Guest Editorial

European hotel development – Focus on budget hotels

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As the hotel market starts to recover across Europe but credit for new development remains scarce, budget and limited service hotels will continue to be the dominant sector for investment, accounting for a greater proportion of new projects than more upmarket hotels.

INTRODUCTION

Hotel developers, owners and operators are still trying to recover from the economic trough in hotel performance while also focusing on an appropriate strategy in terms of brand, product, deal structure and location to be well positioned for the recovery.

Whereas the development of midscale and upscale hotels usually carries a significant amount of development risk owing to the duration and complexity of the development process, the new breed of budget hotels offers (relatively) very efficient development that is clear-cut, cost-effective and quick, allowing developers to reduce development risk and the hotel/brand to become established in the market quicker.

According to Davis Langdon, the possibility of applying off-site modular methods of construction and making use of previously unviable or converted development space has also brought renewed attention to the budget hotel sector. Generally, modular methods of construction are offered at competitive prices while reducing total development time, on-site labour work, waste and contingency. The emergence of ultra-budget brands with minimum space requirements and no frills has enabled developers to make use of more restrictive sites or buildings in terms of total size, layout or views.

Moreover, although bank loans continue to be challenging to obtain in the current lending environment, the total investment needed to develop, for example, a 125-room branded budget hotel in Europe is typically lower than €7 500 000 (excluding land cost).

The lower building costs, the shorter development and market penetration time and the fact that financial backers see a safer and faster return on their investment mean that developers and operators are finding it easier to attract funding for budget hotels.

BUDGET HOTELS OVERVIEW

Budget hotels have traditionally been positioned at the lowest extreme of the value-for-money equation, offering basic accommodation for relatively short periods of time at affordable prices. However, the general increase

Table 1: Sample list of budget brands

Sample Brands[a]			
Ultra-budget	**Core-budget**	**Upper-budget**	**Design-budget**
easyHotel	Travelodge	Holiday Inn Express	Yotel
Etap	Premier Inn	Hampton by Hilton	Qbic
Hotel F1	Ibis	All Seasons	Nite-nite
Premiere Classe	Super 8	InterCity Hotels	Sleeperz
Balladins	Motel One	Comfort Inn	The Big Sleep
Tune hotels	B & B	Days Inn	Citizen M
	Sidorme	Campanile	Dakota
		Kyriad	

[a]This list is not exhaustive.
Source: HVS Research.

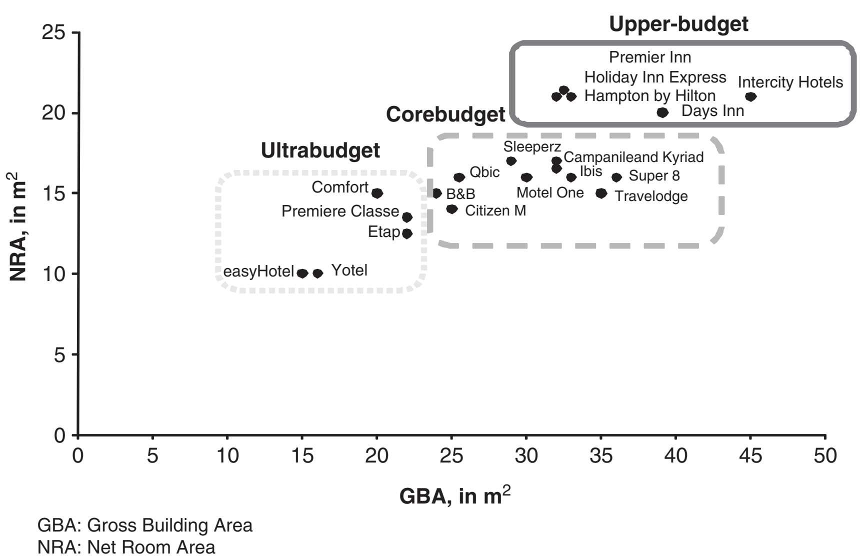

Figure 1: Space requirements by brand (m^2).
Source: Hotel Groups and HVS estimates.

in guest expectations and the emergence of more upscale budget and design budget hotels have raised the standards across all sectors. As a result, many budget brands have introduced modern design, up-to-date in-room technology and select F&B facilities in order to appeal to the 'new generation' of guests, attract longer stays, build loyalty and command higher rates.

Table 1 is a non-exhaustive list of the main budget brands in Europe, classified into four categories according to room size, room amenities, on-site facilities, design and service offered.

This brand classification is both quantitative and qualitative. We have analysed the space and furniture, fixtures and equipment (FF&E) standards of these brands to gain more insight into their positioning with regard to the total space, level of investment required for development and the degree of in-room and out-of-room comfort provided to guests, as Figures 1 and 2 illustrate.

