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Keywords:

branded, budget, Europe, hotel

Comment: The future of the European branded budget hotel sector

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Received: 16th October, 2000

Abstract

The branded budget hotel sector has taken the industry by storm over the last few years with its consistent and substantial growth in France, the UK and the USA. By responding directly to the needs of today's business and leisure traveller on a limited budget, this sector is able to operate on low overheads with high levels of return, indicating positive news for investors and hotel owners alike. This paper provides an overview of this sector's growth throughout Europe.

INTRODUCTION

Branded budget hotels have rapidly become the fastest-growing market within the hotel sector across Europe. A common view is that this phenomenon is only specific to France and the UK, but current market research indicates that over the next five to ten years there will be dramatic growth in branded budget hotels in many if not all the key countries across Europe.

Today, the majority of Europe is undersupplied with quality branded budget hotels and oversupplied with inconsistent, poor-quality, unbranded budget accommodation. New construction methods have enabled branded budget hotels to be built quickly, efficiently and cost effectively, making potential returns for hotel owners highly attractive.

This sector of the hotel market is currently, at least in the author's view, the most exciting to be in. The demand for this kind of produce is huge. Just as we have seen the explosive and continued growth of the branded fast-food market, the budget hotel sector is following in a similar vein.

SIX FACTORS DRIVING THE GROWTH OF BRANDED BUDGET HOTELS

There are currently two mature markets regarding branded budget hotels, namely the USA and France. If we examine these markets more closely we can identify factors which were instrumental in the acceleration of this sector. These factors can be used as a barometer to predict the potential opportunities that lie within other countries across Europe.

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**Value and quality
within a budget**

Economic changes

During recent periods of rapid economic growth, especially in the USA, various changes have occurred which have led to economies being less dependent on moves from large industrial and agricultural production and more service-led. This economic change has resulted in the creation of a high volume of small, independent companies in the domestic market, which has in turn resulted in a sharp rise in the number of people travelling within their home countries looking for value-for-money, good-quality accommodation that meets with their limited budgets.

Growth in GDP

Another contributing factor to the development of the branded budget hotel sector in France and the USA was growth in GDP. Strong growth in GDP provided people with additional purchasing power, enabling them to travel more than ever before. As a result, the demand for consistent, value-for-money accommodation increased yet further.

Hotel branding

There also appears to have been a correlation between the growth of branded budget hotels and the level of branding in the mid- and up-scale market segments. In both France and the USA, the mid-market and up-scale sectors are well branded with both international and domestic brands. This would appear to have shown the importance to both operators and consumers of branding, with the result that there has been branding in the budget sector, so providing guests with the clarity they are seeking in what is elsewhere a confused and inconsistent message and product.

Internal transport systems

Another strong element which has contributed to the growth in the budget sector in both France and the USA is the level and quality of internal transportation systems. If these are insufficient, people will not be encouraged to travel. The internal transport networks in France and the USA are extremely efficient. Major investments in their main motorway systems combined with the introduction of high-speed trains and the emergence of intercity discount airlines, have enabled both the business and leisure traveller to travel more freely with less difficulty and at affordable prices.

Unbranded hotel sector

The emerging branded budget hotel chains are not trying to create a new market — it already exists throughout Europe. The majority of hotels in all countries are already budget hotels, but they are mostly small, poorly run, badly maintained and inconsistent in standard. The budget hotel sector clearly needs more value-for-money branded hotels providing consumers with consistent standards of amenities and services at prices which they deem good

value. This provides the hotel companies with a great opportunity to exploit.

Shift in perceptions

Changes in consumers

Another reason for such extensive growth within this sector is a shift in consumers' perceptions of themselves as well as how they want to be perceived by others. Over the past decade, consumers have, according to some commentators, been shifting from 'upward mobility' to 'downward mobility'. So in the 1980s, consumers sought the status and reassurance offered by brand names. Now, however, the argument runs, consumers have moved on and appear increasingly self-confident and demanding value for money, while still recognising the reassurance offered by brand names. All this drives demand for branded budget hotels in the hotel sector.

OPPORTUNITIES ACROSS EUROPE

There are a number of European countries offering opportunities for growth in the branded budget hotel sector. In the UK, for example, the sector currently comprises around 600 branded budget hotels, accounting for less than 4 per cent of the country's hotels in total. This market will easily accommodate well over 1,100 branded budget hotels, and this will be achieved in the next three to four years if the major brands meet their stated future growth targets.

Spain represents one of the largest opportunities for this sector. It has a well-developed branded mid-market hotel sector in addition to a high volume of unbranded budget hotels. Spain will easily accommodate over 200 branded budget hotels where today there are less than 20.

In Germany the mid market has strong domestic brands with Steigenberger, Dorint, Maritim, Holiday Inn, Tref and Astron. In the budget sector, where there is already a plethora of independently run budget hotels, there are however only two budget hotel brands which are of any significance, namely Ibis and Etap. Between them these brands account for less than 100 hotels. In time, Germany will be able to accommodate well over 300 branded budget hotels.

Other markets including Belgium, Holland, Italy and Switzerland also provide very considerable opportunities, but none is as exciting right now as those offered in the UK, Spain and Germany.

