussion led to the understanding that franchise agreements could be made available with the two options:

- White Label Operator – in this instance an International hotel brand contracts with the hotel owner on the basis of a licensing agreement to use the desired brand name of the International hotel brand. The hotel owner then signs a franchise agreement with a third-party operator known as a white label operator. A white label operator then manages the hotel on behalf of the owner, but on the back of

a specific contracted brand. There is an additional layer of fees to the white label operator, but the focus is to minimise costs through mechanisms such as department clustering, outsourcing of certain departments and other operational efficiencies.

- Owner Operator – International hotel brands can contract to a hotel owner that decides to operate the hotel. This would be subject to a strict franchise approval process to ensure the hotel owner has the experience to operate a hotel. The benefit here is that the hotel owner has the platform of an international brand but takes on the full operational risk of running the hotel.

To summarise, franchising is an effective method that allows owners to utilise an international hotel brand which comes with benefits such as brand recognition, sale and marketing benefits, world renowned IT infrastructure and other support functions. The operational side of the hotel is also beneficial to the owners if value is derived from efficient hotel operations, either by themselves as owner or by utilising a third-party company. The main challenge as highlighted by respondents is the lack of franchise operators available which in Sub-Saharan Africa would be less than a handful, whereas in other regions like Europe or the US, this is far greater.

5.5 Specialised nature of the hospitality industry

Rogerson JM (2012:200) and Nelson (2012) have the view that larger institutions do not understand hotels as an investment class in South Africa. This supports the position that institutions are relying on valuations to determine fair pricing levels and debt covenants for hotel assets they either acquire, consider for disposal or to provide debt. Valuers should be providing a strategic function in assisting with real estate decisions, appears to be true for hotels in South Africa. This is a positive trend and validates the role played by key stakeholders when their clients are not as familiar with a particular asset class.

This strategic support from hotel experts to investors will likely promote the evolution towards HMAs, as the structure brings with it higher uncertainty for investors and lenders in South Africa. The associated variability of income is a divergence from many investors who favour certainty of income, underpinned by a fixed lease and a strong balance sheet.

5.6 SA Hotel investment outlook content

Investment in the South African hotel sector is predominantly by domestic investors, with respondents confirming that owner-operators and local developers still lead investments. Respondents provide interesting trends in the way that capital is being deployed and how it will shape this supply cycle and impact the market. In this treatise, trends in the investment cycle are explored as well as the likely implications that this holds for the hospitality industry. The themes include the following:

5.6.1 Increased liquidity post Covid-19

Hotels are still seen as risky assets due to the mostly unsecured income stream. As a result, financing hospitality projects remain difficult, as financial institutions often struggle to accept the risk profile of hotels. However, there is a definite maturation of hotel investment structures as evident in the emergence of new investors and investment strategies in recent years, enabling investors to enter hotel real estate in ways beyond direct acquisition of assets. These can take the form of debt investments, strategic joint ventures, recapitalisations, real estate and brand mergers and acquisition activity. More generalist investors are partaking in the hotel sector, with approximately 70% of global hotel investments being made by generalist investors in 2018 (JLL, 2018). These investors are seeking alternative investments to fulfil their return requirements and are now considering alternative asset classes, which include hotels. The impact of Covid-19 has affected the hospitality industry significantly. It is expected that many current owners

will be under cash flow constraints which would provide acquisitions opportunities in the form of partnerships, joint ventures or outright acquisitions. There is expected pressure on valuations of hotels due to Covid-19 and the unpredictable nature of future cash flow. This should further related to pricing discounts on acquisitions when it occurs.

5.6.2 12J Structures are gaining interest

There is a high level of fund inflow into Section 12J funds which need to find projects in the short term. Respondents confirm that the structure allows for the offtake of capital during the early stages of a project, providing a guarantee for a portion of the project, and making it easier to approach lenders to raise debt. Hotel assets also generally have a longer-term holding period, which fits well with the minimum holding period in a 5-years. Hospitality assets are generally seen as a good addition to a Section 12J scheme, as this is an asset class that can be converted with relative ease into an alternative use such as apartments and student accommodation and is a complementary to mixed-use schemes that include large office components. This was the confirmed response from the research with those that had exposure to the Section 12J funding model. Many South African owner operator groups have used this structure effectively to roll-out their portfolio across the country.

Many generalist investors are using this model within mixed-use development schemes. This would include hotel or serviced apartment components. Investment in a Section 12J VCC should be about more than the tax incentive. Investors start the investment process in a favourable internal rate of return (IRR) position due to the immediate tax benefit, but the skillset of the VCC team will determine how that IRR grows or erodes. Respondents involved with Section 12J funds confirm that it can be a daunting task to figure out which VCC to trust with managing the money and qualifying investors need to be confident that there is goal alignment. The VCC itself needs to have a solid business model, relevant experience and traction verticals to indicate that it can execute strategy and adhere to

governance protocols. Like all investments, governance is key. When a tax incentive is involved then extra caution should be taken to ensure that the investment structure and strategy are compliant with legislation.

Section 12J VCCs have established a Section 12J industry body to work with policy makers to ensure the sustainability of the regime. There are some inherent factors to consider when investing clients' money in a fund to be managed. These would include the following:

- *Creative business models*- the sole objective of any VCC must be the management of investments in qualifying companies, that can be straight forward to set up or creative in nature.
- *Structure of the investment vehicle* - Section 12J VCCs have structured themselves in various ways, some with creative interpretations of the law to mitigate investment downside risks, but in doing so the risk of non-compliance may have increased.
- *Impermissible investments*- risk of non-compliance if the VCC invests in controlled group companies or other impermissible or non-qualifying investees.
- *Investment in non-qualifying shares*- 80% of the expenditure incurred by the VCC to acquire assets must be for qualifying shares (an equity share issued to a VCC by a qualifying company).
- *Non-deployment of capital*- because no single portfolio investment may account for more than 20% of the funds received by a VCC (after 48 months), it effectively means that any VCC should aim to make at least five investments in time, thus needing a qualified pipeline.

