Global Real Estate Center

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Hospitality Industry

Top 10 Thoughts for 2007

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1. Industry Fundamentals: Supply Playing Catch-Up As Stabilization Sets In

The lodging sector is anticipated to approach a stabilization phase in 2007, with accelerated supply growth and modest demand. Lodging Econometrics forecasts approximately 1,100 new projects in the U.S. in 2007 (116,000 rooms), representing a 2.5% supply increase compared to a 1.8% increase in 2006.[1] The nation's lodging markets, most of which are past their post- 9/11 recovery phase, are absorbing the additional supply. Nonetheless, the economic conditions in 2007 may lead to more moderate lodging demand.

Total U.S. RevPAR as of year-to-date November 2006 increased $63, a 7.7% increase versus the previous year.[2] The strength of the market and increasing RevPAR performance in 2006 was dominated by significant increases in ADR but marginal occupancy growth. Despite the anticipated slowdown of the overall economy, the lodging industry is expected to continue to achieve gains in 2007.[3] Buyers and owners are taking advantage of relatively moderate supply growth to upwardly reposition existing hotels. The industry's sensitivity to the healthy business environment, increasing business travel, and marginal supply growth in 2006 is anticipated to yield a solid position for RevPAR in 2007, albeit below the gains of 2006.

Although stabilization is approaching, buyers, sellers, and lenders continue to be active. The optimism of the peak-of-the-cycle behavior is supported by the industry's growth rate for both ADR and RevPAR in 2006, with a tapering off anticipated in 2007. Active business and leisure travel is anticipated to enhance RevPAR performance, along with the strengthening of the upscale to luxury segments, evidenced by the gains in the mid to high single digits as of year-to-date October 2006. As a result, the outlook for 2007 remains positive, with a healthy business economy that would support RevPAR growth into 2007, below that of 2006, but solid nonetheless.

2. Luxury Brands: Life in the Fast Lane

As the lodging industry's current positive cycle matures, most segments are enjoying the benefits of strong fundamentals, which lead to future increases in supply. One segment, however, stands out as the leader in both recent performance and supply growth. According to Smith Travel Research, the luxury hotel segment has led in occupancy growth, and is estimated to have achieved demand growth of approximately 2.0-2.5% and rate growth of approximately 9.0% in 2006.[4] The luxury segment, the smallest of all lodging segments, with approximately 80,000 rooms nationwide, is rapidly expanding and leads all segments in terms of net supply growth as a percentage of existing inventory.[5]

Fueling the supply growth is the continued expansion of a number of Asian and Middle Eastern luxury brands into Western markets in an effort to diversify their customer base, increase brand awareness, and tap into the lucrative U.S. market. Since Western luxury brands have a strong presence in major U.S. markets, developers, investors and lodging operators are considering expansion into secondary markets. In addition, given the opportunity to add luxury hotels in some gateway destinations, the industry is witnessing the merger of landmark luxury properties into international brands, to penetrate additional niche markets.

While improving segment fundamentals is undoubtedly the main driver, other factors are also worth noting. The appeal of owning luxury assets associated with exclusive brands continues to attract "ego" buyers; from consumers' perspectives, luxury hotels bode well with the trend towards the sale of lifestyle hotel experiences: creating unique guest experiences that are reflective of their way of life, self-image and interests. Further, given that it has been very difficult to build luxury projects today without a residential component, the trend in luxury hotel development has been partially fueled by a hot residential real estate market.

Overall, while some concerns are cited about the depth of the luxury travel market to sustain such fast paced supply growth, the segment appears to be poised for continued strong performance. With a customer base that is anticipated to continue expanding (for example retirement of baby boomers and the associated increase in their travel activities) and which is comprised primarily of affluent individuals who are not as price sensitive, the luxury segment appears to have open roads and clear skies ahead.

3. Hotel Development: Managing Increasing Construction Costs

With strong industry fundamentals, rising profits, and an active transaction environment, the lodging sector continues to attract the interest of traditional developers and those new to the industry. Nevertheless, while the potential for strong operating margins and high transaction prices are appealing, hotel developers are facing a trend of rising construction costs.

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Footnotes:

1. Lodging Econometrics. "LE Revises Supply Side Forecast Downward for '06 and '07 and Identifies Seven Trend Setting Markets to Monitor for '08 and Beyond." October 20, 2006.