UNITED KINGDOM

The UK is an extremely interesting and dynamic market, and over the past three years there has been a huge explosion in the number of budget hotels entering the market. The UK sector was created by the entrepreneurial management of Travel Inn by Whitbread and Travel Lodge by Granada. Both brands were born out of a drive to maximise the surplus landbanks located next to their restaurants. Initially, these lodge brands developed primarily as a bedroom product alongside the branded food and beverage outlet.

The occupancy levels reported by these brands have been high, consistently close to 90 per cent, clearly demonstrating the strong consumer demand for this kind of product.

Over the last few years, however, a number of newcomers have arrived on the market, including Premier Lodge with over 60 hotels, Ibis with over 15 hotels, Lodge Inns with over 20 hotels and Express by Holiday Inns with over 50 hotels.

Given the current continued undersupply and the returns being achieved by all of these brands, other brands are also looking to penetrate this sector, including Ramada Inns and Days Inns, both of which are strong US domestic brands.

The growth in the UK has been phenomenal and will continue, at least in this observer's view, for the foreseeable future. In 1992 only approximately 200 branded budget hotels existed, while today there are more than 600. This is a threefold increase in less than seven years. However, it is forecast that this number will increase to over 1,100 hotels by the year 2003.

EMERGENCE OF AN UPPER ECONOMY

Concerns have been raised by many that in order to differentiate themselves, branded budget hotels will continue to add additional amenities and services which will drive up costs rather than creating value. Over the past three years we have seen the emergence of a new group of branded budget hotels which is providing additional facilities to those offered by the 'lodges'. But we are not seeing amenity creep, rather this should be viewed as the emergence of a new sector within the budget market — namely an upper economy or super budget hotel sector, clearly positioned above the lodges but below the mid-market, full-service hotels. Managed correctly this sector will ensure that its product, services, amenities and prices are differentiated clearly in the mind of the consumer compared to those offered by the lodges and the mid-market hotels.

In the UK in the mid-1990s, the consumer really had only two choices: either to stay in a mid-market hotel with all the amenities and services he/she did not necessarily need and at a price he did not necessarily want to pay, or to stay in a branded lodge which only provided him with a room and very basic amenities. Additionally, the rate differential between the mid-market and the budget hotels sector was large. Since then, the budget hotel sector has evolved naturally and budget hotels have developed, in direct response to consumers' needs, to provide the essential amenities and services at a price below the mid-market hotels.

The essential amenities the consumers are seeking are entertainment in the room through satellite television, safety through the provision of electronic locks on all bedroom doors, additional comfort through en-suite bathrooms, relaxation through the provision of large reception areas, nourishment and refreshment through limited food and bar facilities and business conveniences through modem points in all rooms. These facilities are now being

A new sub-sector

incorporated in the new branded hotel groups which have emerged in the past three years in the UK.

WHY ARE BUDGET HOTELS A GOOD INVESTMENT?

Through the provision of these limited but essential services and amenities, branded budget hotels can still be run with substantially lower head counts compared with full-service hotels. For example, a typical 100-bedroom branded budget hotel can run efficiently with only 20 full-time employees. This level of overhead is one of the key reasons why budget hotels can achieve gross operating profit levels in excess of 50 per cent.

Another compelling reason why this sector will continue to grow is that these hotels are providing great returns for investors. There are typically two types of hotel investors: those who are seeking a ROE (return on equity), and these will not typically invest in this sector, and those looking for strong ROI (return on investment). The returns currently being achieved through ownership of budget hotels are very attractive. In the UK a typical 100-bedroom budget hotel will cost around £4m in total or £40,000 per key. That total is broken down into the following:

— land	£6,000
— design and building	£25,000
— fixtures and fittings	£5,000
— other fees	£4,000
— Total per key	£40,000

Clearly this billed cost is well below that of a mid-market self-service hotel. A 100-bed hotel achieving an occupancy level of 75 per cent, an average daily rate of £36 and a GOP level of 50 per cent should achieve an unleveraged rate of return in excess of 12 per cent per annum. From an investment perspective these returns can be substantially improved through leveraging.

Assuming a reasonable level of gearing, say 70–75 per cent, equity holders should see returns on their equity in excess of 20 per cent per annum with an anticipated internal rate of return of over 30 per cent.

WHAT DOES THE FUTURE HOLD?

Looking ahead, the future holds tremendous opportunities in the author's view. In the UK there is sufficient demand for supply to double over the next few years. The UK domestic budget market will segment into two sectors, namely lower and upper economy, and each of these sectors will have two dominant brands. Moreover, the brands in these sectors will start to differentiate through ancillary benefits, such as the provision of toll-free numbers and loyalty programmes etc, and not through additional services and facilities.

Elsewhere throughout Europe we will see an aggressive market

Two-sector market

entry by both the leading domestic and international hotel companies especially in Germany and Spain.

Clearly the branded budget hotel market in most of Europe is still in the development stages, and specific sales figures are not yet available. But given the buoyancy of this sector combined with the strong and continued interest shown by its investors as well as the increasing demand of the cost-conscious traveller, it is our belief that the prospective returns generated by the branded budget hotel market will be substantial.