- *Performance of the underlying portfolio*- to provide equity finance to SMEs generally means that the investment is unsecured, so if the investee businesses fail, returns will be diminished, and the equity investment may even be lost.
- *Fees charged*- the economics of venture capital is based on the premise that interests are aligned with reasonable ongoing management fees and a vested interest in performance fees after investor funds have been returned. This must remain the despite the nature and potential volatility when investing in hotels.
- *Exit strategy* - Investors need to be comfortable with a long-term investment and ensure that the VCC has a viable exit strategy from illiquid assets, as the tax deduction is recouped if a taxpayer disposes of the VCC shares within five years.
- *Potential tax leakage*- other than the initial deduction for investors in the VCC, there are no special tax benefits for VCCs on exit, and standard Income Tax, Dividend Withholding Tax and Capital Gains Tax rules will apply. Capital Gains Tax will in fact have a bigger impact on the investors at exit as the asset is zero rated and taxed on total capital gain.
- *Withdrawal of VCC status-non-compliance* by a VCC to the stipulated requirements could trigger withdrawal of an approved VCC status. In such an event, an amount equal to 125% of the aggregate amounts contributed by investors must be included in that VCC's income in the year of assessment in which such approval has been withdrawn.
- *Limitation to investment*- with the reduction of amount allowed to be invested by individuals at R2,500,000 and R5,000,000 by companies or trusts, has meant that less big investments are being invested in VCC's, whilst the VCC's are moving to a more retail product with a higher number of investors with smaller investable amounts.

While many Section 12J offerings mitigate downside risks in various ways, they are more suitable for investors in a high-income bracket with a balanced investment portfolio who are prepared to accept the risks inherent in investments of this nature. VCC investors should preferably have an interest in local entrepreneurship and job creation in order to add value to a rewarding journey.

Investors should conduct appropriate due diligence on the VCC and its risk or return profile, seek professional advice and ensure they are investing in a reputable and experienced VCC with the appropriate skills to invest in and build SMEs into assets of value with substance that can result in future exit strategies.

5.6.3 Fresh capital looks for ways to disrupt the industry

Due to higher development costs and higher operating costs of full-service hotels, the road to growth has seemed challenging as discussed with owners and investors during the interview process. The focus on investment seems to have moved to budget and midscale segments where the demand fundamentals are optimal. The operators confirmed that new international brands were being introduced to compete in this sector. Good examples would be the disruption created by the Signature LUX brands by offering a quality product in strategic locations at prices below the market. Further product diversity in South Africa is expected with the introduction of new brands and new concepts around lifestyle, millennial travel and limited service offerings, targeting the niche segments that are possibly underserved at the moment, given the proliferation of Airbnb in certain core nodes.

5.6.4 Investment cycle dynamics

With the injection of capital into the hospitality sector comes an increase in supply. Respondents to the interview acknowledged this and the challenge in specific primary nodes such as Sandton and Cape Town. Increase in hotel room capacity in key nodes is

positive in catering for long term demand, but the concentration of new hotel supply in key nodes will cause some difficulties for hotel assets outside or on the periphery of the key nodes. Investors and owners still perceive value due to price being below the replacement cost of developing the same hotel and their view that the same discount rate or IRR can be achieved through higher growth. Yields pre-Covid-19 remained flat compared to 2018 and 2017 with levels between 8.0% to 11.0% for operating assets, which is often in line with, or exceeding traditional commercial real estate.

South Africa has seen a large increase in internationally branded hotel supply enter the market in the last decade, with an increasing number of international brands looking at South Africa to expand their portfolios and to introduce new brands. This creates a higher liquidity environment for not only single asset transactions, but also the opportunity to acquire portfolios and platforms to quickly expand the presence of hotel companies in South Africa.

5.7 Impact of Covid-19

Covid-19 has had an immediate impact on the hospitality sector. Travel advisories and restrictions are influencing travel plans for individuals and corporations across the globe. International tourism arrivals globally are expected to decline drastically in 2020-21. The pandemic is more difficult to predict in Africa compared to developed countries. Given the acute lack of health resources and challenges in procuring vaccines, governments are lower level lockdowns to minimise the infection rate. Global output, employment, trade and investment have been impacted negatively. The recovery will depend, on among others, access to medical interventions aimed at containing the COVID-19 pandemic. This indicates the significance of the vaccine deployment in the global recovery. The figure below illustrates the impact of COVID-19 on global output and employment.

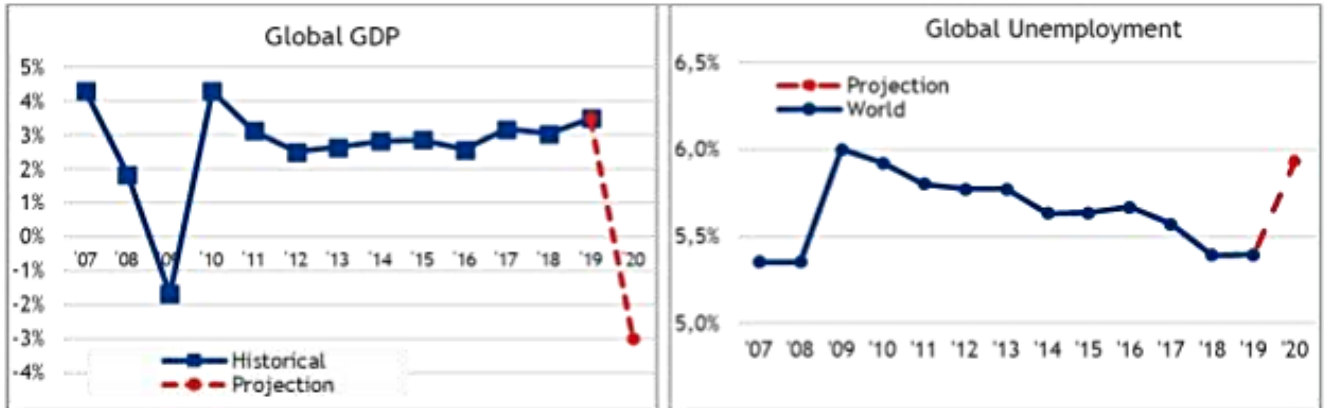


Figure 5.1 Global GDP and Unemployment data

South Africa's first official case of COVID-19 was recorded on 5 March 2020. Since then, a rising infection count prompted government to implement a five-level Risk-Adjusted Strategy aimed at saving lives and preserving livelihoods. The impact of the pandemic has placed many businesses and households in distress and jobs have been lost. Like that on a global scale, South Africa was not spared in terms of the decline in GDP or the rise in unemployment rate.

