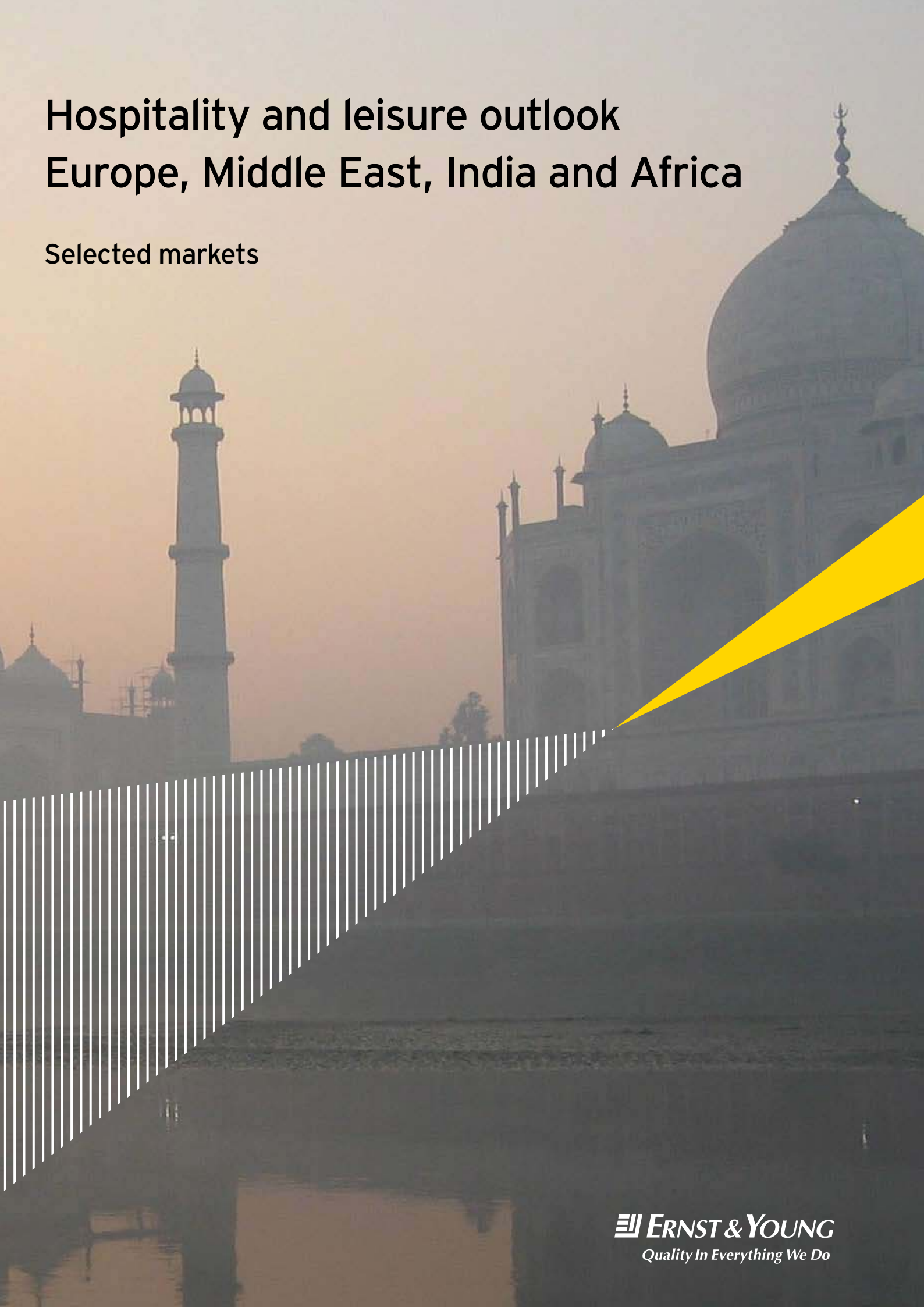


Hospitality and leisure outlook Europe, Middle East, India and Africa

Selected markets



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Overview

2009: will lessons be learned?

2009 has gone into the history books as one of the worst for the hotel industry. Revenue per average room (RevPAR) practically collapsed as travelers stayed away. Companies reined in travel expenditure and tourists stayed at home. Business is suffering against all measures and we have seen hotel stocks fall in value around the world. Despite this, hotel closures and large-scale forced sales of distressed assets have not materialized in the Europe, Middle East, India and Africa (EMEIA) region in any great number. Cash-rich funds continue to wait in the belief that the bottom of the market has not yet been reached. Similar trends are also being experienced in other regions of the world.

The emerging economies of India and Russia were particularly hard hit, with double digit falls in RevPAR. The long-term fundamentals across the developing regions are nevertheless favorable as local wealth accumulates and the propensity for international travel increases.

In the short term, the European Travel Commission¹ predicts arrivals to Europe to stabilize or even have grown by the end of 2009. In the Middle East and Africa, tourist arrivals are slowly showing signs of recovery. South Africa should benefit greatly from the FIFA World Cup – the first modern truly global event on the continent. External factors such as fluctuations in oil prices and currency markets will be key to the speed of economic recovery for the sector. Other factors such as the poor weather that hit most of Europe in January 2010 and possible further flu pandemics could also have significant impacts.

