

Ireka jumps on leaseback bandwagon

The Ruma is the latest high-end luxury living space to board the serviced-residence and hotel-lifestyle gravy train



The Ruma, according to Lai, will showcase contemporary Malaysian design with timber, pewter and Kelantanese copper taking centre stage

→ SINCE cash pays nothing, stocks are volatile and returns from long-term bonds barely keep up with inflation, the hype from real estate is yet to wane. So despite reservations about leaseback investments in real estate, its potential still dazzles, more so when the underlying asset is a high-end luxury hotel in the heart of a thriving city.



by V Sanjugtha

The Ruma by Ireka Corp Bhd is the latest high-end luxury living space to jump on the serviced-residence and hotel-lifestyle bandwagon. The 40-storey development along Jalan Kia Peng, Kuala Lumpur, with a gross development value of RM635 mil, has two components; 13 floors of hotel suites and 19 floors of serviced residences. It is scheduled for completion in 2017.

The hotel portion is being marketed as a real estate asset class with a 10-year leaseback contract promising 6% yields for the first five years, while the subsequent five years will see returns tied to the Net Room Distributable Income (NRDI).

Positioned as a high-end investment instrument, the leaseback programme has good prospects for capital appreciation, as Year Six onwards are tied to the hotel's strong prospects from increased occupancy rates. The idea is to provide the flexibility for buyers to sell easily, based on the relevant terms and conditions, should they wish to move their investments elsewhere.

At the end of the 10-year period, buyers will come together to determine a desired course of action. Options include an en bloc sale, sale to a real estate investment trust (REIT) or a sale to another investment fund or interested buyer. Buyers can also opt to continue running the hotel, especially if it is raking in attractive sums. Buyers are also entitled to seven days of free stay at the hotel, with additional stays at a discounted "owner's rate".

Leaseback sales in hotels have become increasingly popular, especially in the US following the subprime mortgage meltdown which saw a tightening of credit and traditional financing sources. Many large hotel companies and hotel chains have begun seeking alternative capital sources, primarily via leaseback sales. Finance heads of the world's top hotels find this a good method of financing as it frees cash for operating expenses

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Lai believes the lure of the hotel has helped spur the sales of the serviced residences, which share the tower but have a separate lobby and will be serviced by the hotel

rather than tying it up in fixed assets.

Ireka executive director Lai Voon Hon tells **FocusM** leaseback is a popular method of financing in resorts on Bali and Phuket. In Malaysia, he believes reservations towards this type of investment are due to bad publicity from failed leaseback programmes and a lack of understanding of programme fundamentals.

"Investors are more cautious and need some convincing; they need more explanation before they buy in," he says.

According to Lai, occupancy levels are projected at 51% in the first year, hitting 72% in the fifth year of operation. Average room rates (ARR) are projected at RM510 in the first year, with a gradual increase to RM585 and RM603 in the fourth and fifth years.

"This is a good proposition as Malaysian hotel room rates are going up. We recognise the initial three years consist of a stabilising period, so we guarantee buyers the first five years. It is not only an assurance of a 6% yield on their investment but is also an assurance they do not have to pump in money or lose money during this period," he says.

He explains returns for the subsequent five years will be based on a share of the NRDI, forecast to deliver a net yield of 6.2% in Year Six on the back of 73% occupancy rates at an average room rate of RM633. Lai says Year 10 estimates an 8% net yield from 75% occupancy at an ARR of RM770.

In the hotel industry, costs to operate a room total about 15%, which

translates to profit margins of about 85% with overheads being housekeeping. After the apportionment of utilities costs, profits may hover at around 70%, turning in handsome yields for investors.

Based on Ireka's hotel industry experience, Lai says, after two or three years, the project will be cash flow-positive, therefore returns thereafter will be higher than the 6% yield. In the case of its year-old Aloft Hotel at KL Sentral, Lai says it has surpassed all expectations and is now operating as a mature asset, way ahead of its cycle.

"If the distributable income at [the] time of sale is 7-8%, the investor can expect a huge capital appreciation on the property, as capital is a function of yield," he explains.