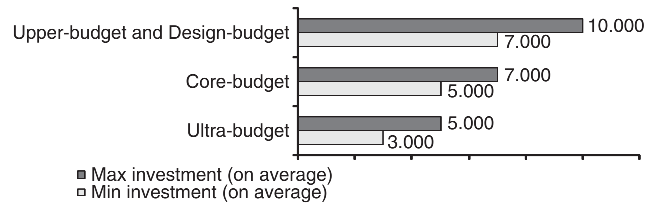

Figure 2: Average FF&E investment in branded budget hotels (€ per room).
Source: Hotel Groups and HVS estimates.

BUDGET HOTELS PERFORMANCE

According to HVS's research and consulting experience, branded budget hotels have been more resilient to the credit crunch and economic downturn, overall experiencing a lower decrease in RevPAR than their midscale and upscale counterparts.

Broadly, we estimate that RevPAR for European branded midscale and upscale hotels dropped by 15–20 per cent on average in 2009. This large decline in RevPAR was caused by a decrease in international and business travel resulting in significant price discounting in an effort to avoid losing important corporate accounts and conference events (which happened anyway) and to attract more price-sensitive leisure demand to replace some of the lost volume during the current economic crisis.

On the other hand, we estimate that European branded budget hotels have experienced an overall decrease in RevPAR of 5–10 per cent throughout the same period. European branded budget hotels have benefited from an increase in the overall volume of room nights as business and leisure travellers traded down from more upscale accommodation.

As of year to October 2010, hotel performance benchmark data indicate that business travel is recovering and midscale and upscale hotels have registered double-figure RevPAR growth. However, this growth has been driven primarily by occupancy, showing that the economic recovery is still fragile and business and leisure travellers remain price-sensitive.

BUDGET HOTELS PIPELINE

Hotel developments have been in decline since the second half of 2008, which was the peak of the most recent hotel development cycle. Since then, the European hotel pipeline has declined at a compound annual rate of 4 per cent, primarily because of a lack of available funding for new projects and lower confidence in the hotel investment market. This decline is expected to continue until 2013–2014 when the more recent hotel builds start to trade profitably and development lending becomes more widely available again.

According to data from Lodging Econometrics, currently, 33 per cent of hotels planned or under construction in Europe are branded budget hotels – a total of 242 – whereas just 100 are mid-market properties. This will bring approximately 10 700 budget rooms on stream. The majority of planned branded budget hotels are in mature markets such as the United Kingdom (38 per cent of those planned), Germany (13 per cent), Spain (13 per cent) and Russia (10 per cent). Mature markets are more likely to see growth in the budget sector as operators establish their core upmarket brands in capital and secondary cities before expanding their limited service and budget properties to create critical mass.

BUDGET HOTELS SUCCESS FACTORS

The main reasons for the success of budget hotel brands during the economic downturn have been as follows.

- The emergence and revitalisation of national and international budget hotel brands with an attractive and consistent product that is successful with guests.
- Budget hotels have shown more resilience to the economic downturn, capturing business and leisure clients trading down from more upscale accommodation as available income and travel budgets shrank.
- Internationally branded hotels have been favoured by investors, lenders and developers as they are perceived to be less risky than independent hotels, owing to the more powerful recognition, know-how and global distribution systems (GDS).
- Budget hotels are less cost intensive to build, owing to lower space requirements, lower quality of building materials and specifications, and potential use of off-site modular methods of construction. This translates into lower development risk and relatively easier access to new finance.
- Brands with a critical mass in the market are able to capitalise on a variety of economies of scale to offer cost-effective solutions throughout the development process and operations procurement.
- Many budget hotel brands operate under lease agreements and in some cases offer strong covenants to risk-adverse freehold owners and loan providers.
- There is an established investment market for branded budget hotels in good locations, trading at strong and stable yields. The lower acquisition cost and high income return of this type of hotels facilitate early exit strategies. Other potential pool of investors are private equity firms interested in the development of the brand, as the acquisition of a majority stake in Yotel by IFA Hotels and Resorts (December 2005), Travelodge by Dubai International Capital (September 2006) and B&B Hotels by Carlyle Group (September 2010) illustrate.
- Operators are prioritising growth through asset-light strategies such as franchise agreements, which are particularly well suited for quick expansion of budget brands. This is because budget hotels are simpler to run independently with a license than more upscale hotels, owing to the limited service offer and larger degree of standardisation.
- Budget hotels also have leaner fixed-cost structures that offer higher flexibility, higher operating margins and therefore higher relative returns. The staff ratio required in a budget and economy hotel ranges from 0.1 to 0.2 per room, depending on the extent of on-site F&B and leisure facilities and contact points with guests.
- Budget hotels usually penetrate the market quicker and reach a stabilised level of operation earlier than midscale or upscale hotels. The ramp-up risk is therefore decreased.