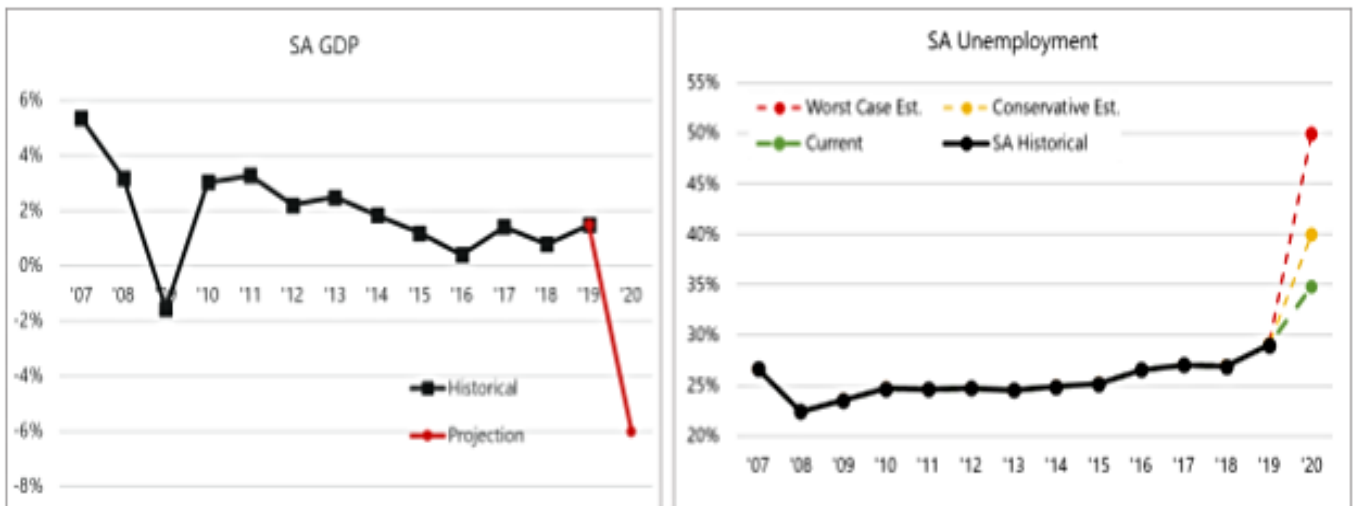


Figure 5.2 Impact of Covid-19 on South Africa's GDP and unemployment

The tourism sector was hardest hit as all borders and airports were closed at the start of the pandemic. International arrivals were reduced to negligible levels and internal movement heavily restricted for several months. Despite the numerous challenges and the onset of the second wave across the globe, there are signs of recovery. SA Tourism has identified 24 source markets which accounted for 92% of all international trips in 2019. These priority markets are segmented into 16 growth & 8 defend markets and have been earmarked to grow tourism into South Africa over the next 5 years.

The UNWTO predicts that international tourism recovery will only begin towards the third quarter of 2021 and in some instances only in 2022. Travel restrictions, varied vaccine response times amongst countries, and low consumer confidence are the main obstacles to international tourism recovery in the short term to medium term. Domestic and regional travel, however, will lead the recovery with Oxford Economics forecasts predicting domestic and regional markets will contribute 86% of South African tourism spend in 2021 and 82% in 2022. Domestic travel will rebound to pre-covid levels before outbound travel mainly due to fewer travel restrictions within own country, more substitution options for non-air-based travel and a larger share of business travel.

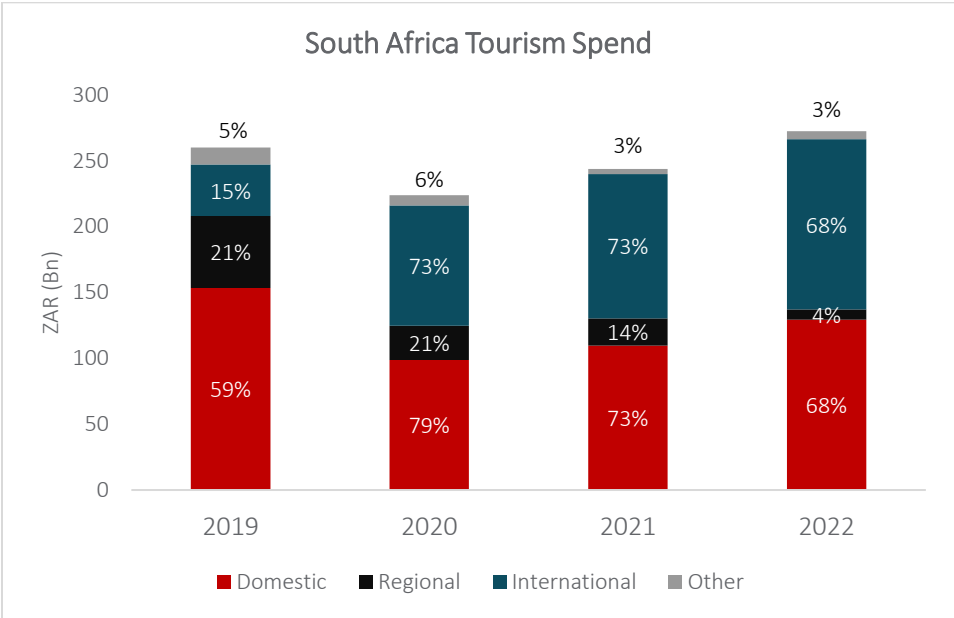


Figure 5.3 South African tourism spend

5.7.1 Macro-economic impact in SSA

Foreign direct investment (FDI) and spending from tourism suffers significant declines as the continent tackles the pandemic. Many respondents that currently own or operate hotels in Sub-Saharan Africa have placed significant focus on each country's response to the pandemic, whether it be total closure as was experienced in Level 1 lockdown in South Africa, or in less stringent countries like Tanzania. Africa is believed to have lost between 20% and 30% of its fiscal revenue, which was USD 500billion in 2019, forcing governments to resort to borrowing to meet the shortfall.

