Northern Exposure

With Delta Hotels and CHIP REIT now in its portfolio, bcIMC has one of the hottest hands in Canada's robust hotel sector.

The fastest way to attain critical mass is to buy it. British Columbia Management Investment Corp. (bcIMC) has done just that. The Victoria, British Columbia-based investment management corporation took less than 10 weeks to mount cash takeovers of Canadian Hotel Income Properties Real Estate Investment Trust (CHIP REIT), a transaction valued at US$1.23 billion including debt, and Fairmont Hotels & Resorts' first-class Delta Hotels brand. Now closed, these deals for two of Canada's domestic power hitters give bcIMC access to both the real estate run-up and the operational gains available in a market with record merger and acquisition activity and solid performance. It will be interesting to see how a fund with over US$88 billion worth of assets under administration and global exposure manages this double play.

MADE FOR THE MARKET

Now that bcIMC has both bricks and brains, it can test the wisdom of expanding its diversified portfolio into the hospitality sector. Maximizing return on investment in CHIP REIT should be business as usual. bcIMC already has more than US$10.4 billion in real estate investments. CHIP opens up a new kind of revenue flow by offering investors both stable income from 32 hotels with approximately 7,700 guestrooms and growth potential through acquisitions, as well as repositioning and franchising under such flags as Delta, Radisson, Marriott and Hilton.

bcIMC's August 1 takeover offer of US$19.83 per unit reflects its belief that the current portfolio and future potential justify a 34% premium (over the July 31 close). "As one of Canada's best-run hotel businesses, CHIP REIT will be a strong complement to our diversified portfolio of assets," says Doug Pearce, chief executive and CIO of bcIMC.

Pearce points out that the REIT will continue to pursue its existing strategy under its current management team, which means a sustained focus on mid-market and first-class full-service hotels.

CHIP REIT's new owners face some intriguing challenges. On one hand, value for strategic hotel assets is soaring. Colliers International Hotels, Toronto, reports that, in 2006, 10 strategic assets sold for a combined US$1.97 billion. It took just 13 strategic assets to get to the US$1.04 billion mark the previous year. While that is good news for investors who own these assets or want to become sellers, buyers are going to have to be either very bullish or very savvy investors to make the numbers work at a time when the cost per key rose 35% year-to-date for the first nine months of 2007 (US$117,000 versus U$86,600).

bcIMC has acquired the Delta hotel brand from Fairmont and has designs to grow the brand within the region and internationally.

STRATEGIES FOR DELTA

That is where Delta Hotels comes in. With more than 40 city center and airport hotels and resorts with more than 21,000 rooms, Delta has kept global brands at bay and positioned itself as Canada's dominant 4-star flag. President Hank Stackhouse gets good marks from the experts for hotel performance, building the largest national sales team of any brand operating in Canada, giving unmatched penetration into corporate accounts and for establishing excellent distribution—particularly in terms of well-chosen secondary markets and strategic resorts. He has also made ▸

Given limited opportunities for third-party management contracts across Canada, and particularly given Delta's disrtibution in major markets, growth would be limited without franchising, says Colliers' Pirani.

In the Delta deal, bcIMC acquired just the management contract for the Delta Whistler Village Suites in Canada.

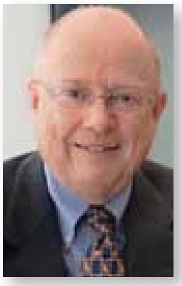
Delta one of The Globe and Mail's "50 Best Employers in Canada."

However, Delta has a substantial amount of unfinished business, which bodes well for bcIMC. One factor focuses on the company's fledgling franchising business launched before Kingdom Hotels and Colony Capital bought out Delta's parent company, Fairmont, and merged it into its new incarnation as Fairmont Raffles Hotels International. "Their objective was to grow the business through management contracts," says Alam Pirani, Colliers' managing director. "Given the fairly limited opportunities for third-party management contracts across Canada, and particularly given Delta's distribution in all major markets, growth opportunities would have been limited (without franchising)."

With its real estate expertise and the use of CHIP as a platform, "I would imagine growth opportunities for Delta won't be restricted to just management and franchising," Pirani adds.