Hospitality being seen as an extravagance

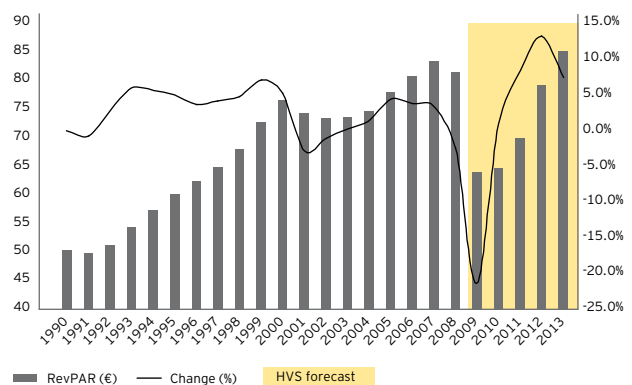
Lower discretionary income has forced decision-makers to analyze their travel priorities, cutting down the number of journeys or the length of stay. Long haul is being replaced by short haul, although poor summer weather in Europe led a last minute revival, for example to Turkey or Egypt. Package holidays are falling out of favor, except in Germany, and destinations priced in euros have suffered given the relative strength of the currency.

Business travelers with reduced travel budgets are now frequently staying in budget-branded hotels because of their companies' cost-saving measures or are seeking alternatives to client meetings such as video conferencing. Across the EMEIA region, conferences and exhibitions have to cope with fewer delegate numbers; meetings are being scaled back and are rarely being held in an external hotel conference suite.

Will we come full circle?

There is some comfort from the knowledge that the hospitality and leisure sector is highly cyclical and, albeit with a slight time lag to the general economy, recovery may be in sight. It appears that we may be at the end of the trough in the current cycle and prospects are starting to improve. It will be a tough year ahead and we anticipate RevPAR will mostly stay flat during 2010 as the corporate sector continues to drive some hard bargains. Revenue levels will eventually return and hotel operators and investors should act accordingly. The following chart shows the severity as well as anticipated faster rebound compared with the recovery from previous recessions. The fast rebound which is predicted is driven by economic growth forecasts across Europe, which are closely correlated to hotel demand, combined with the slowdown in the supply pipeline and pent-up demand.

RevPAR in Europe



Source: HVS Research – London office 2009

The financial crisis led to the drying up of credit for new hotel projects as much as any other. In 2009, very few new hotel investment projects were registered. Refinancing strategies which are available for general real estate companies are often not for hotels – the property is often difficult to convert or relocate, whereas for most companies these factors are unrelated to corporate success. Restructuring strategies have therefore concentrated on optimizing existing properties rather than saving plans in the development pipeline. Remedies should be designed to stabilize the revenue situation for owners over the long term.

Recent international hotel flotations and IPOs have proved that investors will back sound propositions in our sector.

¹ <http://www.etc-corporate.org/resources/uploads/ETC-Insights-2009Q3-web.pdf>

Overview

Have hotel transaction fundamentals changed?

The next phase of the growth cycle is likely to be characterized by new considerations – the more sober approach to arranging accommodation and meetings/incentives/conferences/events. Yet the long-term fundamentals are clear: recent international hotel flotations and IPOs, such as 7 Days Inn of China and Hyatt Hotels Corporation of the US, have proved that investors will back sound propositions in our sector. Budget and 3-4 star accommodation is being favored, especially where there was previously a shortage as in India, but also in anticipation of major events such as the Olympic Games in London and Sochi. South Africa should benefit greatly from the FIFA World Cup – the first modern truly global event on the continent. Other investments are being used to create defensive positions in the more competitive markets. Cooperation and consolidation is increasing and owners are becoming more involved in the search for management cost efficiencies.

Hotel owners are being forced to invest a greater proportion of their own capital in any new projects and take on new risks, leading to fewer hotel projects being realized. Recent transactions are down compared with the peak years of 2005-07, but acquisitions do occur where the circumstances are right.

European hotel transactions

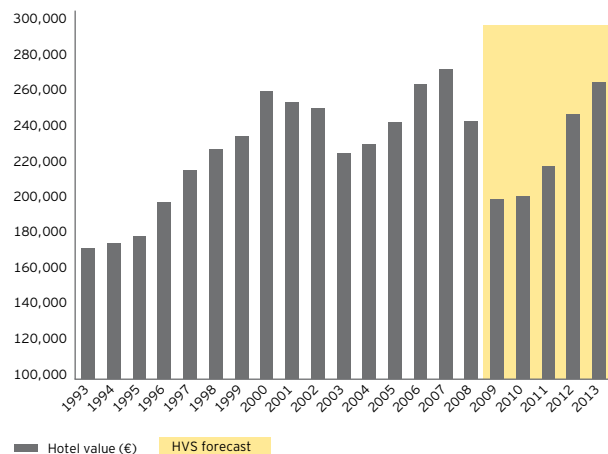
Hotel	Rooms	€/Room	Buyer
Four Seasons Hotel des Bergues, Geneva (50% stake)	100	1,600k	International Hotel Investments
The Stafford, London	105	827k	Britannia Hosp.
Melia Madrid Princess, Madrid	274	320k	BBVA Renting
Radisson Royal Viking, Stockholm	459	286k	KLP Fastigheter
Lapa Palace Hotel, Lisbon	109	270k	Private
Radisson Blu Hotel, Krakow	196	163k	Union Investment
NH Frankfurt City, Frankfurt	256	156k	Deka Immob.
Park Inn, Oslo	119	149k	Kristiania Eendom
Travelodge London Tower Bridge	190	149k	E African Investors

Source: HVS Research – London office 2009

The table above shows a selection of European transactions from 2009. There are obviously numerous buyers in the market – they are simply waiting for the bottom. Has this already been reached?