Many respondents gave feedback that although much of the current discussion is directly related to the impact of Covid-19, broader macro-economics in Sub-Saharan Africa had to deal with challenges prior to the pandemic. This included reduction in oil prices which impacted on economies in Africa that relied heavily on oil sales such as Nigeria. Commodity-dependent countries such as Algeria, Angola, Cameroon, Gabon, Ghana, Nigeria, and the Republic of the Congo will be most affected.

Together with tourism, oil represents approximately 25% of the GDP in Africa. The slump in the oil price to below USD 30 a barrel in 2020, and a nosedive of the tourism sector, will arguably be the greatest fiscal shock to Sub-Saharan Africa. Owner operators were most vocal about the employment that tourism and the hospitality sector bring to the economy. Tourism employs more than a million people in Nigeria, Ethiopia, South Africa, Kenya, and Tanzania and more than 20% in each of the countries of Seychelles, Cape Verde, São Tomé and Príncipe, and Mauritius.

5.7.2 Impact on lenders in the hospitality

From the early announcement of lockdown Level 1 in South Africa in March of 2020, the majority of banks funding commercial property advised that clients requested restructures on existing facilities. This included the following:

- Capitalise interest for 6 to 12 months
- Pay interest only for 6 to 12 months
- Restructure completely and have the risks of deals being repriced
- Restructure deals to assist with deferrals as a precautionary measure and not take up the facility

The respondents noted that this was a difficult situation, specifically in the hospitality sector as there was no certainty of income generation. Hotels are impacted to a greater extent, but commercial lenders are insulated by less exposure to the asset class. Where they do have exposure, it is often with a client who has a mix of asset class exposure that mitigates the impact. Distressed hotel assets will come through the system as there is no other way to provide liquidity for an extended period. South Africa does not have fiscal policies or budgets to inject billions of Rand to save the sector, unlike what has been provided for in developed economies. Stimulus has however been received from the central bank because of reducing the liquidity cover against which to borrow.

In South Africa, the respondents who work in the financial sector acknowledged that pricing is difficult now due to the low interest rates. The prime lending rate is the lowest it has been since 1994 at 6.75%. Most of the DFI's are seeing the same challenges as commercial banks but are more focused on longer term fundamentals and the need to support economic growth and developmental impetus has never been greater in the Southern Africa region. Payout on construction loans will be postponed in many cases.

To summarise, deals that are currently on the lender's books will get assistance in the form of a payment holiday or extension of loan. This would include measures such as extending a 10-year facility to 11 or 12 years by capitalising the interest during this time. In SSA liquidity is problematic and existing deals may become difficult even in assisting with interest roll up or capitalisation.

5.7.3 HMA considerations for developments

Most new hotel developments where HMAs have been signed define these timelines according to milestones. This would include the following:

1. Start vertical construction
2. Building top-up
3. FF&E procurement
4. Opening date

Some will provide a long stop date, but not all. If this date is not met then the operator can terminate the HMA. Respondents and specifically those that have close relationships to brand or operate themselves, noted that HMAs now have to offer some flexibility in development timelines when delays are caused by an event of *force majeure*. Based on the respondents' experience, some operators link brand exclusivity to development timelines. Due to COVID-19, owners are negotiating the inclusion of terms allowing for construction delays due to *force majeure* with a view to keeping brand exclusivity.

5.7.4 Covid-19 summary

The focus towards re-opening post a second wave has begun in many parts of the world. Each country will have unique risk adjustment factors in terms of opening their economy and by default, the hotel markets re-opening will be determined by this policy. Respondents fear there are still many unknown factors and the recovery will not be homogenous, thus there remains a collection of scenarios that will evolve with time. The implementation of vaccinations throughout the world will greatly assist in reviving the industry, but there are too many unknowns around procurement and administration in Sub-Saharan Africa to understand the pace at which a revival is expected.

5.8 Investment scenario

The literature review claims there are different kinds of investors and each investor values different investment attributes. Among hotel owners and operators, attributes of location and finance are important to the investment. The data is important as it informs investors what involvement is required as an operator or owner and the various factors in a specific investment. Investors should seek hotels investments that offer a strong five-year return on investment, great site attributes, and an acceptable level of volatility of demand.

On the other hand, individuals who are investing in hotels and are not operating or owning the hotel, first seek factors based on finance. Hotel investors analyse five-year returns on investment, historical returns, and segmentation diversification to understand the potential investment returns. This is important to interpret because investors who contribute capital to the investment are less concerned about the physical attributes that attract business. Rather, hotel investors are concerned about the previous and future financial performance of the investment. It is important to understand the rationale of both kinds of investors. Whether an investor will have an active or a passive role in the

investment, one should understand the value behind all investment factors related to the proposed hotel. Respondents provided some interesting insights into the type of investments that provide better returns. For example, hotels in the upscale and midscale tiers tend to be more profitable than those in luxury brands that offer multiple restaurants and other amenities, as these can become operationally intensive and expensive. When it comes to franchising, owners and developers will have more top line revenue if they choose a name like Holiday Inn Express or Four Points by Sheraton versus an independent hotel name. This can be interpreted as a huge benefit because it will impact the profitability of the hotel and the overall value of the hotel.

The selection of the right operator is especially important because the right operator will add value to the hotel by managing a profitable business. This would include determining the correct management agreement, whether it is a lease, HMA or franchise agreement. Investors wanting to hire an operating company to manage the business of the hotel should take great interest in learning about base management fees (BMF) and incentive management fees (IMF) as these are a cost to the owner. There are many operating companies available that specialise in managing different types of hotels in Sub-Saharan Africa and should be compared to ensure the most competitive operator is selected. The role of the operator has the biggest impact on investment returns. One of the key contributions from the respondents is that owners who invest in assets in multiple market cycles may mitigate development and operating risk. Assessing the economic climate and market cycle will influence investment policy, returns and decisions. The hotel industry is one that changes quickly. Investors and owners need to adapt and stay up to date on the current market cycle stages. The concepts behind the market cycle will not change, but the cycle will always be moving. South Africa specifically is geopolitically distinctive and possesses natural and cultural diversity that supports a globally compelling tourism proposition.

