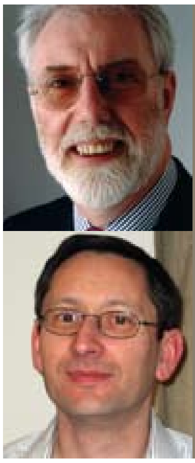
Hotel chain portfolios in Europe 2007: sluggish growth and declining capital availability



Paul Slattery and Ian Gamse from Otus & Co look at the collapse in the supply growth of European hotel chains

Introduction

As we take stock of the European chain hotel market at the end of what turned out to be a turbulent year, it's easy to forget the prevailing sentiments of 12 months ago. We would have expected then to be writing now of another year of strong growth, with seemingly ever-increasing amounts of cash being pumped into the European hotel market resulting in a continued expansion of supply.

And we would have expected the main beneficiaries of that expansion to be the existing chains – the global majors, the strong regional players and even the national brands.

Yet the picture that emerges from our preliminary comparison of the state of supply on 31st December 2006 and that at the end of 2007 is very different. In this article, we will focus on the companies and chains that were on the radar in 2006; our next piece will look at the new chains that have emerged during the year.

The overall market

At end-2006, the Otus Hotel Brand Database ("OHBD") listed about 12,500 hotels in the 52 countries of Europe, with roughly 1.5m rooms. At end-2007, the brands that made up those rooms had managed a net gain of only 60 hotels – less than 0.5%, though the hotels being added tended to be larger than the average so the room stock increased by about 21,000 or 1.4%.

Of course, these simple statistics do not tell the whole story and we must dig a little deeper to get a clearer picture of what has been happening.

Market level

Our regular readers will know that we apply a consistent classification system to all hotels so that we can make valid cross-national comparisons. The first leg of our hotel taxonomy is market level, an assessment of the level of investment that has gone in to each room of a hotel. We judge this by a number of means – room size, type and quality of fittings and so on – and also use a number of global brands as benchmarks for each of our five market level categories against which we can judge less familiar brands.

At end-2006, the market-level breakdown of the European chain hotels looked like this:

End-2006	Hotels	Rooms	Average size	Percentage
Deluxe	226	33,171	147	2%
Up-market	2,289	424,430	185	27%
Mid-market	4,971	696,787	140	45%
Economy	3,731	308,508	83	20%
Budget	1,337	92,005	69	6%
Total	**12,554**	**1,554,901**	**124**	

12 months later, the picture was:	Hotels	Rooms	Average size	Percentage
Deluxe	241	35,064	145	2%
Up-market	2,299	427,588	186	27%
Mid-market	5,007	704,968	141	45%
Economy	3,767	318,599	85	20%
Budget	1,300	89,692	69	6%
Total	**12,614**	**1,575,911**	**125**	

And the change between the two years:	Hotels	Rooms	Average size	Percentage
Deluxe	15	1,893	126	6%
Up-market	10	3,158	316	1%
Mid-market	36	8,181	227	1%
Economy	36	10,091	280	3%
Budget	-37	-2,313	63	-3%
Total	**60**	**21,010**	**350**	**1%**

(The percentage column shows the growth achieved by each segment.)

Net numeric growth, such as it was, was concentrated in the economy and mid-market segments, while the budget segment actually shrank. Meanwhile, it was the deluxe segment, small as it is in terms of the overall market, which grew most strongly in percentage terms while the upmarket and mid-market stagnated.

Hotel configuration

The second key element to our hotel classification system is hotel configuration, a measure of the non-rooms features of the hotel and their importance in demand and revenue generation. Again, we start by looking at the end-2006 picture:

2006 Hotel supply	Hotels	Rooms	Average size	Percentage
Resort	788	180,992	230	12%
Full feature	3,148	561,200	178	36%
Basic feature	3,930	476,235	121	31%
Ltd feature	2,242	179,433	80	12%
Room only	2,446	157,041	64	10%
Total	**12,554**	**1,554,901**	**124**	

Then at end-2007:

2007 Hotel supply	Hotels	Rooms	Average size	Percentage
Resort	821	186,297	227	12%
Full feature	3,147	560,798	178	36%
Basic feature	3,931	484,649	123	31%
Ltd feature	2,203	182,540	83	12%
Room only	2,512	161,627	64	10%
Total	**12,614**	**1,575,911**	**125**	