HVS predicts a slow recovery in European hotel transaction prices over the next four years, although they are unlikely to return to 2007 values. The credit crisis absorbed all liquidity in the market and its return will be noticeably slow, evidenced by the low number of transactions to date. Together with the price expectation gap across several EMEIA markets, there continues to be a conspicuous lack of confidence. Many purchases are being left to vulture funds.

Trend in European hotel values (€)



Source: HVS Research – London office 2009

Many investors who intended realizing short-term gains are now finding themselves to be long-term hotel owners. Errors in financing during the acquisition phase lead to problems in refinancing. Novel solutions are now required.

“Despite significant additions, including premium brands, opening over the next 12 months, there will still be a major demand-supply gap indicating that the industry is poised for a better future.”

Avinash Narvekar

Partner, Ernst & Young Pvt. Ltd. India

Is green regulation for the hotel sector inevitable?

Improving energy efficiency has a higher profile in hotels and other public buildings compared with general real estate. Green designs can reduce energy bills by 4% to 8%. The 2008 Ernst & Young report *Hospitality going green*² reported Hilton Hotels in Europe had saved over EUR 6m within two years through energy and water-saving measures. It is obvious that physical restructuring of the building's infrastructure can be costly, and if temporary closure is not an option, the works may have a negative long-term impact on guests.

The environmental agenda presents new challenges due to a continuous government focus and public pressure as well as increased regulations to adopt sustainable technologies for new developments and converting existing properties. As part of Ernst & Young's global climate change and sustainability services³, Ernst & Young LLP in the USA assisted companies such as Las Vegas Sands Corporation to optimize the building design for The Palazzo Las Vegas to realize environmental tax incentives. It is now crucial that hotel companies consider the following in their strategies to increase revenue, reduce costs and meet stakeholders' expectations. Successful companies are:

- ▶ Proactively marketing their climate change strategies to enhance their brands
- ▶ Exploring emerging carbon market opportunities
- ▶ Seizing opportunities to offset reductions through existing carbon markets
- ▶ Taking full advantage of tax credits, grants and other incentives to encourage businesses to become more climate change friendly

Why don't all governments' stimulus packages consider hospitality?

Across our region, national and local governments are creating tax and legislative environments to promote economic growth. In countries where hospitality and leisure is a key industry, such as Spain and Egypt, there are major government investment schemes. We are, however, also seeing that governments from the UK to Russia are not prioritizing the sector, leaving operators to manage their way through the downturn.

Now is the time for hotel operators and investors to examine where their weaknesses were during the credit crunch and what can be done to better position their businesses going forward. Ernst & Young conducted 40,000 interviews with senior executives to understand what lessons could be learned from the economic downturn to identify the performance objectives critical for future growth and cash management of their business, including how real estate and hospitality companies are reevaluating their entire business models.

If you would like to discuss how your company can improve its performance in the new business environment, and in particular the results from the *Lessons from change*⁴ initiative, contact your local Ernst & Young representative. We have a network of hospitality and leisure sector professionals, working together for the benefit of international hotel chain clients and other hospitality and leisure sector companies.

"Competition is fierce in today's market. Those hoteliers who are able to offer value for money will weather the storm, build customer loyalty and hopefully recover quickly.

Hotel owners whose capital structure does not match the financial and operational needs of the business should review and possibly renegotiate covenants as well as develop an appropriate financial platform that meets cash requirements"

Paul Arnold

Head of Transaction Real Estate Advisory Services in the Middle East and North Africa

² http://www.ey.com/GL/en/Industries/Real-Estate/Real_Estate_Global_hospitality_insights

³ <http://www.ey.com/ccass>

⁴ <http://www.ey.com/GL/en/Issues/Business-environment/Lessons-from-change>

Egypt

Egypt has a rich history, a diverse environment and a strategic geographic location at the crossroads of Europe, Africa and Asia. It also has other competitive qualities such as year-round sunshine, extensive beaches on the Red Sea and Mediterranean coasts as well as the western and eastern deserts, offering popular desert safari excursions. Alongside ancient Pharaonic, Greek and Roman sites, Islamic and Christian locations, there are health/medical and therapeutic resorts.

According to the World Tourism Organization, Egypt is currently among the top 25 destinations worldwide, accounting for approximately one percent of the global market. Revenues in 2007-08 reached EUR 7.5b, contributing around 3.4% of GDP and a primary source of foreign exchange.

The government's target is to improve Egypt's reputation as a business destination and to increase its share of global tourism to 2.2%. This should boost annual revenue in the sector to EUR 9.4b. Meanwhile, operators are looking to grow hotel capacity to 300,000 rooms – enough to meet the goal of hosting 18m visitors by 2015, up from 10.7m in 2008, and generating some 1.2m new job opportunities in the sector.

Operators are looking to grow hotel capacity to 300,000 rooms.