As the sixth most biodiverse country in the world (African Wildlife Foundation, 2018) and by far the most diverse for its size, South Africa is blessed with outstanding ecological richness. The country's recent liberation from apartheid and the construction of a multi-racial democratic dispensation is a touchstone for universal aspirations of peace, freedom, equality and dignity. These core differentiators are reflected in a tourism value proposition that offers high-quality, value-for-money experiences spanning wildlife and safari, the scenic outdoors, beaches, adventure tourism, cultural and city lifestyles. 2019 saw 10,23 million international arrivals and 7,11 million domestic holiday trips.

Tourism also plays a critical role in the broader South African economy. As a tertiary sector with strong linkages to transportation, other network industries, consumer retail and financial services, tourism's indirect economic contribution is substantial. The sector accounts for 2,9% of GDP (8,6% indirect), supports over 725,000 jobs directly (1,49 million indirectly) and accounts for 8,2% of total investment activity as indicated by the South African Tourism Annual Report (2018). Perhaps most importantly, inbound tourism generates some R82,5 billion in direct foreign spend (R127 billion total), contributing an equivalent of 9,2% of total national exports. This makes tourism the second most important export sector in the economy. Domestic tourist activity contributes a further R9,49 billion in direct expenditure. Tourism supports a vibrant and complex value chain and is a sector not characterised by significant market concentration or deep vertical integration like many others in South Africa. Activity occurs across five sub-sectors: 'Travel Distribution and Intermediaries', 'Transport and Related Services', 'Accommodation', 'Entertainment and Related Services' and 'Support and Indirect Services'.

5.9 Role of the commercial banks and DFI's

Feedback from the respondents was quite clear in the sense that funding in the hospitality sector is extremely challenging. There was however a distinction between the treatment of hotel funding in South Africa and Sub-Saharan Africa.

5.9.1 South African perspective

Commercial property funding is one of, if not the most liquid markets in Africa, yet the challenge for commercial funding institutions is understanding the operational risk associated with HMAs and how these impact on cash flow. Commercial banks look to de-risk their exposure and want fixed income from a lease with no operational risk. Leases in the hotel sector are rare and often, when available are provided from operators with weak balance sheets or covenants.

If commercial banks are not available for funding, then the next option would be to approach DFI's. The DFI's would include partners like the Industrial Development Corporation ("IDC"), KZN Growth Fund, National Empowerment Fund ("NEF") and Development Bank of South Africa ("DBSA"). The DFI's have strict Broad-Base Black Economic Empowerment ("BBBEE") policies that rightfully promote investments that address issues of the past, but also limit the eligibility for some investors and developers as they may not qualify in terms of the BBBEE criteria. DFI's also predominantly look at developments or portfolio acquisitions or additions to a portfolio which again restrict newcomers to the market. The only other alternative, which is regarded more as mezzanine funding is to raise capital via a Section 12J VCC. This has worked well for certain groups like The Capital Hotel group and Westbrooke asset managers, but also has limitations with the maximum allowed per VCC of R50million. Further restrictions

include the maximum amount of investment which has now been capped to R5million per company and R2.5million per individual. To summarise, the local South African market is liquid when compared to countries in Sub-Saharan Africa, but challenges remain funding hotels due to the variable income nature of the sector. Development banks play a role, but BBBEE requirements do hinder certain possible transactions. In addition, the Section 12J can play a role in raising capital but has a cap on the amount that can be raised per project.

5.9.2 Sub-Saharan perspective

The Sub-Saharan market is more complicated due to lower levels of liquidity as compared to South Africa, as well as currency risk which is a challenge when borrowing in local currency. The positive perspective as mentioned from the respondents is that often hotels in Sub-Saharan Africa will earn a portion of their income in hard currency being US dollars, Euro or British Pounds. This eliminated some of the devaluation risk in owning an asset in these countries.

The main challenges remain in obtaining finance in these markets. Commercial funding institutions will often only lend to a maximum tenor of 8 years which places significant strain on serviceability of loan facilities. In addition to this, most commercial banks will only consider term loans and not construction loans. Therefore, commercial bank funding is available for acquisitions of which a portion will be based in local currency which affect IRR's and the term of these facilities is shorter and therefore impacts the loan to value of the loan. DFI's provide another funding mechanism available to developers but will only be available for developments and not for the acquisition of assets. At the end of the construction period, DFI's have the capacity to convert to a conventional loan and tend to provide longer tenors which assist in cash flow and the ultimate loan to value of the loan approved. DFI's as mentioned in the interview by many respondents, tend to take much longer in their decision-making process and are not as competitive with their interest rates offered. Another concern is that DFI's in Sub-Saharan Africa are not allowed to participate

in the South African market as they consider South Africa too developed. This removes potential opportunities for the DFI's in South Africa, and alike limits the DFI's available for funding for developers in South Africa. Most of the respondents concur that DFI's entering the South African market will be viewed as positive due to the competition that comes with more funding providers in the market.

5.10 Joint-venture ownership models typically found in hotel investments

With funding difficulties in the hospitality sector in South Africa and the Sub-Saharan Africa region, many respondents spoke of the required capital stack and need for additional equity. This is mostly due to funders placing reliance on fixed income such as a lease when lending, which is not available with hotel investments. Developers will most often look to raise capital in the form of private equity or mezzanine funding. Private equity will have many places to invest including other sectors that may have more stable income generation and therefore means more competition outside of the sector itself. Mezzanine funders are scarce in Sub-Saharan Africa and often have IRR requirements of over 20% which makes it unfeasible a development or acquisition.