Strikingly, the percentage segmentation of the market has not changed significantly. It is only when we look at the changes in detail that any patterns emerge:

Change 06-07	Hotels	Rooms	Average size	Percentage
Resort	33	5,305	161	3%
Full feature	-1	-402		0%
Basic feature	1	8,414		2%
Ltd feature	-39	3,107	80	2%
Room only	66	4,586	69	3%
Total	**60**	**21,010**	**350**	**1%**

Strongest growth, in percentage terms, was at the two extremes of the scale: room-only hotels and "resorts", hotels which have the full complement of non-rooms business and leisure facilities. In between, the full feature segment scarcely moved while the basic- and limited-feature segments lost small hotels while gaining larger ones, resulting in a net decrease in the number of limited-feature hotels but an increase in room stock.

This begs the question of what the net change figures presented so far mean in terms of actual gains and losses; we will return to that question towards the end of this note.

Location

The "European" market is of course no such thing: it is a collection of more than 50 national markets each of which relates to each of the others in different ways, if at all. So we should look at the countries that constitute the European market and see how they fared.

First, the largest country markets:

Countries (ranked by size)	Rooms 2006	Rooms 2007	Change	% change
Spain	328,687	327,175	-1,512	0%
UK	261,931	267,790	5,859	2%
France	255,556	257,006	1,450	1%
Germany	183,148	186,055	2,907	2%
Italy	69,993	72,182	2,189	3%

Growth in these markets was roughly in line with Europe as a whole, though the Spanish market shrank and France under-performed. The United Kingdom performed strongly and, indeed, produced the largest numeric growth of all:

Countries (ranked by absolute growth)	Rooms 2006	Rooms 2007	Change	% change
UK	261,931	267,790	5,859	2%
Germany	183,148	186,055	2,907	2%
Russia	12,280	14,991	2,711	22%
Italy	69,993	72,182	2,189	3%
Croatia	9,734	11,310	1,576	16%

But the tigers, in percentage terms, were, as one might expect, to the east:

Countries (ranked by percentage growth)	Rooms 2006	Rooms 2007	Change	% change
Azerbaijan	629	918	289	46%
Ukraine	625	859	234	37%
Khazakstan	1,346	1,755	409	30%
Russia	12,280	14,991	2,711	22%
Monaco	1,157	1,375	218	19%
Croatia	9,734	11,310	1,576	16%
Romania	4,603	5,272	669	15%
Serbia & Montenegro	1,109	1,249	140	13%

Outside Russia and Croatia, of course, this seeming strength is spurious: a tiny market bolstered by the opening of one or two hotels. And the total number of chain rooms in Russia remains tiny compared to the size of the country and population. (It remains the case that the global brands are confined almost entirely to Moscow and St. Petersburg, cities which have to be considered quite separately from the rest of the country.)

And where were the losers?

Countries	Rooms 2006	Rooms 2007	Change	% change
Spain	328,687	327,175	-1,512	0%
Greece	40,268	39,069	-1,199	-3%
Malta	4,406	3,336	-1,070	-24%
Bulgaria	9,953	9,132	-821	-8%
Hungary	19,256	18,625	-631	-3%

Numerically, the biggest losses were in the classic package tour destinations. Indeed, if we split Spain into the Costas and the interior, the pattern is even clearer:

Countries	Rooms 2006	Rooms 2007	Change	% change
Spain interior	110,373	114,025	3,652	3%
Spain Costas	218,314	213,150	-5,164	-2%

While the beach hotel supply shrank, Spain's internal dynamic produced growth ahead of the market.

Cities

Among the European hotel market's important cities, the strongest absolute growth was in London:

Cities	Rooms 2006	Rooms 2007	Change	% change
London	67,070	69,010	1,940	3%
Madrid	21,953	23,642	1,689	8%
Istanbul	6,114	7,529	1,415	23%
Moscow	5,157	6,066	909	18%
Vienna	13,057	13,913	856	7%

While in percentage terms Istanbul topped the list:

Cities	Rooms 2006	Rooms 2007	Change	% change
Istanbul	6,114	7,529	1,415	23%
Moscow	5,157	6,066	909	18%
Valencia	5,859	6,711	852	15%
Dusseldorf	7,336	7,992	656	9%
Madrid	21,953	23,642	1,689	8%
Manchester	8,385	9,017	632	8%
Vienna	13,057	13,913	856	7%

Madrid, Moscow and Vienna performed strongly in any terms, while Manchester continues to develop.