Price cuts being used to attract domestic visitors and maintain occupancy

The economic downturn is affecting activity in the tourism sector, forcing Egypt's hoteliers to compete more intensively for market share. It provides some indication of the impact of the global recession on one of the country's main sources of foreign exchange earnings. Official figures show a 17.3% year-on-year fall in tourism revenue to EUR 1.5b in the period January-March 2009. There has been a recent rise in occupancy rates, mainly obtained through price cuts and other promotional offers, attracting more domestic guests, but affecting overall receipts, a trend likely to continue through 2010. Business tourism is also forecast to rise.

Mega-projects point to future

Egypt has recently become an attractive investment option, due to the hospitality-friendly policies adopted by the government and the improvement of the general investment environment. Several tourism mega-projects are under way around Marsa Alam and on the north coast, and the Al-Futtaim group has properties in the pipeline at the Cairo Festival City project.

The Ministry of Tourism has also set an integrated "Tourism Sustainable Development Plan" that will continue with improvements to the tourism sector up to 2020. The Minister of Tourism, Zoheir Garana, has said "Egypt is preparing to turn the north coast into an international tourist hub."

The Ministry of Tourism and General Authority for Investment (GAFI) identified 205 companies investing in hospitality and leisure in 2008; in the year to November 2009, 167 companies were participating in the sector. There are currently 624 new tourism projects, 98 of which are on the north coast, 66 in Taba and Nuweiba and 54 in Marsa Alam.

Several programs have been targeted to cushion the effect of the downturn. These include the following:

- ▶ Rescheduling of outstanding debt and providing various loan facilities to projects in the tourism sector
- ▶ Intensifying joint marketing campaigns with international travel agencies
- ▶ Concentrating marketing efforts towards emerging economies with high potential
- ▶ Supporting charter flights programs
- ▶ Enhancing efforts aimed at introducing low-cost carriers to the Egyptian market

Investment considerations

The enactment of the new real estate tax law issued in June 2008, subjecting all real estate properties in Egypt to tax, could well affect the hospitality and leisure sector. This law requires owners of real estate or of the exploitation right to pay real estate tax on their property. The law also applies to the owning company of hotels or the hotel operator. In such cases, the owner is expected to adjust the tax-affected prices in the management agreement, with the operator probably bearing the tax burden. The tax return has to be filed before 31 December. The real estate tax rate is an annual flat rate of 10% on the annual rental value, after allowing 32% deduction from that value to cover all related costs for non-residential properties, and is due on 1 January each year.



Germany

The global economic downturn has had a huge impact on the German hotel sector. According to the Federal Statistics Authority, in the first half of 2009, overnight stays were down by 1.6% compared with the same period in 2008. Foreign visitor overnight stays fell by 7.1% to 23.4m and domestic overnight stays fell by 0.6% to 139.1m over the same time frame.

We are seeing real estate investors steer away from hotel purchases in the Europe, Middle East, India and Africa (EMEIA) region and many are willing to hold on to assets for now. Germany is, however, a prime target for acquisitions, particularly the cities of Munich and Hamburg. These two cities are, alongside London, Paris and Rome, among the most desired investment locations in the EMEIA region, confirming the appetite of investors to remain in the traditional European hotel markets.



Hoteliers have tried to buy occupancy at the expense of room rates.

Property prices likely to fall but occupancy could be rising

The occupancy level in the German hotel sector is expected to bottom out soon, if it has not already done so. The German Hotel Association (IHA) predicts a fall of 5% in RevPAR by the end of 2009 and most hotel operators do not expect an improvement through 2010, rather similar results as generated in 2009. Hotel property prices will continue falling below the long-term average. Historically, the investment market requires two to three years to recover once occupancy levels start increasing. It is expected that the hotel investment sector will recover no earlier than 2011.

Source markets compound suffering

The economic slowdown hit major cities as well as regional markets. The severe recessions in the key foreign source markets of the US, UK and the Netherlands, in combination with the loss of purchase power of the US dollar and sterling, led to cancelled travel to events and meetings in Germany and to losses of occupancy and average room rates. The markets with a high share of domestic demand might have suffered less in terms of occupancy but generated lower room rates. Consequently, hoteliers have tried to buy occupancy at the expense of room rates and focus more intensively on leisure demand.

Market analysts calculated that there were 440 new hotels (76,000 rooms) across Germany, Switzerland and Austria in the pipeline for 2009, in planning stages or under construction. Many of these developments are expected to be postponed. Nevertheless, German cities are still of interest to hotel investors. Many active projects currently in the pipeline are in the growing international destination of Berlin.

Investment considerations

Some hotel management agreements are being renegotiated in consideration of restructuring requirements in a hybrid of management and lease contracts. Consequently, more risk is being taken by the operator, e.g., employing inadequate personnel and building renovations. Performance guarantees are still included to ensure full payment of management fees.

Agreements based on fixed lease payments are commonly being renegotiated to be based on turnover. Consequently, the property owner becomes more involved in the management of the property.

For newly built properties, financing continues to be very difficult to obtain because the hotel operator is no longer liable for fixed rental payments. The traditional German contract is being rewritten according to international standards. Budget hotels are the exception in being more likely to obtain finance and operating on fixed lease payment contracts.

The federal government has reduced the marginal sales tax (value-added tax/VAT) rate for the hospitality sector (purely for accommodation without ancillary services) from 19% to 7% as part of the fiscal stimulus package. This will bring down Germany's relatively high sales tax to similar levels as the structures in neighboring countries. The change came into effect on 1 January 2010; it is anticipated that the savings by hoteliers will be partly invested in training and infrastructure projects.