Other reasons for Joint-Venture ownership models would be operational or hotel experience. Respondents spoke of having land banked a promising site earmarked for hotel development, but not having the correct expertise to proceed from planning to completion stage. These challenges often lie with selecting the right operator for the hotel, understanding HMA's and/or other contracts to be negotiated, as well as funding for the development. Joint venture partners are selected carefully as the right partner could have the right experience in the hospitality sector which is key for funders when lending to the sector. Additionally, these operators may have stronger balance sheets that the developer who has the land, can assist with successful funding.

Lastly, some international hotel operators will look to secure the operation of a hotel by providing equity for a project. Many international hotel operators have key investors that are already in Sub-Saharan Africa and are attached to their specific brands. Joint-Venture ownership models can also be where these international hotel brands bring their known investor to a proposed development which provides the security of operating the proposed hotel, as well as fulfilling the capital stack to ensure the hotel development is completed.

5.11 Summary of research findings

The answers to the three main research questions of the study can be summarised as below:

- How do hotels perform as an alternative property investment asset class as compared to traditional property investment asset classes in terms of investment yields during different stages of the property cycle

The evidence shows that developers and investors alike are looking at alternative investments in times during a downturn or where the market is bottoming out. It may seem less of a desire to pursue investment yield from assets in the hospitality sector as compared to traditional asset classes, but the current pressure on yields have meant that developers and investors have had to diversify to look for higher performing assets in less traditional asset class sectors. Historically, hotels investors were very specific in their investment asset classes with most investors in this sector having purely focused on hospitality assets. This has now changed with increased generalist investors coming to the market with more exposure to the hospitality sector. This is a function of lower yielding opportunities within the retail, commercial and industrial sector which is still preferred due to the certainty of income.

Leases are still preferred to variable income contracts found with HMA's which is the major challenge to investment in the sector. The main reason for this is the difficulty for funding in the sector as indicated by respondents with links to banks and other funders. Mixed-use developments have however required better understanding of HMA's and the operational risk attached to hotel assets.

Financiers and investors alike are now more attune to these contract as compared to the past. Investors and developers will continue to look for higher yielding assets in sectors with more secured leasing contracts, but with the market bottoming out, it would seem alternatives are being reviewed more favourable in times of yield pressure. The outcomes of questions 1 to 12 focused on the aspects of this question.

- If there is evidence that developers and property funds are considering hotels as an alternative property investment asset class, how aligned are the commercial banks, DFI's or 12J funds and what are their requirements to fund single hotel assets versus portfolio lending

The majority of investors and developers had knowledge of financial institutions which included traditional commercial banks, DFI's and Section 12J VCC's. Most investors and developers that pursued investments in the hospitality sector still preferred commercial funders due to the perceived challenges with DFI's. This included the restrictive challenges of qualifying for DFI funding, the fact that most international DFI funds are not actively involved in South Africa and the perceived delay in decision making with DFI's. Even fewer investors or developers were actively looking at Section 12J VCC's for alternative funding and those that did have experience in this found the quantum limit of R50 million and compliance requirements a challenge. Respondents actively invested in the hospitality sector confirmed that portfolio funding increased the success rate of funding a project or acquisition compared to single asset funding. The main reasons for this would be the ability to reduce risk and increase diversification for financiers. This

would apply to commercial banks and DFI's. The outcomes of questions 13, 14, 18, 19 and 20 focused on the aspects of this question.

- How do these funding challenges compare to those experienced in the rest of Sub-Saharan Africa, specifically looking at DFI funding?

Most respondents revealed the desire to focus on investments in South Africa compared to Sub-Saharan Africa. This is mainly due to the perceived political instability in most Sub-Saharan Africa countries. DF funding would seem to ease the burden of funding projects in Sub-Saharan Africa, but most investors and develops still look to South Africa for yielding hospitality assets. The outcomes of questions 16, 17, and 21 focused on the aspects of this question.

Chapter 6: CONCLUSIONS AND RECOMMENDATIONS

6.1 Introduction

Chapter 5 presents the results and interpretation of the interview held.

South African financial institutions are yet to align their approaches to commercial property funding with the increase in number of developers and investors investing in hotels. South African financial institutions are yet to align with the dynamic nature of the hotel industry. Yet owners still have a greater preference in applying for finance from traditional commercial banks as compared to DFI's.

The shift in alternative funding such as the Section 12J space, indicates a real-estate sector that is continuously evolving. There is a growing understanding of the hotel sector from developers and investors in terms of the risk difference between a HMA, franchise agreement and lease. Many developers and investors still look to obtain a lease or HMA with guarantee as they are more comfortable with traditional commercial property that traditionally has a fixed lease in place. Financial institutions are similar in their approach to funding. There is also slow adoption from institutional investors. This despite understanding that hotels owned and operated on the basis of a HMA carry increased operational risk, the preferred model is still to invest in an internationally branded hotel on the back of a lease or HMA with strong guarantees.

6.2 Summary of the study

The study looks at returns achieved by hotel assets versus other traditional property asset classes in South Africa and the funding mechanisms available. The South African real-estate sector and literature available compares the mature retail and commercial sector with the hospitality sector. The study also investigates the type of lending available to developers, investors, REIT's and other large institutions looking at investing in this asset class. The results indicate that developers and investors would look at investing in the hotel sector as an alternative to traditional asset classes, but find the risk associated with a HMA difficult to overcome in a more volatile market such as South Africa. Results further inform that commercial banks are still preferred when funding developments or acquisitions of hotels, despite the relative lack of knowledge of DFI's in South Africa.

6.3 Research Objectives

Research objectives were achieved due to the understanding of leases, HMA's and franchise agreements amongst the research. Despite the limited data available to research topic, the study provided a good base for the sector and future studies. This results also present further insight into how developers and investors approach the risk aspect of the operating entity, the requirements for returns to an investment and the approach to financiers. Alternative funding, specifically in the Section 12J space, is also understood.

All research questions are answered as indicated in 5.11 above, and thus the research objectives were met. Although this provides primary data for researchers in this hotel field in the future, the findings can be implemented on a broader basis. The study can be used in the context of South Africa as well as in Sub-Saharan Africa as many elements are viewed similarly.

