COLLIERS INTERNATIONAL HOTELS

INNvestment CANADA

THIRD QUARTER 2005

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A Lagging Canadian Lodging Sector Creates an Opportunity

Written by Michael Smith, CFA, Real Estate and Hospitality Analyst, National Bank Financial

Introduction

National Bank Financial covers three of the four Canadian hotel REITs: Legacy, Royal Host and CHIP. The fourth REIT is InnVest. Our hospitality sector coverage also includes Four Seasons, Fairmont and Intrawest Corporation. Of the 24 stocks/REITs in our coverage universe, Fairmont, whose stock price is being penalized by the slow recovery of the lodging industry in Canada, is our top pick—more on this later. First, we provide a brief overview of the lodging market in the United States and Canada.

Hot U.S. Travel Market

So far in 2005, RevPAR in the United States is up 8.3% on average according to Smith Travel Research, being led once again by the luxury segment. Unlike in prior years where occupancy gains were leading the charge, rates are now the driving force. This helps the bottom line as rate increases go directly to profits and help improve margins, unlike occupancy which involves additional costs.

Practically every market in the United States is experiencing growth in both room rates and occupancy, especially Manhattan. Manhattan RevPAR grew 22% in 2004 and this double-digit growth is continuing as expected given the limited supply in the market and the ongoing demand.

The weaker U.S. dollar is a boon to the U.S. lodging industry. This, combined with a positive outlook for the economy, has led to industry expectations for 2005 RevPAR growth of approximately 8%, with the luxury segment leading the way with expected growth of 11%. Based on the strong growth exhibited by U.S. lodging companies (e.g. Marriott, Starwood, Hilton) in the second quarter, there is no reason to believe that expectations won't be met.

Lagging Canadian Market

The Canadian hotel recovery has been lagging the United States, much of it to do with the decline in American travel to Canada. On average, Smith Travel Research reports Canadian RevPAR is up 4.5% in 2005 (compared to the above quoted 8.3% for the United States). According to The Tourism Industry Association of Canada, the decline has to do with the strong Canadian dollar, higher fuel prices and border crossing delays.

Recent trends show that there has been an increase in European and Asian travelers to Canada. A recent Statscan report indicates that overseas travel to Canada has gone up for seven consecutive months. Chinese travelers represent the greatest jump (up 12%), not surprising given that Canada became an approved Chinese tourist destination earlier this year.

Domestic travel has gone up as well, with fewer Canadians travelling abroad. These positive trends, however, have not offset the effects of the decline in U.S. travel given that American travel accounts for over 80% of Canada's tourism (Canada just does not have the population to support its own tourism industry). In fact, for the month of June, American tourists accounted for 87% of total tourists to Canada.

While the Canadian lodging industry has started to rebound from the events of the past few years, it still lags the robust conditions seen in the United States. We see the recovery as more of a 2006, and possibly, a 2007 story. However, we have no doubt that the robust conditions in the United States will eventually spill over into Canada.

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The Condo Market and Hotels

While we are in the early stages of a hotel development cycle, it has been somewhat subdued by the red hot condo market. For many, developing a condo offers more favorable economics than developing a hotel. What's more some prime hotel properties such as The Plaza and The Mayfield in New York are being partially or fully converted into condos thereby reducing the supply of rooms. In Canada, Legacy REIT has announced that it is studying the partial conversion of its large city centre hotels into condos. For obvious reasons, this bodes well for existing hotel owners.

Hotel REITs

In the next 12-18 months we believe that Royal Host REIT will disappear either through a privatization or merger. Its largest and by far best asset, the Grand Okanagan, has benefited from soaring real estate values in Kelowna. It also owns a number of other sought after assets which we don't believe are fully reflected in the REIT's unit price. An "activist" investor has accumulated 19.7% of stock and we believe he will ultimately cause the REIT to be put "in play".

CHIP REIT has emerged as one of the best managed and aligned REITs in the country. If we are correct and Royal Host is privatized, CHIP will be the only internally managed, internally advised REIT in the country. What's more, the board of trustees owns a significant interest in the REIT—the approximate value of their holdings is $156 million.

Legacy REIT has huge leverage to a recovery in Canada. However in the near term, it is hard to envision the REIT outperforming its peers given its above-average reliance on U.S. travel to Canada.

Hotel Companies

In Canada, we are fortunate to have two top tier, world class hotel companies headquartered here—Four Seasons (FSH-T) and Fairmont. According to scores of independent ratings such as Condé Nast, Five Diamond, Harpers Travel and others, Four Seasons Hotels is the number one luxury hotel chain in the world. Currently, it is undergoing the largest expansion in its history with 25 properties under construction literally around the globe. We believe the Four Seasons brand is on par with other global luxury brands such Cartier, Tiffany's and Louis Vuitton and long term, the stock is destined to be a great performer. That said, in the near term (3 - 4 months) the stock is likely to drift sideways owing to near term quarterly outlook and the company's current valuation.

