Although tourism plays a key role for developing countries, investment projects in these countries carry a high level of risk. This risk can only be borne via a long-term commitment and rigorous project selection. The International Finance Corporation’s (IFC) investment analyses are based on its long-standing experience in the sector and allow it to integrate both economic and developmental objectives. IFC tailors its operations to the type and environment of a project.

As the largest employer after agriculture, employing approximately one-twelfth of the world’s population (World Travel and Tourism Council (WTTC), 2010) and a significant forex earner, tourism is important in many of IFC’s client countries, typically yielding a high development impact on society. However, projects in this sector, such as hotel investments, face a high level of risk, particularly in developing countries. Therefore a strong role exists for multilateral donors to boost investment. Since its founding in 1956, IFC has supported more than 220 hotel projects in 80 countries, investing in excess of USD 2 billion. IFC’s hotel portfolio currently stands at USD 570 million, with 60 projects in more than 40 countries, representing just over 1% of IFC’s total investments.

Tourism strategy unpacked

IFC’s hotel investment strategy focuses on viable projects that impact positively on the local community and surrounding areas, catalysing economic development, creating jobs, deepening local supply chains, and improving infrastructure.

When considering a new project, IFC focuses on the alignment of each project with the needs and tourism priorities of the area concerned within the context of three primary investments themes. Prospective investments are evaluated and assessed on various criteria before a decision is made. Firstly, it focuses on modernising the business infrastructure of developing countries through investment and establishing best practices. In so doing it raises the overall standards of competition, attracting foreign investors and business travellers. Secondly, it examines the suitability of resort destinations for developing quality hotels to attract tourists and meetings. Finally, IFC encourages hotel developments that are accompanied by other components such as shopping centres, office towers and residential units, to address multiple property development needs and diversify risks.

To align with these themes, IFC looks for high-quality local, regional and global hotel companies, including those interested in new construction, refurbishment, financial restructuring and acquisitions. It also searches for owners of hotel assets, including clients in search of multi-project financing, to achieve growth and domestic, regional, and global property diversity by type and location. In addition, IFC considers single asset investments in frontier markets and locations with a shortage of quality hotels. It also considers equity investments where there is potential upside and a viable exit. For all cases, there must be compliance with the environmental and social requirements defined in its Performance Standards and Environmental Health and Safety Guidelines.
IFC often contributes to the regulatory and legal environment where it invests through its advisory services arm. IFC has handled hotel privatisations in such diverse locations as Yemen, Uganda, and Sierra Leone, and is promoting investments in greenfield opportunities in Mozambique, Madagascar and the Solomon Islands. It works with governments to refine tourism strategies aimed at improving overall destination competitiveness and investment appeal, and its advisory services are active in the area of tourism supply chain linkages. In Rwanda, for example, IFC is helping to strengthen small and medium enterprise (SME) supplier access to markets and finance. Here, the program is strengthening linkages between SME tour operators, travel agencies, restaurants and hotels. In Sri Lanka, a similar program includes capacity building for SMEs to meet the quality and service delivery standards of local hotels.

Where required, IFC helps clients navigate the environmental and social issues that can affect hotels - life and fire safety, sewage system management, water supply and waste disposal, and the like. For example, in a number of hotels IFC has supported energy efficiency audits. Investments in support of audit recommendations have followed. In the area of life and fire safety, clients, like the Hyatt Regency Kyiv in Ukraine, have successfully complied with internationally recognised standards, with support and expertise from consultants identified by IFC.

**Tourism offers an attractive development opportunity**

City hotels typically attract business travellers, unlike resort hotels, which attract tourists and vacationers. However, both types can draw the lucrative meeting, incentive, conference, and exhibition market segment.

Development impacts vary, depending on hotel type. Both business and resort hotels are important for employment, foreign exchange and generating tax. However, business hotels often provide essential business infrastructure and can help with urban renewal or regeneration efforts. Resorts and resort destinations too, especially in newly emerging locations, can spark construction of critical infrastructure.

IFC supported the development of the tourism sector in Puerto Plata and Punta Cana in the Dominican Republic with direct investments and other investments in support of tourism development, such as airport concessions, a cruise port and toll road, which often helps to diversify economic development.

The types of hotel development that are financed often differ according to a country’s economic development and the location’s lifecycle. In emerging or transitional economies, the initial need is for international-standard hotels for business travellers and pioneering leisure travellers. As economies develop, mid-range hotels for domestic and regional travellers, price-conscious business travellers, and tour package members are required. For established destinations to remain competitive, existing hotels may require upgrades and diversification into new products or markets; for example, there is increasing support of hotels with a green design.