BUDGET HOTELS DEVELOPMENT COSTS

The construction economies of Europe have all been affected by the recession and consequent fall in workload, although to different degrees. Deep reductions in activity in Portugal, Ireland, Greece and Spain have resulted in dramatic adjustments in prices relative to the European average. The United Kingdom, Benelux and Scandinavia have also seen substantial contractions in construction activity, which have led to stronger competition for tendered work and significant price reductions. Few economies, Poland and Switzerland, for example, have seen sustained growth over the past 2–3 years, resulting in moderate, input cost-driven cost escalation for construction and development work.

Competitive pressures between bidding contractors have been intensified to such a degree that ‘below-cost’ bids are being submitted. When this occurs, there is a risk that contractors are not able to secure profitable work and do not provide for sufficiently robust risk contingencies to absorb the costs of unforeseen events or miscalculation on projects should they occur. A common contractor strategy these days consists of securing work at the lowest entry cost and increasing the exit cost through claims for additional work outside of the initial scope, disruption and other contractual entitlements.

Table 2 sets out a comparison of development cost factors for a 125-room branded budget hotel across Europe compared to the European average as of July 2010. These costs include Construction Costs, Professional Fees, FF&E and Contingency and exclude land, preopening expenses and interest during construction. The entry development cost factors can be used to extrapolate development costs

Table 2: Development cost factors across Europe (differential against the average)

Country	*Differential cost factor 3Q 2010*	*Development cost (€)[a] for a 125-room branded budget hotel*	*Approximate development cost (€)[a] per room*
Europe (average)	**1**	**7 500 000**	**60 000**
Austria	1.2	9 000 000	72 000
Belgium	1.04	7 800 000	62 400
Czech Republic	0.72	5 400 000	43 200
Denmark	1.21	9 075 000	72 600
Finland	1.21	9 075 000	72 600
France	1.17	8 775 000	70 200
Germany	1.17	8 775 000	70 200
Greece	0.69	5 175 000	41 400
Hungary	0.69	5 175 000	41 400
Ireland	0.92	6 900 000	55 200
Italy	0.93	6 975 000	55 800
Netherlands	1.13	8 475 000	67 800
Poland	0.75	5 625 000	45 000
Portugal	0.67	5 025 000	40 200
Spain	0.77	5 775 000	46 200
Sweden	1.15	8 625 000	69 000
UK (average)	0.88	6 600 000	52 800
UK (London and South East)	0.98	7 350 000	58 800

[a]Excludes land, preopening and interest during construction.
The values in bold represents the Europe (average)=100 per cent index benchmark.
Source: Davis Langdon.

from one location to another. We note that some of the entry cost factors have been slightly affected by currency fluctuations, such as in the United Kingdom, some Scandinavian countries and some accession states.

The following factors represent some of the key cost drivers when considering the development and construction of budget hotels in the current market:

- Country – as the previous analysis demonstrates, there is a large variation in development costs across Europe for delivering effectively the same product, and often further variations can arise within a country depending on location.
- Specific location factors – development within a city centre is usually more costly than developing on a 'green field' site out of town.
- Site-based factors – there can often be site-specific factors that influence costs; these can include the level of any remediation or demolition required. High-risk sites and locations will often deter interest from budget hotel developers and operators.
- Budgetary constraints – many budget hotel projects are driven by what is affordable as a build cost once an ROI or development appraisal has been undertaken. This will often drive the target 'cost per guest room'.
- Brand standards – within the budget hotel sector, there are a wide range of different brand standards that will drive specifications and costs.
- Design configuration – the size of guest rooms, the configuration of floor plates, the number of storeys and the height of the building will all influence costs.
- Extent of public facilities – the extent of front-of-the-house support facilities is a key cost driver, although for budget hotels these tend to be minimal (and represent less than 10 per cent of the gross area).
- FF&E and IT facilities – the quality and level of the furniture, fixtures and equipment and the hotel's IT offer will influence costs. Modular construction – prefabricated and modular construction methods can help drive construction efficiencies and reduce programme delivery dates, potentially reducing contractors' preliminary costs by around 5 per cent. Straightforward branded budget hotels are usually less expensive to build in locations where the cost of labour is lower. On the other hand, mature construction markets can offer greater benefits from the use of modern methods of construction as mentioned before. Sustainability – the extent to which a developer or operator wants to embrace the 'green' agenda and drive sustainability could have a significant impact on construction and operating costs. Savings in terms of initial capital cost are still marginal (and could even be slightly higher). However, the reduced operational cost can justify higher rental income or profitability from operations.

All in all, if developers, investors, lenders and operators want to take advantage of the opportunities for growth in the current hotel market, the budget hotel sector is well positioned to offer quicker expansion, less development and operational risk and trendy concepts that are cost-effective and successful with guests.

Ana Campos Blanco and Arlett Oehmichen
HVS London Office, London, UK.
E-mails: acampos-blanco@hvs.com; aoehmichen@hvs.com

Stephen Frood
Davis Langdon Manchester Office, Manchester, UK.
E-mail: stephen.frood@davislangdon.com