2. Smith Travel Research Weekly Lodging Review. Dec. 10- 16, 2006.

3. The Global Hospitality Advisor. "Industry Outlook: Looking Back on 2006, Looking Forward to 2007." December 2006.

4. Smith Travel Research Lodging Review. Performance by Industry Segments. October 2006.

5. Lomanno, Mark. H&MM. "Fundamentals, Guest Makeup Keep Luxury Segment Strong." November 20, 2006

Total construction costs are estimated to have increased approximately 5.0% in 2006, while some specific construction materials, including steel and concrete, experienced double digit price increases.[6] Although new residential construction started to decline towards the end of 2006, alleviating pressure on some construction goods (e.g., lumber, gypsum), worldwide commercial construction continues to cause high demand for construction materials.[7] This, in addition to increasing fuel prices, has caused the price of some construction goods (e.g., concrete, metals) to reach record high prices.

One effect of increases in construction costs is the shrinking of margins on ground-up and even renovation projects. In an effort to improve returns and mitigate development risks, developers have become more creative in planing, developing, and financing new lodging developments. The expansion of stand-alone hotels into hotel-enhanced mixed-use developments by adding residential, retail, office and other forms of recreational components (e.g., golf, spa, marina) to the projects is not a new trend, but remains a popular way to increase density and to spread the development risk (and potential rewards). Especially in the upper-upscale and luxury lodging segments, mixed-use appears to be the preferred strategy for developers facing costs upwards of $500,000 per key and more in many circumstances. As such, a significant portion of the new supply has been announced as part of urban or resort mixed-use developments. The sale of condominium-hotel units further provides upfront cash receipts that partially reduce the need for and cost of debt.

As international demand for basic construction materials from countries such as China, Dubai, and India is anticipated to continue to be strong, construction material costs should continue to escalate in 2007. However, with the cooling of the U.S. housing market, domestic construction labor shortages should become less frequent, therefore diminishing increases in construction labor costs. Nonetheless, careful planning is critical for developers to maximize project density and diversity to improve their margins.

4. Operating Costs: Creative Control

While the U.S. lodging industry experienced double-digit profit growth in 2006, hotel operating costs increased at almost twice the rate of inflation for the same period, with the greatest increases occurring in areas that traditionally experienced little volatility.[8] Labor, energy, insurance, and real estate taxes all impeded the industry's ability to achieve higher profit margins. As a result, management's focus is on fine tuning expenses that can be controlled, understanding that there are new operating paradigms that will result in some operating expenses remaining at their current high levels.

Demographic changes, government regulations, new contracts, and higher benefit expenses have all affected labor costs, which account for over 40 percent of total operating expenses. Unfortunately, the benefits of automation enjoyed by other industries are difficult to attain in lodging, but creative steps are being taken with attempts at maintaining service quality and guest experience while simultaneously reducing expenses. Web-based check-in and lobby self-service kiosks are following the trend of the airline industry in efforts to streamline processes, reduce labor, and increase efficiency.

The double-digit increase in recent utilities costs represents the largest increase of any individual expense on a hotel's operating statement. Increasing energy costs have had an impact on profit margins.[9] As a result, the "green hotel" is becoming more of a strategic operational initiative. For example, the recent announcement of the "1" brand seeks to address guests' desire for a luxury, eco-friendly hotel brand while demonstrating that green principles and the U.S. Green Building Council's LEED certification can coexist. The economic benefits of green buildings, however, are still unclear. In addition, there is limited data suggesting that complying with LEED standards and going "green" enhances the operator's ability to increase rates or gain market share. However, rebates and tax incentives offered by some states in implementing these measures are making some of these initiatives more appealing for developers. And with issues such as global warming increasingly in the forefront of the news, the "feel good" factor associated with green hotels may become a competitive advantage in capturing guests.

Current profit growth and property reassessment based on new developments are driving property tax increases to levels higher than anticipated. Combined with escalating insurance costs, particularly in

Footnotes:

6. Construction News, The Associated General Contractors of America. "Construction Costs Cool In November But Outpace General Inflation For Year." December 19, 2006.

7. ENR, McGraw-Hill Construction. "Housing Slump Undercuts Lumber Prices" December 18, 2006.

8. Hotel Interactive. "U.S. Hotel Profits Up 13.1 Percent in 2006." November 28, 2006.

9. PKF Reports: Hospitality Net. "U.S. Hotels: Revenues and Profits Rise, But So Do Expenses." May 29, 2006.

coastal regions in the U.S., these represent a new reality in operating expenses. While other expense increases are able to be allocated, operators are encountering a "no value added" scenario to customers with insurance and real estate increases. It is unlikely that the industry will see a retraction in these costs; for this reason, operators will need to continue to be innovative in order to drive profit to the bottom line.