Further tax breaks include a restructuring clause (Sanierungsklausel) for companies facing possible insolvency so that they can be taken over while keeping loss carry forwards, provided the new owner offers job security. Furthermore, the threshold on interest expenses has been raised. These measures are being utilized across the German hospitality industry. Other fiscal measures, such as subsidies for reduced working hours, will soon run out, leading to the threat of further unemployment and reduced confidence in the hospitality and leisure sector.

India

The Indian hotel industry witnessed unprecedented growth during the Indian Financial Years (FY) 2003-08 due to the booming economy, resulting in an increase in business and leisure travel and visible growth in inbound tourism. The increase in business travel in the country during this phase can be attributed to rising trade flows and the entry of an increasing number of international players into the country. According to the Ministry of Tourism, during this period foreign tourist arrivals (FTAs) to India grew at an annual rate of 14.5% as the country emerged as an attractive tourist destination. Attracted by India's rapidly growing hospitality industry, several international hotel chains, including Hilton, Marriott, Starwood, Shangri-La, Carlson, InterContinental, Accor and Hyatt strengthened their market presence in the country. This led to a significant increment in revenue (room rentals and food and beverages receipts), with the industry turnover tripling from EUR 949m in FY03 to EUR 2.73b in FY08 (per *Annual review of the hotel industry*, CRIS INFAC, September 2009).

Over the last few years, business travel to smaller cities such as Bhubaneswar, Pune, Jaipur, Mangalore and Kochi has increased as IT and IT enabled service (ITES) companies have expanded operations. India has also become a preferred tourist destination with a number of smaller cities such as Jaipur, Udaipur, Thiruvananthapuram and Kochi witnessing increased foreign arrivals.

Existing hotels in these cities are not adequately equipped to meet the growing demand and several hotel chains plan to develop properties. Most of these properties are expected to be in the budget segment, which has witnessed robust growth in India over the last few years, driven by the growth in domestic travel. Both domestic and international hotel chains have lucrative plans for this segment.

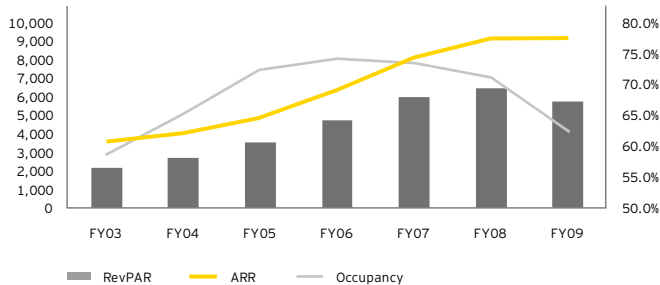
In 2008, the global economic slowdown had a significant adverse impact on the Indian hospitality industry as rising job insecurity levels significantly reduced leisure travel. Business travel was also on a downwards trend as companies trimmed their travel budgets, resulting in a drop in occupancy across most hotels in the country.

Most properties are expected to be in the budget segment.

Revenues hit hard by downturn

The average occupancy rate for the 10 major cities in India has declined from 70.6% in FY08 to 62.3% in FY09. This resulted in a RevPAR decrease from EUR 94.40 in FY08 to EUR 83.90 in FY09, even though the average room rates (ARR) marginally improved from EUR 133.30 in FY08 to EUR 133.60 in FY09. Consequently, the industry witnessed an annual decline in revenues (of 4%), to EUR 2.62b in FY09, for the first time since FY02.

Occupancy, ARR and RevPAR growth



Source: Annual review of the hotel industry, CRIS INFAC, September 2009

Increased supply to hamper recovery

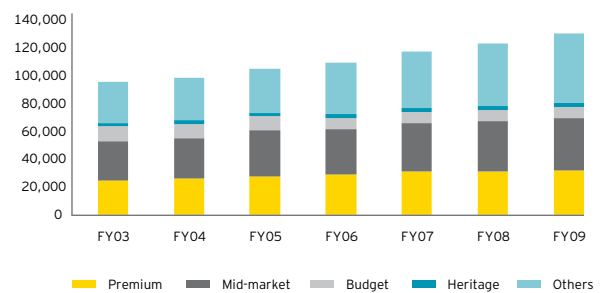
Despite the rampant pressures of the economic slowdown, the situation in the Indian hotel sector has improved over the last couple of months. This is primarily reflected by the improvement in tourism metrics. For example, according to Ministry of Tourism data, the decline in FTAs during the January to October 2009 phase was 7%, as against 13.7% in the January to March 2009 period. The improved market scenario and the rise in FTAs are expected to improve occupancy rates in 2010. Once the hotel supply problem begins to be rectified, lower rates are likely, due to increased competition, pulling down RevPAR further.

Real estate developers placed their hotel projects on hold due to the liquidity crunch and some international hotel chains deferred their expansion plans. The anticipated increase in supply never materialized, further extenuating the demand-supply gap in the industry going forward. There were only 129,982 hotel rooms in India as of FY09, of which 25% and 29% are in the premium and mid-market segments respectively. This number is very low compared with other large countries: the US had 4.6m hotel rooms at the end of 2008, while China had 1.45m guest rooms in 2006 (per American Hotel & Lodging Association).