In examining general trends in the market, it's more useful to look not at individual cities but at the types of locations where hotel supply is growing. We classify hotel locations first in terms of population: a "city" has a population of more than 100,000, a "village" less than 10,000, while a "town" is anything in between. Within cities we then classify locations as "urban", "suburban" or "airport". The year's changes on this basis look like this:

Conurbation types	Rooms 2006	Rooms 2007	Change	% change
Urban	528,116	543,527	15,411	3%
Suburban	195,294	200,276	4,982	3%
Airport	49,180	52,426	3,246	7%
Town	387,856	389,794	1,938	0%
Village	394,455	389,726	-4,729	-1%

What is absolutely clear from this is that across Europe the chain hotel market is growing in centres of population and shrinking elsewhere.

Ins and Outs

Finally, let's consider how that net growth of 60 hotels is made up. For the first time this year we are presenting data on movement in and out of the affiliated market and between brands:

Changes 2006-7			*
	Hotels	Rooms	Average size
Brand changes	518	65,790	127
New hotels	344	45,185	131
Newly-affiliated	276	24,598	89
Closed	146	15,524	106
Lost flags	413	32,972	80

This table gives a very different picture of the dynamics of the market. Although the net effect of last year's activity was small, there was plenty of movement, with 620 hotels and more than 70,000 rooms joining the affiliated market - and more than 550 dropping out. In addition, more than 500 hotels moved between brands (though some of those were internal re-arrangements). Observing this activity over the year we might have got the impression of healthy growth; but the worrying fact remains that the companies and chains that we have been tracking since the beginning of the year added just 60 hotels and 21,000 rooms. Meanwhile, more than 500 hotels left the chain market. The good news is that the new hotels – and even the newly-affiliated hotels – are larger than the ones that they are replacing.

Unanswered questions

What initially looked like an unspectacular year for the European chain hotel market turns out on closer inspection to be a very interesting one. While the top-level numbers show little change, there has been plenty of activity and some of the trends are clear: traditional tourist destinations are losing out while the city market grows and older, smaller stock is being replaced by newer and larger hotels.

We leave for another article some unanswered questions, particularly about the way in which the different brands – global, regional and local – are performing and about the continued emergence of new brands.

Conclusions

In the analysis of the hotel business, demand, like profit, is a matter of opinion. However, supply, like cash, is a matter of fact.

Nowhere is this more evident than in the contrasting bullish data published on RevPAR growth throughout Europe in 2007 and the actual collapse in the rate of hotel chain supply growth from an average of 7% per year between 2000 and 2006 to less than 2% in 2007.

The RevPAR growth for the chains was achieved more by the reduction in the rate of growth in supply than it was by real growth in demand. This is not a common phenomenon. Typically, demand has slowed before exuberant developments have been stopped.

There are four general observations to be made about the collapse in hotel chain supply growth in 2007. First, the credit crunch cannot be blamed. It only emerged in the second half of the year and it was not until Q4 that it materially slowed transactions that in any case would not have started trading until 2008. The slowdown in portfolio growth occurred throughout the year.

Secondly, the balance sheet re-structuring of the past seven years was expected to make the major chains more able to grow their portfolios at a faster rate by signing more franchises and management contracts. This has not happened.

Thirdly, over the past three years, particularly in the major chains, there has been a significant growth in the number of developers hired to accelerate portfolio growth. Thus far, they have failed to achieve their goals and the economic and capital markets outlook do not provide encouraging prospects for portfolio growth in 2008.

Fourthly, the flurry of activity by larger asset buyers over the past five years now looks to have been a damp squib. In the main, they acquired existing hotels managed by or franchised to the major chains. They have not been interested in building new hotels. Large capital was also not available to fund consolidation among hotel chains in Europe.

In 2007, the largest acquisition, the NH acquisition of Jolly Hotels, valued the target at €669m, of which NH already owned 21%. As we look forward to 2008 from a more uncertain economic and capital market background than we did a year ago, all that we are currently prepared to predict is that the year will be an interesting one for more reasons than many in the business might expect.

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* All tables source Otus & Co. Advisory Ltd.