6.4 Conclusion

Developers and investors alike are looking at hotels as an alternative investment asset class. This is already shown in the number of new entrants in the market. Many are still grasping the differences in risk between a HMA and lease. Leases in the hotel sector are not easily obtainable and becoming less so as the South African market comes to grips with the International Hotel Brand's and their preferences for HMA's. Commercial banks should follow by increasing their comprehension of this, with DFI's already having a good understanding of the risk implications, but possibly the key for them to be more inclusive and responsive is assisting investors with funding. It is safe to say that investment in this sector is still in its infancy. The growth in the sector could benefit many other sectors of the economy, specifically labour, as hotel traditionally provide a number of primary and secondary jobs.

Although the uncertainties brought about by the COVID-19 pandemic is presently placing significant constraints on the industry globally, in more so on an already stressed economy in South Africa, this pandemic will not last forever. Current trends will show that drive-to-destinations will most likely recovery sooner than markets heavily reliant on international travel. This will certainly bode well for South Africa as compared to other African economies. Transactions will be more difficult as debt markets remain a challenge as illustrated below:



Figure 6.1 Debt market trends and challenges

Africa may in the short-term shift from a dominant development cycle to an acquisition cycle, but the long-term fundamentals for hotel development in South Africa and Sub-Saharan Africa remain strong. Hotels as a real estate asset class require a longer investment horizon and will outlast the present situation. Once the property cycles turn, as they always do, this will remain a very lucrative investment opportunity especially during portfolio diversification.

6.5 Opportunities for Future Research

The treatise has expanded areas for future research in the sector with specific focus being broadly categorized into two subcategories, namely hotel investments and hotel funding. Hotel investment can be further investigated to consider alternative countries in Sub-Saharan Africa. Many elements are the same as what has been experienced in South Africa. The level of understanding by developers and investors in this sector in emerging markets could benefit from more research in this field.

In terms of hotel funders, certain findings can be further explored by researchers looking to assess whether the South African framework is too narrow, with too many restrictions on credit applications and with specific emphasis on the understanding the risk and benefits of a HMA with an international branded hotel company versus a lease which is seldom available.

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Annexure 1 - Questionnaire

1. What role does your company play in terms of property development or acquisitions in the hospitality sector in South Africa and/or outside of South Africa.

1.1 If none, why is it that hotels/resorts are not considered as an appropriate property investment asset class in your property portfolio

Open-ended and exploratory

2. When the property cycle is of such a nature that traditional property asset classes (commercial/retail/industrial) are under pressure to achieve desired returns/yields, would you consider more non-traditional asset classes such as hospitality assets?

Open-ended and exploratory

3. Are hotels/resorts part of your existing property portfolio or is it a consideration for the future?

Open-ended and exploratory

4. If you do have hotels/resorts as part of your property portfolio, what percentage of the entire portfolio would this account for?

Quantity

5. How do you think a hotel would fit in a mixed-use development? Is it traditionally a supportive function or hinderance to the rest of a mixed-use development?

Open-ended and exploratory

6. Have you ever sourced a lease or tried to source a lease for a hotel development or acquisition opportunity?

Open-ended and exploratory

7. Do you know of hospitality brokerage firms in South Africa or outside of South Africa that can assist with leasing or operator selections? Please compare this to the leasing brokers you know in the more traditional property asset classes such as industrial/retail and commercial.

List

8. Could you provide your understanding of the differences between a hotel management agreement and hotel lease, which you would prefer and provide reasons?

Open-ended and exploratory

9. Do you know the different types of hotel management agreements and if so, please elaborate on your knowledge of them?

Open-ended and exploratory

10. If you had to rank in preference, being 1 the most preferred and 3 the least preferred, which “hotel management agreement” would you prefer for a hotel opportunity:

- 10.1 Lease where the operator takes the risk, but covenants may not be as strong.
- 10.2 HMA with a base guarantee and incentive fee which shares the risk between property owner and operator.
- 10.3 HMA with no guarantee where the property owner takes all the risk but benefits on the upside and better terms.

Ranking

11. Do you use a leasing broker for your properties, or do you have your own internal leasing division?

Open-ended and exploratory

12. Would you consider a franchise agreement where you could owner manage a hotel/resort off the systems of an international hotel brand, similar to having an internal leasing division for other traditional property asset classes?

Open-ended and exploratory

13. If considering a hotel as a development opportunity, could you elaborate on the funding mechanisms you would consider.

Open-ended and exploratory

14. If you have or have tried funding a hotel development/acquisition, could you describe the financiers you approached – traditional banks, development banks, 12J, and any others.

Open-ended and exploratory

15. What is your knowledge of the criteria for funding using a Development Funding Institution such as the IDC, NEF, OPIC, IFC.

Open-ended and exploratory

16. What challenges did you find or are you aware of with the Development Funding Institutions?

Open-ended and exploratory

17. Development Funding Institutions outside of South Africa are not allowed to invest in South Africa. Do you think this would make a difference if they could participate in South Africa?

Open-ended and exploratory

18. What is your understanding of the Section 12J and its relation to the hospitality sector?

Open-ended and exploratory

19. Would you consider the Section 12J as a funding mechanism for a hotel development or acquisition opportunity?

Open-ended and exploratory

20. What do you see as the limitation to a Section 12J scheme?

Open-ended and exploratory

21. Knowing the interest rates and returns in the South African context; in comparison to interest rates and returns in the hospitality sector in Sub-Saharan Africa – what is your preference in investment destination for hospitality and why?

Open-ended and exploratory

As can be seen with the above, 18 of the 21 questions require open-ended answers which lead to having an exploratory one-on-one interview with the participants and is in line with the outlined qualitative methodology approach.