Investment considerations

The Reserve Bank of India recently excluded hotels run by developers from the scope of commercial real estate exposure for the purpose of bank lending. This is expected to ease funding for hotel projects and boost the revival of delayed projects. International hotel chains are also expected to resume their plans once the global economic situation eases, as the hospitality industry in India is still attractive and offers significant opportunities to these players. Although over 6,200 hotel rooms are expected to be added in the premium segment alone during FY10-11, analysts anticipate that the demand-supply gap will remain intact.

Number of hotel rooms (by category)



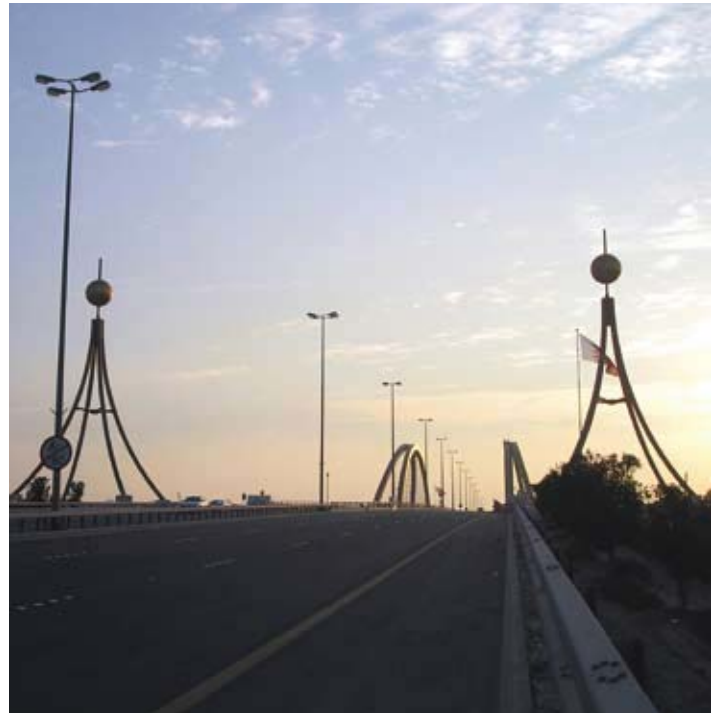
Source: Annual review of the hotel industry, CRIS INFAC, September 2009

The hotel industry in India continues to appear attractive in the medium term, driven by fundamental growth drivers, including the uptrend in domestic tourism and increasing FTAs. Moreover, the growth of niche tourism, including medical, adventure and rural tourism, augurs well for the growth of the industry in the future.

Lower rates are likely due to increased competition.

Middle East

2009 was an extremely challenging year for the Middle East and North Africa region, which registered an average decline in RevPAR of approximately 15% to 20% compared with 2008. Individual markets were impacted differently and there were also some exceptions. Beirut, for example, achieved an increase in RevPAR of over 90% due to the renewed political stability in Lebanon, while Jeddah witnessed growth in RevPAR of approximately 7%, driven by strong increases in corporate demand coupled with limited supply.



The delay in developing tourism generators coupled with the plethora of hotel rooms presently under construction is likely to delay the speed of recovery.

Several markets holding rates successfully

Regionally, although the Gulf Cooperation Council (GCC) markets of Oman, Bahrain, Kuwait and Riyadh have witnessed declines in occupancy in 2009, all were able to maintain their rate integrity or in some cases achieve significant increases in average room rates. It is anticipated that these markets will have the distinct advantage of a relatively speedy recovery once demand recovers, although some markets will face pressures from new supply.

Downward pressures in Dubai

Dubai had achieved the most significant decline in performance across the region, marked by a 35% reduction in RevPAR. Corporate belt-tightening coupled with leisure travelers seeking discounted packages and booking at the last minute placed significant downward pressure on occupancy and average room rates. Furthermore, new supply additions are further exacerbating the declines in performance and will most likely postpone the recovery in Dubai.

A key concern for Dubai is the emirate's proposed supply pipeline which is anticipated to substantially increase by 26% in 2010 and further increase by 19% in 2011. Even after taking into account the hotel projects which have been announced as cancelled or put on hold, it is anticipated that Dubai will still have an additional 37,500 rooms by 2013, which represents an increase of 74% from its current inventory today. Although the Dubai government has been successful in further developing its infrastructure in order to accommodate additional tourists, many private developers have faced liquidity problems and their tourism projects for Dubai have been either significantly delayed or put on hold for an unspecified time frame. The delay in developing these tourism generators coupled with the plethora of hotel rooms presently under construction in Dubai, is likely to lead to significant oversupply in Dubai's lodging sector and delay the speed of recovery.

The impact of the financial crisis has been less severe on Abu Dhabi's lodging market compared to Dubai, mainly due to a major shortage of hotel rooms in Abu Dhabi. Abu Dhabi is moving close on the heels of Dubai's strategic positioning as a tourism destination through its cultural and entertainment tourism projects along with an expansion of its airport. This is anticipated to create a shift in demand from corporate traffic to a more balanced mix of corporate and leisure visitors. However, an additional 21,000 rooms across the city by 2013, which represents an increase of 165% from its current inventory today, may prove to be challenging for Abu Dhabi hoteliers.

Investment considerations

Overall, Saudi Arabia, Libya and Iraq still offer significant development opportunities due to strong underlying fundamentals in each country and limited product. In Dubai, there may be potential opportunities for investors to acquire under-construction or operating assets at attractive rates in the coming year. For hoteliers across the region, cost containment initiatives coupled with maintaining (and in some cases rebuilding) rate, while still offering value for money, will be the key focus in 2010.