Piers Talalla, managing director of the international investment bank, Avington, London, which served as financial advisor to bcIMC along with Bentall Capital LP (with principal offices in Vancouver and Toronto), says the upside options "are numerous." Among the most obvious:

- Grow this strong brand into regions "not fully served," including Canada's rapidly growing western provinces (Colliers reports Western Canada—specifically Alberta—accounted for 52% of transaction volume through September).
- Grow through brand extensions outside of the urban 4-star segment into other hospitality and real estate segments, including extended-stay and select-service, as well as develop deeper penetration into resorts and "perhaps" the residential sector.
- Expand the Delta brand into select international destinations.



Doug Pearce, CEO and CIO, bcIMC.

Talalla bases that belief on Delta's ability to attract all guest profiles—business, leisure and group—as well as the strength of its customer loyalty and brand recognition. Separation from its globalized parent should not undercut the effectiveness of its loyalty programs since Delta did not share loyalty programs or Web sites with Fairmont, according to Talalla. ▸

CANADA'S QUIET BOOM

Record M&A activity in the United States has made it hard to focus anywhere else in North or South America. However the companies that expanded their vision to include Canadian hotels are happy they did. Alam Pirani, managing director, Colliers International Hotels, Toronto explains why:

- The market: Canada's hotel industry is in a robust up-cycle. Transaction volume hit all-time highs both in 2005, hitting US$1.75 billion, and again in 2006, when it reached US$3.09 billion. If strategic assets are excluded, traditional transaction volume rose 59% from 2005 to 2006. 2007's momentum is keeping pace, with total transaction volume increasing almost 20% from September 2006 to September 2007, growing from US$2.71 billion to US$3.16 billion.
- The contenders (in addition to bcIMC): Oxford Properties Group, the real estate investment arm of OMERS (one of Canada's largest pension funds); current and recently privatized Canadian hotel real estate investment trusts (Legacy, CHIP, InnVest); Westbridge Hospitality (Westmont and Cadim); Fortress Investment Group LLC; Kingdom Hotels International, Colony Capital LLC, Cascade Investment (Bill Gates' investment fund); and Starwood Capital.
- The upside: Liquidity is strong. International and domestic investors are competing vigorously for real estate that is providing superior returns relative to other commercial sectors. Hotel trading performance is improving. Supply growth is moderate. Fundamentals are moving from recovery to growth. The Canadian economy continues to expand at sustainable levels and interest rates remain relatively low.
- The risk: Transaction activity is expected to slow in response to uncertain economic conditions in the United States as a result, in part, of tightened debt markets.

Avington's Talalla says ownership can provide the level of control and operating leeway necessary to test new ideas and programs within company-owned assets before a systemwide rollout.

Delta has a lot to gain from its independence, in Talalla's view. "With the singular focus afforded to Delta under the new ownership it is expected to benefit from being more independent from Fairmont and will be able to pursue a more aggressive growth strategy," he says.

Bucking the industry trend to separate brands and real estate creates new synergies. "For some companies, ownership of real estate can facilitate growth and enhance the brand," Talalla says. He maintains that ownership can provide the level of control and operating leeway necessary to test new ideas and programs within company-owned assets before a systemwide roll out. "This allows for faster, more efficient research and development and, ultimately, a better product and better service offerings for the brand and independent owners," Talalla says. Should this be a trend? "It would depend on the particular brand and its growth strategy," he adds.

Talalla sees bcIMC using its capital tools, real estate interests and expertise in other asset classes such as office, residential and retail to bolster Delta's ability to expand. Delta's management hopes so. A company spokesperson told *HOTELS' Investment Outlook*, "bcIMC shares our vision for the future. We want to expand and strengthen our current position as well as capitalize on opportunities through organic growth, investment and brand extension."

FACING OBSTACLES

bcIMC's timing is good. The Canadian market continues to perform well as economic growth continues and unemployment settles in at record lows. Growth in the commodities' markets is fueling a significant upturn in the western provinces. But, there are a few clouds. Although Delta's demand is mainly domestic and its marketing plan has been consciously broadened beyond the United States, the chain could still feel some ill effects from the high value of the Canadian dollar.

Pirani says exporting the brand may be more of a concern. "Growth outside of Canada is likely limited unless bcIMC is able to execute on a portfolio transaction of similar first-class hotels and resorts in other markets. The opportunity, I believe, is to expand further in Canada," he says. ■