5. Globalization: Inbound and Outbound Investments Make Capital Global

During 2006, capital markets' interest in hospitality assets strengthened as lodging fundamentals continued to improve, and returns on the sector continued to outpace other real estate classes and portfolio alternatives on a risk-adjusted basis. As domestic lodging assets become increasingly pricier, U.S. investors are set to intensify global strategies in order to maximize deployment of soaring corporate profits, while select international players will continue to enter the country in search of stable properties and trophy assets in major markets.

As the most transparent market in the world, the United States provides a favorable investment environment for cross-border investors. Record petro dollars from Russia and the Middle East and investment from the Euro zone will continue, as oil prices are set to remain high and the dollar continues to depreciate relative to the Euro. Hotel-condominiums in Florida and Hawaii have also provided a vehicle for minor investors to enter the lodging arena, mostly from Western Europe and Japan, by owning single-room assets. On the other hand, investors from the Middle East are investing in significant luxury assets in an attempt to gain from the lucrative U.S. market. In contrast, and despite sustained growth in RevPAR, foreign appetite has decreased cap rates, thereby reducing investment returns, and encouraging U.S. investors to look elsewhere.

Recurring patterns in foreign investment, which started in 2006, will continue to focus on portfolio strategies in large developing economies with robust GDP growth, and on single-asset, mixed-use plays in baby-boomer, second-home destinations. China, India, and United Arab Emirates are likely to remain the preferred choices for outbound investment, driven by anticipated GDP growth of 9.5%, 8.0%, and 9.9% respectively in 2007 and significant RevPAR improvement. All the major lodging companies have aggressive expansion strategies in these locations through joint ventures with local partners. As investment banks become more comfortable with these geographies, new partnerships are expected to incorporate substantial foreign investment. Similar strategies, albeit at a smaller scale, could take place across cities that have recently joined the European Union, where transparency and law enforcement are more recognized. Branded products are ripe for growth, particularly in the select service category. Asia is also anticipated to see a growing number of foreign investments in the gaming-lodging industry, particularly in Macau, where gambling revenues are projected to exceed those of Las Vegas by 2010. Consumer appetite for gambling and increased disposable income is attracting major industry players to the region.

In the Americas, domestic opportunity funds are setting up portfolio opportunities in Mexico, Central America, and the Caribbean, taking advantage of a relatively stable political environment, strong lodging fundamentals, and demand for sun-and-beach and residential second homes from affluent baby boomers. Costa Rica and Panama are likely to continue to attract investment into Central America, whereas Turks and Caicos and the Bahamas are also likely to remain sought-after investment markets in the Caribbean, with products across the region heavily relying on residential uses to achieve target returns. South America, particularly the growing economies of Brazil, Argentina, and Chile, could also see increased activity, albeit with hotel-only strategies.

6. Western Hemisphere Travel Initiative: Long-Term Benefits for Short-Term Costs

In January 2007, new passport requirements for U.S. citizens traveling within the Western Hemisphere went into effect, requiring that all U.S. citizens have a passport to re-enter the U.S. when traveling by air. The policy is a continuation of stricter national security measures that also introduced requirements in 2005 for foreign nationals visiting the U.S. The concerns surrounding the new policy focus on timing and cost issues associated with obtaining passports, implications which may have a positive effect on the U.S. as it experiences a short-term shift in travel from the Caribbean and Mexico to domestic locations.

Government statistics have indicated that although a minority of U.S. citizens have passports, approximately 60% of travelers utilize passports to travel internationally.[10] As U.S. citizens fail to obtain passports in a timely manner, since the application process may slow during the first half of 2007 due to an influx of applications, there may be a decrease in travel to the Caribbean and Mexico. This decrease, anticipated to affect mostly leisure travel, may temporarily enhance visitation to domestic destinations, especially coastal, resort-oriented locations, with a short-term increase in demand.