TOP PICK – FAIRMONT (FHR-T)

Fairmont is fundamentally a value story—i.e., net asset value (NAV). On an EPS multiple basis or an EV/EBITDA basis, the stock looks expensive relative to its peers. This is not surprising since approximately 50% of the company's operating earnings come from the cyclically depressed Canadian market versus its peer group which have much more leverage to the hot U.S. lodging market. Moreover, as mentioned above, it's uncertain whether the Canadian lodging recovery will be a 2006 story or a 2007 story. Because of this, and the fact that many stock investors make their decisions based on one year forward EPS multiples, the stock is currently in the "dog house".

However, on a NAV basis the stock is inexpensive. Our NAV for Fairmont is US$38.50, based on a 6.7% cap rate on 2006 owned operating income, which implies an average value per room of US$322,000. Fairmont's NAV is simple to understand, with the majority of its portfolio value coming from approximately 10 properties (see below).

	Fairmont's Portfolio	Rooms
1	The Fairmont Orchid, Hawaii	540
2	The Fairmont Scottsdale Princess	651
3	The Fairmont Chateau Whistler	550
4	The Fairmont Chateau Lake Louise	550
5	The Fairmont Banff Springs	770
6	The Fairmont Copley Plaza Boston	383
7	The Fairmont Acapulco Princess	1,017
8	The Fairmont Pierre Marques	335
9	The Fairmont Southampton	593
10	The Fairmont Hamilton Princess	410
11	The Fairmont Royal Pavilion	74
12	The Fairmont Vancouver Airport	392
13	The Fairmont Jasper Park Lodge	451
14	Fairmont Le Chateau Montebello	211
15	Delta Vancouver Airport	412
	Total	7,339

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We would emphasize that rather than looking at this year's or next year's earnings (as the stock market typically does), private market hotel buyers usually rely on a 10 or 15-year discounted cash flow analysis to value a property.

Recent examples of major hotel sales include the acquisition of Wyndham International by The Blackstone Group for US$3.24 billion in June 2005, with an implied 14.1x - 14.7x 2005 EBITDA (6.8%-7% cap rate). Hilton completed the sale of 11 hotels from May to July 2005 for a total price of US$416 million. The transaction price implies a 6.3% cap rate on a trailing 12-month basis. The Plaza (which was managed by Fairmont), was sold to El-Ad for US$675 million, or US$838,500 per room and is to be converted mainly to residential condominiums. Another transaction was the Blackstone Group acquiring Boca Resorts for $24 per share, implying 13.5x 2005 EBITDA or a 7.4% cap rate. Boca Resorts owns five luxury resorts and golf courses in Florida.

Towards the end of the tech bubble in 1999-2000, many real estate stocks were also in the "dog house" and were trading below NAV. This created an extraordinary opportunity for several shrewd pension funds. During that period, Cadillac Fairview, Oxford Properties, Bentall Properties and Cambridge Leaseholds were all privatized. Control of Fairmont is in the market, thus a privatization or takeover of Fairmont cannot be ruled out.

As a going concern, we like the direction management has taken. From the start, the company has shown "an owner's mindset" through shareholder friendly capital allocation (a key risk when buying a stock). We've seen this by way of dividend increases, debt pay downs, skilful acquisitions and dispositions (e.g., The Fairmont Kea Lani in Maui) and consistent stock buybacks. With the exception of when the company has been in a regulatory blackout period, FHR has generally been purchasing 25,000 shares per day and it has been doing so for almost 12 months.

A catalyst going forward could be a sale of one or more of the company's properties. We believe this would cause more investors to buy into the NAV story. Also, as noted above, an outright takeover cannot be ruled out. In the meantime, the Fairmont brand is gaining momentum. This is evidenced by a number of recent contract wins. In addition, when Host Marriott acquired The Fairmont Kea Lani, it retained Fairmont's management contract of 47 years, a huge endorsement in our view.

Finally, Fairmont enjoys a pristine balance sheet with a net debt to capitalization of only 10%. The balance sheet will be a future driver of earnings growth as it can be used to grow the company's third-party property management business. Additionally, a sure fire, low risk way to create shareholder value is for the company to continue to buyback its stock when it trades below NAV. Indeed, we would not be surprised to see the pace of the buybacks accelerate.