Ireka's involvement in the hotel industry includes with The Westin Hotel KL, Aloft Hotel and the Four Points by Sheraton Sandakan at the Sandakan Harbour Mall. It garnered a name in the industry in 2009, following the RM455 mil sale of The Westin to Newwood Assets Ltd, an international property investment company, which worked out to about RM1 mil per room. Hotels tend to make very good capital gains.

According to Lai, hotels generally lose money due to F&B operations as restaurants must hold perishable stock and maintain sufficient human resources regardless of occupancy. This is in contrast to room operations, in which housekeeping overheads are variables tied to occupancy rates. Lai says this has prompted many hotels in the UK and US to outsource the F&B function to chain restaurateurs who pay rent to the hotel.

An analyst from a local stock-broking house describes The Ruma's leaseback programme as "an interesting proposition". He says a similar leaseback concept was recently applied by Somerset Puteri Harbour and was well-received.

However, he was quick to point out the proposed rates place The Ruma in the league of the Mandarin Oriental and Hyatt Regency, requiring The Ruma to live up to similar standards.

"I am not very excited about the hotel industry as the rates have not risen to pre-economic crisis levels. There is also the issue of an oversupply of hotel space in the KLCC area" with most not seeing good occupancy rates, he observes.

He nevertheless calls the arrangement a fair investment as it will take about eight years before The Ruma is well into its sixth year of leaseback, offering time to garner a clientele and for rates to improve.

The lure of leaseback programmes

According to Lai, The Ruma is the first high-end property to hit the market on a leaseback basis. While there are other local resorts with a similar investment concept, none is of five-star rating. Generally, the Malaysian investing public has had a bitter experience with leaseback contracts. Also known as guaranteed rental returns (GRR), buy-to-let, cashback and own-for-free, market experts warn against these schemes as the terms and conditions of the agreement may not be in the buyers' favour and many believe it fuels property overpricing.

Defending The Ruma's leaseback scheme, Lai points out Ireka has a strong record in the industry and the returns of 6% for the first five years are "reasonable", unlike some other schemes that promise unrealistic returns of 8-12%.

"Sometimes the starting point is wrong. The developers are not confident of the sale of the apartments or condominiums so they put in yield-kickers to encourage people to invest. Why must you guarantee returns when the apartment is good?" Lai asks.

He discloses Ireka chose to promote the sale of the hotel via a leaseback programme as Aseana Properties Ltd (APL), which is a closed-end property fund at the mature stage of its lifecycle, requires shareholder permission for continuation next year.

"The initial years of all hotels are very important; we need to nurture them before we exit. It is too close to the timeline for APL and we do not want The Ruma to fall into a possible disposal too soon. We need two, maybe three years to ensure it is stable," he explains.

In 2006, listed luxury resort operator Karambunai Corp Bhd (KCB) marketed the Nexus Karambunai Residence Spa and Pool Villas as part of its five-star Nexus Resort in Kota Kinabalu, Sabah. It was reportedly marketed by the company under the Malaysia My Second Home programme.

The seaside villas were sold for about RM1.28 mil and investors foreign and local were promised a guaranteed rental income of around 7%. Investors claim payments stopped coming in 2011 and are suing KCB for arrears in leaseback payments of up to RM32 mil. They also claim KCB neglected to maintain their properties. **FocusM**



10-year forecast by The Ruma Hotel

| | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 | Year 6 | Year 7 | Year 8 | Year 9 | Year 10 |
|------------------------------|--------|--------|--------|--------|--------|--------|--------|--------|--------|---------|
| Occupancy level | 51% | 56% | 61% | 67% | 72% | 73% | 73% | 73% | 75% | 75% |
| Average daily room rate (RM) | 510 | 551 | 568 | 585 | 603 | 633 | 665 | 698 | 733 | 770 |
| NRDI (RM mil) | 8.961 | 11.638 | 13.530 | 15.936 | 18.764 | 20.534 | 21.683 | 22.900 | 25.099 | 26.502 |