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Footnotes:

10. Associated Press. "DHS to Require Passports From All Travelers Entering United States." November 22, 2006.

Still, the reduction in travel to the Caribbean and Mexico is of concern. For this reason, several lodging operators, in addition to travel agents and airlines, have been providing warnings and notices to those booking trips in 2007. Although this benefits advanced bookings, short-term, spontaneous travel plans by those without passports would decrease. To address fears that some U.S. citizens may balk at the price for a passport, $97, some hotels are offering rebates to first-time passport holders. A survey conducted by the World Travel and Tourism Council, commissioned by the Caribbean Hotel Association concludes that visitor exports in the Caribbean will be impacted by nearly $2.6 billion, and estimates a potential loss of approximately 188,330 jobs.[11]

In the end, it may be difficult to accurately measure the economic impact the passport regulations have on travel, but it is anticipated that domestic demand may increase in 2007. The real positives of the passport regulation are the long-term efficiencies created by a one document system which eases confusion over which documents are acceptable at which destination. Additionally, the standardization should ease congestion at airline ticket counters and customs, and provide for amplified security by making it more difficult to enter the U.S. using falsified documents.

7. The Transaction Environment: Can the Asset Fill the Price's Shoes?

During the last 24 months, the lodging industry has experienced a wave of transactions that has demonstrated a somewhat unusual and interesting trend: hotel companies (and their assets) going from public to private ownership. Fueled by strong industry fundamentals and increasingly available streams of capital, the hotel transaction environment has been quite active. Many of these transactions involved the acquisition of public companies (at substantial premiums vs. their stock price) by private equity firms, whose funding sources include high net worth individuals and institutional investors. These investors are betting on a "turn-around-and-sell" strategy that is characteristic of leveraged-buyout transactions, where holding periods are less than five years.

One notable recent trend is an increase in the number of "million-dollar-per-room" transactions, driven by a combination of strong industry fundamentals – i.e. trophy assets in premier locations – and an influx of foreign capital. While some may argue that these transactions might be overvalued, the question lies, in part, on the compression in capitalization rates and borrowing rates for lodging assets into the near future. While "going in" rates were anticipated a year ago to be on the rise by year-end 2006, they have remained stable. Although interest rates in general have increased over the last 12 months, the lending community continues to be eager to finance lodging transactions, and is willing to compress loan spreads so that borrowing rates remain competitive. In addition to reasonably priced debt, plenty of equity capital continues to chase what are considered to be "prime" deals, with many investors willing to reduce their required equity returns.

Overall, the lodging industry has experienced increasing performance fundamentals over the past few years due to increases in both leisure-based and corporate travel. Combined with limited supply additions, as construction costs escalate, and the tempting returns for investors in hotel conversions and renovations, the industry observed a surge in transaction activity. Yet, as industry fundamentals stabilize and new supply is added, it may be difficult for lodging properties to maintain the operating growth levels experienced in the past two years.

In the mid-term, the industry is likely to start observing the divestiture of many of the current large private-equity hotel portfolios, as the private equity firms begin execution on their exit strategies. A normalization of RevPAR growth may lead to a reversal in the transaction environment, potentially leading to higher capitalization rates and lower asset valuations. Under those circumstances, increases in operating performance, rather than favorable valuation metrics, become the true driver of investor returns.

8. Private Equity: Strong Activity from Non-Traditional Hotel Investors

While the strong performance of the lodging industry seems to be catching the attention of experienced investors and those new to the sector, the prevalence of private equity firms, especially on the buy-side, is evident. Motivated by the anticipation of strong returns, driven not only by robust operating fundamentals but also by the anticipated appreciation of the assets, and by the availability of capital (both on the debt and equity side), private equity firms have found themselves in the industry spotlight, frequently in the center of multi-billion-dollar transactions involving large hotel portfolios.

With such an influx of private equity players into the industry, it will be interesting to see how these new funds execute their strategies.

Footnotes:

11. Tourism Economics. "Shifts in US Outbound Travel – A New Paradigm." July 2006.

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While the most common approach remains the search for assets that have allowed for turn-around opportunities through renovation and repositioning, larger funds are more broadly exploring opportunities beyond the asset level to also include the acquisition of management companies and their associated portfolios. Several high profile transactions demonstrated investors' appetite to go beyond traditional asset acquisitions to further extract value through other components of the industry's value chain: management, branding and franchising.

As the current industry cycle matures, private equity is anticipated to continue to play a key role in the industry's transaction market, not only on the buy-side but also on the sell-side. With the tremendous liquidity of the current market chasing yield, private equity firms are enjoying the benefit of peaking valuations which affords them great opportunity to monetize assets at attractive IRRs ahead of their intended timelines. At the same time, their ability to raise capital has never been better. The greatest difficulty is finding the new investments in this frothy market that will ultimately pencil out to their underwriting targets. Competition is intense to say the least. Will all private equity funds be able to take a "perfect ride" through the industry cycle? Only time will tell.