Michael Smith is Canada's Number 1 ranked Real Estate and Hospitality Analyst (Brendan Woods International 2004 & 2005). In addition, according to StarMine, which ranks analysts exclusively on the accuracy of their stock picks, he is the only real estate analyst to make the top three stock pickers every year since the survey began in 2002. To receive the most recent research on the companies mentioned above including estimates and disclosures, please send an e-mail to Grace.liou@nbfinancial.com.

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CANADA

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Q3 2005 TRANSACTION SUMMARY

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Bill Stone
Alam Pirani
Deborah Borotsik

Vancouver: 604-681-4111
Tom Andrews

United States

San Francisco: 415-788-3102
Bob Eaton
Mark McDermott

Irvine: 949-724-5593
Bob Kaplan

Seattle: 206-223-0866
Chris Burdett
Andy Layton

Mexico

Cancun: 52-998-898-1487
Juan Jose Gallardo

Europe

London: 44-20-734-4666
John Sheppard
Paul Bartrop
Colin Hall

Moscow: 7-501-258-5151
Robert Stoddard

Prague: 4-20-221-451-518
Richard Horton

Asia/Pacific

Sydney: 612-9257-0222
Robert McIntosh
George Nicholas
Michael Thomson

New Zealand: 64-9-356-8826
Jack Charters

Hong Kong: 852-2828-9888
Antonio Wu
David Faulkner

Singapore: 62-223-2323
Rachel Wee

Tokyo: 81-3-5563-2111
Alec Menikoff

Interest in Canadian hotel investment continues to intensify, as the third quarter ended with another fourteen hotels trading at an aggregate value of approximately $240 million.

Five provinces reaching coast to coast witnessed activity, with properties including the 149-room Cambridge Suites Hotel Sydney, Nova Scotia, and the 438-room Vancouver Airport Conference Report in Richmond, British Columbia.

There were three trades in excess of $30 million in the third quarter, namely the 425-room Holiday Inn on King in Toronto that sold for approximately $107 million to Westmont Hospitality Group (this includes 205,550 square feet of office space, a retail component and parkade), the 313-room Crowne Plaza Hotel Georgia in Vancouver, which sold for approximately $61.4 million (including a substantial residential development component) to American-based Goodman Real Estate and Delta Land Development Inc., and the 415-room Delta Vancouver Airport which sold for $32.5 million to private investors.

Transaction volume year-to-date Q3 2005 is estimated in excess of $1.4 billion, surpassing the total annual transaction volume recorded at the peak of the investment cycle in 1998. While it is important to note this year's activity has been influenced by ten strategic trades, representing aggregate transaction volume of approximately $860 million, traditional hotel trades amounted to $524 million - the highest volume since 1998 and more than double the $221 million reported during the same period in 2004.

There continues to be signs supporting strong investment activity through the balance of 2005 and into 2006, with strengthening cash flows, continuing demand for all product types and the wide availability of debt and equity capital desirous of investing in the Canadian lodging industry.

A summary of Q3 2005 trades is presented below.

Name	Location	Rooms	Date	Price	Price Per Room	Cap Rate (%)
Cambridge Suites Hotel Sydney	Sydney, NS	149	Jul	$7,500,000	$50,300	11.5
Travelodge Regina East	Regina, SK	181	Jul	$2,350,000	$12,900	5.2
Travelodge Ingersoll	Ingersoll, ON	98	Jul	$2,400,000	$24,500	8.1
Chateau Royal Hotel and Suites	Montreal, QC	135	Jul	$11,000,000	$81,500	n/a
Ambler Airport Hotel	Mississauga, ON	222	Aug	$5,750,000	$25,900	2.1
Towne and Country Hotel	Cranbrook, BC	91	Aug	$1,700,000	$16,700	n/a
Vancouver Airport Conference Resort	Richmond, BC	438	Aug	n/a	n/a	n/a
Super 8 Motel - Ajax	Ajax, ON	64	Sep	$4,001,800	$62,500	n/a
Holiday Inn on King * [1]	Toronto, ON	425	Sep	$107,000,000	n/a	4.1
Crowne Plaza Hotel Georgia * [2]	Vancouver, BC	313	Sep	$61,400,000	n/a	2.8
Delta Vancouver Airport [3]	Richmond, BC	415	Sep	$32,500,000	$78,300	n/a
Knights Inn Toronto North	Richmond Hill, ON	62	Sep	$2,315,000	$37,300	n/a
Super 8 Motel - Cambridge	Cambridge, ON	65	Sep	$2,700,000	$41,500	n/a
Town & Country Motel - Burlington	Burlington, ON	30	Sep	$1,850,000	$61,700	n/a

* Strategic acquisition

Notes:
[1] Purchase price includes 205,550 square feet of office space, retail component and parkade.
[2] Purchase price includes the hotel along with an adjacent parkade.
[3] Subject to a leasehold interest with Delta Hotels.