For hoteliers across the region, cost containment initiatives coupled with maintaining rate while still offering value for money will be the key focus in 2010.

Russia

The Russian hospitality market is highly layered. There are the two major cities, Moscow and Saint Petersburg, boasting numerous hotels, very high rates and relatively high occupancy levels, whereas the Russian regions are characterized by a shortage of quality hotel supply and an underdeveloped tourist infrastructure.

During the years of high economic growth, the tourist flow rose rapidly along with direct investments in hotel development. The global financial liquidity crisis has, directly and indirectly, affected all sectors of the Russian economy. The hospitality sector also declined across all basic performance indicators.

Nevertheless, new projects continue to be built. We believe that the crisis has merely slowed down hotel development plans and filtered out the unstable market players.

Very few Russian cities can be marketed as leisure destinations. Most cities attract only business visitors and the hotel client base is formed by corporate clients, who are usually offered significant discounts against the rack rates, and will undoubtedly be expecting further reductions.



Moscow undersupplied

The Moscow hotel market is one of the most mature and developed in Russia. By the end of 2009, there were 261 hotels operating in Moscow (a 6% year-on-year growth rate), with around 40,000 rooms. Many key hotel operators are represented in the market, most of which were operating more than one property. Relatively high yields testify to the shortage of quality hotels. According to preliminary Ernst & Young estimates, occupancy at quality Moscow hotels will reach 59% for 2009 and the average room rate will be EUR 155.

RevPAR decreasing less in 2010

Russian hotels were showing a stable yield growth rate up to the end of the economic downturn. During this time, RevPAR dropped considerably in comparison with previous periods. We expect that in 2010 the rate of decrease will temper and RevPAR will level off, anticipating a minimal growth rate.

Pipeline subject to delays

Economic factors have made raising funds extremely expensive. Many hotel projects have been put on hold and construction timelines postponed. Financing of projects that were in the planning stage was all but stopped. Many hotel openings, which were planned to come into operation in 2009, have been delayed until 2010. Currently, the Russian 2010 pipeline includes 23 hotel projects (4,817 rooms) to be managed by international operators.

Investment considerations

Investors and operators considering launching a new hotel in Russia are not only looking at Moscow and Saint Petersburg. They see high potential in the major Russian regional centers, especially those with a population over one million. The wish lists of the international chains usually include the centers of the oil and gas regions, Novosibirsk, Yekaterinburg, Chelyabinsk, Kazan, Ufa; the center of the Far East Region, Vladivostok; and Sochi, the city of the Winter Olympic Games 2014.

The downturn has led to a considerable gap between the sellers' and the buyers' expectations of hotel property prices. Owners are still trying to sell their properties at pre-downturn levels, while buyers are expecting considerable discounts. Investors or operators are undertaking very careful object investigations and surveys.

Due to the quality accommodation shortage in Russia, local administrations have developed special programs aiming at encouraging hotel construction, mainly offering tax and land benefits. However, market operators and investors regularly complain about bureaucratic barriers preventing these incentives from being pursued.

We believe that the crisis has merely slowed down hotel development plans and filtered out the unstable market players.

Spain

Spanish households saw their economic power fall through 2009, although their discretionary income increased, mainly due to the fall in inflation caused by reduced economic activity and the fall in interest rates. The Euribor, fixed by the European Central Bank, is at its lowest level ever and over 95% of Spanish mortgages have variable interest rates. This increase in discretionary income resulted in the highest level of savings in recent years rather than greater consumption. Meanwhile, the unemployment rate has increased over the last 12 months to over 19%.

The main tourist feeder markets of Germany, the UK and France have also suffered, meaning that foreign demand has continued to fall, accentuated by competition from lower-priced Eastern Mediterranean countries.



The government's
regeneration plan budget was
exhausted within one month.

Falling hotel stocks

It is unsurprising that both individuals and company personnel are travelling less, which directly affects hotel income, with RevPAR in 2009 falling in many regions by over 20%. The stock exchange quotes of the two main hotel chains, NH Hoteles and Sol Meliá, are a good indicator of current conditions: in the 18 months between 28 March 2008 and 30 September 2009, the share listings of both companies fell by 24.17% and 57.88% respectively.

Consolidation slow but likely to accelerate

The buying and selling activity of hotels during the period between January and September 2009 was moderate at best. Some companies reorganized their portfolios and others took advantage of the economic climate to expand. The economic downturn, the strict conditions imposed by the financial institutions and, in particular, difficult access to financing, all constrained hotel investments. Nonetheless, it is worth noting that the chain Hotasa Hoteles added six hotels to its network. According to media reports, in the first 10 months of 2009, 18 purchase and sale operations were finalized, mainly in the vacation sector. During this time, hotels such as the Meliá Princesa in Madrid changed hands, being sold to BBVA.

The relatively fragmented Spanish hotel market is ripe for consolidation, and we anticipate collusions and takeovers to take place in the aftermath of the economic downturn. In September 2009, NH and Hesperia announced that they had reached an agreement to integrate their hotel management activities to create the largest Spanish hotel group in terms of hotel numbers and turnover. The aim of the agreement is to consolidate management activities, maximizing cost-saving synergies.

According to the BNP Paribas Real Estate⁵ report on the European hotel market, the main hotel chains have changed their expansion plans in the present economic downturn climate, focusing mainly on leasing and management contracts rather than investment through acquisition or new build.