**Reward in financing hotels**

Most hotel investments have a positive and often significant impact on local economies. While development costs vary widely by destination and hotel type (budget, mid-market or luxury), all hotels are capital-intensive and have high fixed operating costs. This implies large investments with a long-term perspective on returns.

Hotel investments are complex, because environments are risky, revenues are often seasonal or cyclical, and success can depend on factors outside a sponsor’s control. Investors approach hotels as both an investment in an operating entity and a real estate investment. Thus, investors face risks from operational cash flows as well as from fluctuating real estate values. In both cases, the industry tends to be cyclical, with more vulnerability in emerging markets. In the event of an oversupply of
hotel rooms and other factors negatively affecting demand and decreasing real estate values, investors stand to lose substantial amounts. Moreover, the high level of perishability in hotels – income lost from a hotel room not sold can never be recaptured – accentuates the risk.

Business risks also vary by hotel type. Demand for city hotels is influenced by investment, economic, and political environments, and the oversupply of hotel rooms is a frequent problem. On the other hand, resort performance can be affected by fluctuating exchange rates, air access, seasonality, natural disasters, and perceptions of health and safety risks. Furthermore, the popularity of resort destinations is strongly affected by consumer trends, which change frequently.

Given the high level of risks, in recent years, more new hotels globally have formed a part of mixed-use developments, with combinations of offices, retail, and residential components. This approach provides synergies and can help diversify risks. Particularly for expensive resort developments, residential, condominium, and timeshare/fractional components are often required to achieve a sufficient financial return. They often provide the developer with upfront money to defray expensive development costs.

Despite the mixed-use development possibility, investors and lenders are often reluctant to finance hotel projects in developing countries. While hotel investments in developed and developing countries face the same risks, developing countries often present additional risks that need to be assessed – economic instability, political risks, safety, healthcare, etc. Investors’ reluctance is even stronger when the project entails a long-term investment in the 10- to 12-year range.

This is the typical length of an IFC loan in a greenfield hotel. Equity financing is similarly considered from a long-term investment perspective. Strong development impact, high investment risk, and reluctance on the part of many investors to invest in emerging market hotels warrant IFC’s catalytic investment role, especially when complemented by, among others, improvements in the environment, life and fire safety standards, and assistance with developing linkages to, often small and medium-sized, suppliers.

Lessons learned by IFC over the years

IFC’s lengthy experience in the sector has resulted in a number of lessons learnt. These lessons guide current investment analyses.

In project analysis and implementation, four aspects are particularly important to examine. First, the broader issues affecting tourism such as transportation access – including the condition of the airline industry and its impact on the hotel industry – potential infrastructure and human resource constraints, developments in competing destinations, and major source markets, must be considered. Second, attention must be paid to striking an appropriate fit between the hotel product, the market, and the operator. Third, it is important to consider the advantages that affiliation with an international hotel chain can provide in certain markets, although this does not guarantee success. Fourth, resorts built from the ground up have developmental impacts, requiring well-articulated development plans including infrastructure, government support, regulatory support, and interest from the travel trade. Finally, identifying and addressing environmental and social issues early in the project cycle is particularly useful.

Regarding investment structure, financial structures should be conservative, in the range of 50/50 debt to equity for most projects. Equity investments in hotels can be difficult and may require a longer time frame than other investments. Equity exits/sales should be timed to avoid market downturns. To minimise this risk, an alternative may be loans with subordination features or kickers with equity conversion rights. Although hotel operator equity should be encouraged, operator guarantees, key money, performance clauses, lower fixed-rate fees, an incentive fee structure with waived, subordinated or deferred fees, or other mechanisms are sometimes more effective in encouraging operator efficiency and commitment.
Concerning environmental and social issues, several aspects need to be analysed. First, because the site chosen for a hotel can have a major environmental impact, early engagement helps ensure that appropriate issues are addressed while changes and adjustments are still possible. Second, savings opportunities in energy and water usage are often available, and investments can be both cost-effective and environmentally beneficial. To help its clients navigate through these issues, IFC recently hired a green buildings specialist as part of its tourism team. Third, IFC takes sponsor compliance with its Life and Fire Safety Guidelines seriously. Often, independent audits of the design, specification, construction and operation of a facility’s life and fire safety features are required. Finally, if a regional tourism development plan does not exist, the project may require regional actors to coordinate and to build a regional approach.

IFC considers other risk factors such as cost overruns due to inaccurate cost estimates, inexperienced development teams, implementation delays, changes in project scope, and cost increases in labour, import taxes, and construction materials. It pays particular attention to implementation delays that cause repayment difficulties and often loan rescheduling. Typical reasons include poor project management, unrealistic timetables, difficulty obtaining construction materials and import licenses, as well as project scope changes.

References / WTTC, 2010. Travel and Tourism Economic Impact, report.

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