News

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Hotel construction in CEE: plenty of room for development

Growth potential still evident, according to KPMG

While the ongoing economic crisis could place an obstacle to some planned projects, Poland and Romania are likely to be hot spots for hotel development in the near future. This, one of the findings of the newly released *Hotel Development Costs Survey in Central and Eastern Europe (CEE)*, prepared by KPMG's Real Estate, Leisure and Tourism practice, which reveals that although the CEE region was hit particularly hard by the financial crisis, it is expected that its growth potential is still higher than in the more developed Western European economies.

Can CEE still be "the growth engine of Europe"?

The strong overall growth of the economy in the years prior to the recent global economic crisis led economists to dub the emerging markets of Central and Eastern Europe "the growth engine of the EU". Although the CEE region was hit particularly hard in the escalation of the financial crisis, it is a common belief that the potential for growth in CEE is still significantly higher than in Western Europe.

Hotel market in the region

With an average industry contribution to GDP of 12% in CEE, investment in tourism and in the hotel sector will continue to be an area of focus. Poland, the largest country in the Region, registered the highest number of tourist arrivals in the region in 2007, followed by the Czech Republic and Croatia. While Romania and Bulgaria recorded significantly fewer tourist arrivals, over 90% of them were registered in hotels, compared to the regional average of 70%.

Currently, the Czech Republic, Bulgaria and Poland have the most hotel rooms in CEE, followed by Romania, Croatia and Hungary. These six countries provide nearly 80% of the overall supply in the region, with significantly different supply patterns per individual country.

Growth in the percentages of hotel room supply was particularly apparent in Bulgaria (+47%), Romania (23%) and in Poland (+19%) in the last five years, while the Czech Republic and Hungary experienced a similar boom in the 1990s. As a result of the current economic recession and the credit crunch, a slowdown in developments is likely in the short/medium term, particularly in those countries that have developed rapidly over the last decade. Still, Poland and Romania are likely to be the primary hot spots for future development, according to KPMG's survey.

Currently, 2- and 3-star hotels dominate the market, representing 75% of total hotel room supply. In comparison to Western Europe, the share of 4- and 5-star hotels is lower. However, there is a clear shift towards quality accommodation in the region: in Poland, for example, the share of 4- and 5-star hotel rooms has increased from 15% to 20% in the last five years; similar trends were experienced in Hungary and in the Czech Republic.

Average development costs and construction time

Based on the Survey, the average construction time of a hotel is approximately 12-18 months in the Region, excluding the time spent for obtaining all necessary permits, planning activities and securing of financing. The average development cost per hotel room ranges between EUR 51,000 for an economy hotel and EUR 143,000 for an upscale hotel, according to the survey findings.

On average, development costs have increased by around 10% in CEE (up to 20% in some countries) in recent years, versus 2-6% in Western Europe. However, according to the survey respondents, construction costs are expected to decrease in the short to medium term (80% expected a discount of more than 6%).

Key obstacles to and aspects of project financing

Developers are also facing certain difficulties during the realisation of their projects. Obtaining the necessary permits from local municipalities was the most frequent problem cited by those surveyed, mentioned by almost half of developers. While financing was ranked second among the main obstacles to development, it is likely to become a crucial issue for developers in the short to medium term.

Banks that participated in the survey are planning to finance fewer projects in 2009 and will particularly scrutinise developers' track records and the location of projects before providing debt financing. They also stated that they preferably finance inner city upscale hotels in countries where they already have established subsidiaries or lending policies. While financing is expected to become more restricted, margins will go upwards and equity contributions are also expected to increase, while hotel projects with a good location and concept, a sound market environment and sustainable operations will likely still receive financing, regardless of the current financial crisis.

Appendix:

Survey methodology
The analysis presented in this report has been prepared based on a questionnaire-survey and in-person interviews with hotel developers, hotel management companies, hotel architects, construction companies, and cost consultants as well as banks active in hotel financing in the CEE region. Our survey only considered hotels that have opened since 2004. Furthermore, in order to complement our analysis, we have used secondary data that was available at the time of the publication of this report. In order to allow for more meaningful comparisons between different hotels, our survey focuses only on hotel development costs and excludes financing costs, investments related to land acquisition, as well as the in-house costs of developers.

The collected data was placed into three different hotel categories:

- budget/economy
- mid-scale, and
- upscale hotels.

Please note that our survey did not consider any luxury hotels. Many of these properties in CEE are conversions of existing landmark buildings and consequently have significantly different cost structures than new developments. Differences in timing of development, inflation, fluctuation of exchange rates as well as variances in the development stage of the various countries involved in the research are constraints that we could not overcome. It is also important to note that part of our analysis was conducted prior to the full scale unfolding of the financial crisis and economic downturn of 2008. It is still too early to assess the extent of impact of the crisis, but it is expected that investment activities in the hotel sector will decline in the short term. However, as a result of the fundamental deficiency of hotel supply in some CEE markets, hotel investment is expected to recover in the mid/long term.

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