Annexure 2 - Understanding of the differences between a hotel management agreement and hotel lease

	Lease	HMA	Preference
Respondent 1	Tenant is the hotel company and assumes all operating responsibilities and financial obligations. Benefits from the fruits of the property if successful but suffers on the losses if not.	Agreement between hotel operator and property owner where the operator assumes responsibility for managing the property, staff, but takes no risk in terms of the property. The property CAPEX, FF & E and finance obligations are the responsibility of the hotel owner.	HMA
Respondent 2	Operator assumes all the risk in operating the hotel as they must provide a fixed monthly income to the owner, less stringent if it is a variable lease.	Owner of the property assumes the risk in the operations of the hotel.	HMA
Respondent 3	There is a legal obligation to pay rental in terms of a fixed lease amount and period. Typical landlord and tenant relationship where the hotel operator is the tenant.	Hotel operator manages the hotel, pays all related expenses of the hotel and receives a fee for this operation. The owner of the property will then make a profit or loss once expenses are deducted.	Lease
Respondent 4	Risk is with the tenant to perform. Fixed lease beneficial to the landlord during low occupancies.	Risk is with the landlord should the hotel operator not perform.	Lease

Respondent 5	Hotel operator signs a lease for a fixed term and amount and takes operational risk.	Landlord takes risk due to no fixed income.	Lease
Respondent 6	Hotel management company manages the property and takes the risk in operating the hotel at a level where a fixed lease is paid to the landlord. If the operator does not perform then they have the risk of making a loss.	Landlord takes the risk and has no control of the management of the property. The landlord has the risk of reduced returns if the operator does not perform according to budgets agreed.	Hybrid
Respondent 7	Hotel operator signs a lease for a fixed term and amount and takes operational risk.	Landlord takes risk due to no fixed income.	Lease
Respondent 8	Defined lease period with fixed income to the landlord. The hotel operator takes the risk in having to achieve a certain level of income to cover lease obligations.	The hotel operator defines the role and responsibility of the management of the hotel. The landlord takes the risk of underperformance by the hotel operator.	Lease
Respondent 9	Leases are riskier for the operator due to fixed commitment and even more so for new builds as required yields are not feasible for smaller operators.	HMA's are less onerous on hotel operators and can ride out months of low occupancy especially if the HMA is over a long period of time. A strong involvement or owner-operator relationship is key in the success of a hotel.	HMA
Respondent 10	With a lease the operational risk is taken out of the equation.	The property owner takes on the management and operational risk.	Lease

Respondent 11	The lease means more risk for the operator, but the freedom to market one's own brand.	HMA allows for the management of the hotel with the owner very involved due to the shared risk.	Lease
Respondent 12	The lease separates the operating income from the property income through imposing a rental stream. Risk is with the hotel operator to perform at a level above minimum lease obligation.	HMA provides the property owner with the risk and reward retained. The hotel owner benefits from the upside of a well operated hotel that achieves NOI above approved budget, but also has the same risk on an underperforming hotel.	HMA
Respondent 13	Risk is with the tenant to perform and ensure payment of the lease is made, whilst the hotel still outperforms lease obligations.	Landlord carries the risk should the hotel operator not perform.	Lease
Respondent 14	Hotel operator signs a lease with fixed agreed terms. The hotel operator takes the risk of running the hotel and committing to a fixed rental.	Landlord takes risk for the operation of the hotel. A minimum lease amount may not be achievable to the landlord.	HMA
Respondent 15	With a lease there is no operational risk, and this is beneficial to the landlord.	Property owners take management and operational risks. This is beneficial to the hotel operator as they have less risk in the operational elements of the business.	Lease
Respondent 16	The hotel operator will be contractually liable to a fixed lease, or in some instances fixed and variable. This places	Landlord takes the risk as his fees are net of all expenses. However, with the right hotel operator there is upside benefit to	HMA

	the risk on the hotel operator to outperform the lease obligations.	the landlord whereas a lease would not provide this potential upside.	
Respondent 17	No operational risk as the hotel operator signs a lease like a commercial lease.	Operational risk is with the landlord as the income derived from the operation of the hotel is variable. It is performance driven.	HMA
Respondent 18	Dependent on the market, a lease will provide the owner with downside protection, but will not benefit from the upside of the hotel performance. Leases give more certainty of income less volatility. This is dependent on the strength of the lease.	The landlord takes the operational risk of the hotel but will benefit financially and operationally if the relationship with the owner and operator is strong.	HMA
Respondent 19	Hotel lease provides fixed (or semi-fixed) income to cover owners financial obligations for the landlord. This gives a lower risk on investment but limits the upside which can benefit the hotel operator if the hotel lease terms are favourable and the hotel is successful.	HMA's provide the owners with the benefit of upside if the hotel performs where a lease is limited. The landlord does sit with the operational risk of the operator but can have much higher returns as only management and incentive fees are paid to the operator. Returns can fluctuate in a more volatile market.	HMA
Respondent 20	A lease has limited upside potential but provides a more risk averse approach to landlords.	HMA's have increased potential to benefit from the successful operation of a hotel. Difficult to fund hotels on a HMA basis due to variable income streams.	Lease

Respondent 21	A hotel lease is a legal obligation to pay rent in terms of a monthly rental and for a specific period which would include fixed escalations, and landlord and hotel operator's relationship.	Management agreement is where the hotel operator agrees to manage a hotel in exchange for a payment of services in the form of management fees. All related expenses and their fees come from the operation of the hotel. Once all the expenses have been deducted the owner (landlord) will either get a profit or make a loss.	Lease
Respondent 22	A lease is a guaranteed fixed income per month, excluding operational risk to the owner.	HMA is where a hotel group is appointed to manage a hotel for a fee. The hotel group manages the property and passes on derived income to the hotel owner. Operational risk is with the hotel owner.	Lease
Respondent 23	A hotel lease is like the hotel management agreement, but generally the lessee receives some additional profit benefit with fixed lease having to be paid to the landlord.	A HMA is generally done with international hotel brands in order to operate a hotel with skilled staff to ensure the hotel is operated successfully. They are then compensated with fees for the management of the hotel.	Lease
Respondent 24	A lease provides secure income to the landlord and eliminates operational risk for the hotel.	The HMA only provides security if the hotel management company operates the hotel efficiently. Income is not secured for the landlord.	Lease

Respondent 25	A lease provides fixed income for the landlord but could place severe constraints on the operators to achieve certain minimum thresholds.	HMA is a partnership with the landlord and operator and carries operational risk for the landlord.	Hybrid
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