9. Condominium-Hotels: Growing Pains

Last year's U.S. Lodging Report noted the popularity of this sector and discussed how condominium hotels' "complex nature equals risky business." 2006 has seen a pullback in this sector in the face of a cooling real estate market, as issues and risks have become better understood, and operators become more cautious.

Condominium-hotels have been a popular financing option for developers over the past years as developers sold into a hot real estate market. This approach may reduce the exit strategy alternatives of developers who are left owning a hotel's public space after the units are sold, which has, at present, a limited secondary market. This, combined with a cooling real estate market, complexity over shared facilities budgets, risks associated with the sales process, and other issues, have cooled their heels.

In the second half of 2006, several major branded management companies took a step back from condominium-hotels. The often unanticipated complexity of everyday hotel operating issues in this environment, like complimentary room and frequent guest programs, combined with inventory control, budgeting issues and uncertainty over ability to maintain operating standards, led to a re-evaluation of their involvement within the segment. In many cases, these operating complexities were not appropriately addressed when documents were drafted. Invariably, multiple headaches will arise while trying to manage expectations of dozens to hundreds of owners – all with different agendas, motivations and levels of understanding relative to hotel ownership.

With estimates of over 8,000 condominium-hotel units anticipated to become operational in 2007,[12] owners who purchased with the anticipation for a quick "flip" in a hot real estate market may find themselves holding onto assets longer than intended, while lifestyle buyers begin to settle into their first year of hotel ownership. A "honeymoon" period may occur in 2007, and it remains to be seen how owners will react to the realities of the hotel business (e.g., ramp-up to stabilization, seasonality, ADR versus rack rates) and the costs of ownership. A primary issue of concern that will become more relevant as projects open is that condominium budgets are assembled long before the asset opens, often prior to the involvement of the lodging operator. Changing these budgets materially without conferring rescission rights to buyers, which varies by state, will bring enormous challenges. This, and how the documents treat operating shortfalls in this environment will become prevalent issues. The biggest concern remains the sales and marketing process – and whether there were misrepresentations made to buyers and whether this might transition to rescission claims on behalf of buyers and/or securities fraud.

We are headed into the growing pains portion of the latest iteration of condominium-hotels. Opening properties will begin to produce results and provide a sense of the real economics of this operating model while developers and operators will learn what works and what does not and put together more refined programs to take to market. Ultimately, there will continue to be a pipeline for condominium-hotels, albeit at a more moderate pace and structured more thoroughly to better address some of the complex issues and problems that are arising.

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Footnotes:

12. Hotel-Online. "New Hotel Projects with Condo, Private Residence and Timeshare Components Set to Decline as Developers, Lenders and Consumers Turn Cautions." April 14, 2006.

10. Global Lodging Market Resiliency: Standing Firm Through Waves of Disasters

Over the last few years, a trend toward rapid recovery has occurred in markets with heavy emphasis on tourism, in light of various natural disasters and human conflicts. Even though the lodging industry has faced numerous challenges, particularly in markets affected by hurricanes along the U.S. Gulf Coast, the tsunami in South Asia, and terrorist attacks in the Middle East, there are continued plans for long and steady development. In the wake of any such disaster, the lodging industry is usually one of the first impacted, yet it is also a key player in a region's overall economic redevelopment. The road to recovery is usually a struggle that encompasses not only the rebuilding of infrastructure, but also revitalization of communities and regaining confidence amongst travelers. Despite such obstacles, the industry as a whole has proved quite resilient, with affected markets making significant progress over a short period of time.

Within the U.S., the Mississippi Gulf Coast welcomed approximately 5 million visitors in 2006. However, authorities are projecting 30 million visitors annually by 2010, 11 million more than before Hurricane Katrina.[13] As of September 2006, room inventory was at 55% of pre-Hurricane Katrina levels, up approximately 23% since March 2006, while monthly gaming revenues have surpassed 2005 levels for the first-time since August 2005. Another nine casinos are proposed to open by 2010, with more than $4 billion invested in 2006 alone.[14]

Despite terrorist attacks aimed at the Sinai Peninsula region in Egypt in recent years, tourism has continued to improve with an increasing number of visitors, easing the fear that the heavily tourism-driven economy would be negatively impacted. Visitors to Egypt increased for the month of October 2006 to 855,000, 20% greater than the same period in the previous year.[15] According to the World Travel and Tourism Council, Southeast Asia travel and tourism has generated approximately $236 billion in economic activity in 2006.[16] Most of Thailand's tsunami-affected resorts had plans to open within two weeks of the disaster. This aggressive commitment and subsequent real estate development, particularly by large local and international chains, have helped the region rebound. The Kasikorn Research Centers predict that the number of tourists to Thailand in 2006 will rise to 4.7 million, an 87% increase from the previous year.[17] The study further states that international travel would have accounted for approximately 3.3 million visitors, only 6% below pre-tsunami levels.