Hotel chains have also been seeking other methods to obtain financing for their expansion plans. Sol Meliá announced recently it was floating exchangeable bonds and NH increased its share capital and sold non-strategic assets.

The clear slowdown of large-scale operations has affected merger activities in the sector such as portfolio operations (including takeover bids) and new project start-ups, although observers predicted greater movement in the second half of 2009.

Investment considerations

The government's Tourism Facilities Renewal Plan (Plan Renove Turismo) was approved in November 2008 and implemented through a new line of official loans from the Instituto de Crédito Oficial with EUR 400m available for 2009. The amount was exhausted within one month of the Plan coming into force. In May 2009, the Council of Ministers approved a further increase of capital for the same year of EUR 600m, which was exhausted within six days. According to the published data, the Plan has so far financed 1,091 investment projects aimed at modernizing and improving tourist establishments, resulting in an investment of over EUR 800m and the creation of approximately 15,000 jobs.

According to recent economic press reports, the Secretary of State for Tourism has assigned a further EUR 400m of the 2010 budget to the second phase of the Plan.

⁵ <http://www.realestate.bnpparibas.com>

United Kingdom

The UK has seen a significantly sharper drop in gross domestic product (GDP) than in previous economic downturns, with a consensual view that GDP will not return to pre-recession levels until 2012. Although the hospitality sector tends to lag the onset of a recession, UK hotel consumption has historically tracked GDP, suggesting that there is a way to go until a recovery.

Corporate travel accounts for around 60% of UK hotel demand, and has driven a year-on-year UK RevPAR fall of 10.4% in 2009 (per Tri Hospitality). This was originally occupancy-driven as hoteliers sought to maintain rates, but fierce price competition in the early part of the year resulted in a 7.5% room rate decline in 2009, with occupancy down 2.4%.

The 3-4 star field continues to be the key battleground as operators flex their rates to compete with the budget offerings. While corporate rates are extremely low and business was lost to the budget segment due to reduced expense budgets, many 3-4 star hotels, led by the brands, have benefited from a refocus on leisure business and the successful packaging of rate offers. As a result, and with the current stay-at-home attitude of British travelers and a weak sterling, the 3-4 star hotels have outdone the budget operators on quality and value for money.



London holding up

The London market took longer to be affected by the economic downturn than the rest of the UK, and only entered into negative RevPAR territory following Lehman Brothers' collapse in October 2008. Despite apocalyptic forecasts by some commentators, London hotel occupancy in particular held up reasonably well (down only 1.5% during the first 10 months of 2009). This was largely due to a comparatively buoyant leisure market, the weakness of sterling helping to maintain both UK domestic and overseas tourist traffic.

RevPAR for 2010 remaining flat

Both the London and regional UK hotel markets experienced some slowing in the rate of year-on-year RevPAR decline in Q3 and Q4 2009. However, demand patterns remain unpredictable, corporates are continuing to seek rate reductions in their annual rate renegotiations, and there may also be an adverse impact from a potential post-election reduction in government and public sector expenditure. Consequently, we believe Q1 2010 will be particularly difficult and that year-on-year RevPAR growth will not return until Q4 2010 at the earliest. Overall, we expect 2010 RevPAR in the UK will be flat on 2009 at best.

Pressure to consolidate

We expect that, as in previous recessions, the market will begin to consolidate and that this may start to happen in early 2010. Indeed, there are signs that the banks are providing impetus to this process as they start to exert pressure on more highly leveraged owners. As such, while we may not see many hotel closures, we believe there is likely to be a shift in ownership, with smaller hotel owners at greater risk.

Active development continues largely to be the preserve of the budget sector both through new builds and conversions. Nonetheless, as the capital and gateway city, London continues to see the most development as the focus moves towards the Olympic Games in 2012, with more than 13,000 new rooms predicted to come online over the next two years. New openings are planned by, among others, Hilton, Starwood, Shangri-La Hotel Group and Park Plaza.

Elsewhere in the UK, the market in Edinburgh continues to grow and other key cities such as Manchester and Birmingham anticipate their rise out of recession. In general, however, development and refurbishment is on hold for many – the lucky few who can afford it are building themselves a strong position in anticipation of the upturn. At the luxury end, this includes both the London Savoy and Turnberry resort in Scotland which have undergone multi-million pound investments, while Holiday Inn has recently completed a rebranding exercise.

Investment considerations

The lack of availability of debt finance and a continuing gap between potential buyers' and sellers' price expectations has resulted in the lowest level of hotel sales since 1992 in terms of expenditure and since 1969 in terms of transaction volumes. There is also a general scaling-back of refurbishment expenditure, but while this conserves cash in the short term, such actions run the risk of eroding brand value.

Hotel operators are recognizing the need to be flexible over management agreements that were often negotiated in their favor at the height of the market, with incentive fees and furniture, fixtures and equipment expenditure particular areas of potential revision. More proactive property owners are also increasingly employing asset managers to seek greater cost efficiencies from operators.

The UK government has not generally seen hospitality and leisure as a priority industry sector and it has been adversely affected by increasing regulation (e.g., the smoking ban) and minimum wage increases in recent years. Low interest rates and government fiscal stimuli have increased household discretionary income in 2009 and helped maintain consumer spend, but expected tax rises in 2010 may have a depressive effect on hotel leisure spend.

Corporate rates
are extremely low.

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