Even though some regions severely impacted by disasters may have to diversify their economic base to maintain stability, the industry has shown its resiliency with its speed of recovery in a post- 9/11 world. This rapid response will continue to be fueled by the locals' eagerness to rebuild and by international travelers who seek adventure through foreign cultures, both groups increasingly accustomed to natural and man-made disasters while longing for a state of normalcy.

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- Assurance
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- Risk Advisory Services
- Finance and Performance Management

Please contact any of the individuals on the back of this report for more information.

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Footnotes:

13. Mississippi Gulf Coast. "Moving Forward." June 8, 2006

14. ibid

15. Reuters. "Egypt October Visitor Numbers Up 20 pct y/y." December 19, 2006

16. Reuters. "Asian Economies Feel the Growing Beat of Tourism." November 12, 2006

17. Kasikorn Research Info - Thai News Service. "Thailand: Tourism in Phuket Faces Bright Prospects." December 13, 2006

U.S. HOSPITALITY CONTACTS

Michael Fishbin
National Director
Hospitality & Leisure
+1.212.773.4906
michael.fishbin@ey.com

Dan Lasik
Mid-Atlantic Area Industry Leader
+1.703.747.1287
dan.lasik@ey.com

Michael Straneva
Transaction Advisory Services
Real Estate Leader
+1.602.322.3610
Phoenix
michael.straneva@ey.com

Troy Jones
Pacific Northwest/Southwest Area Leader
+1.213.977.3338
Los Angeles
troy.jones@ey.com

Mark Lunt
Southeast Area Leader
+1.305.415.1673
mark.lunt@ey.com

Brian Tress
Northeast/Mid-Atlantic Area Leader
+1.212.773.8359
New York
brian.tress@ey.com

GLOBAL HOSPITALITY CONTACTS

Asia
Ryo Kuwasaki
+813.3595.8414
ryo.kuwasaki@jp.ey.com

Australia/Asia-Pacific
Stephen Chubb
+61.2.9248.4799
stephen.chubb@au.ey.com

Europe
Christiane Fiack
+49.6196.996.26347
christiane.fiack@de.ey.com

India
Mona Chhabra
+91.11.4159.4169
mona.chhabra@in.ey.com

Caribbean
Mark Lunt
+1.305.415.1673
mark.lunt@ey.com

Latin America
Rogerio Basso
+1.305.415.1321
rogerio.basso@ey.com

Middle East
Mohammed Dahmash
+971.4.332.9276
mohammed.dahmash@ae.ey.com

Russia
Gerald Gaige
+7.495.755.9681
gerald.gaige@ru.ey.com

GLOBAL REAL ESTATE CONTACTS

Global and Americas Director of Real Estate
Dale Anne Reiss
+1.212.773.4500
dale.reiss@ey.com

Global Director of Real Estate Assurance & Advisory Business Services
Ad Buisman
+31.55.5291.428
ad.buisman@nl.ey.com

Global Director of Real Estate Tax
Michael Frankel
+1.214.969.0632
michael.frankel@ey.com

Global Director of Real Estate Transactions AdvisoryServices
Hartmut Fruend
+49.6196.9962.6351
hartmut.fruend@de.ey.com

Global Director of Real Estate Risk Advisory Services
Malcolm Bairstow
+44.20.7951.3685
mbairstow1@uk.ey.com

Northern Europe & Africa
Dean Hodcroft
+44.20.7951.4870
dhodcroft@uk.ey.com

Continental Western Europe
Michael Hornsby
+352.42.124.8310
michael.hornsby@lu.ey.com

Central Europe
Hartmut Fruend
+49.6196.99.62.6351
hartmut.fruend@de.ey.com

India
Ganesh Raj
+91.11.4154.0000
ganesh.raj@in.ey.com

Middle East
Mohammed Dahmash
+971.043.129.276
mohammed.dahmash@ae.ey.com

Far East
Soo Hock Teoh
+60.37495.8717
soo-hock.teoh@my.ey.com

Japan
Tom Brown
+81.3.3503.2093
brown-thms@shinnihon.or.jp

Oceania
Stephen Chubb
+61.2.9248.4799
stephen.chubb@au.ey.com

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