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Budget, Mid-Market Hotels Offer Cheap Sleep

By Alec Luhn

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Budget hotel Ibis Moscow Paveletskaya is one of the most profitable hotels in Moscow. **Francois Kotler**

Picture the Moscow hotel market as an upside-down pyramid, with a throng of five-star luxury hotels at the top and the city's lone budget hotel, the Ibis Moscow Paveletskaya, at the bottom. The pyramid is now righting itself, as mid-market hotels continue to open and budget hotels start to be built.

That's the picture David Jenkins, head of hospitality at consulting firm Cushman & Wakefield, drew in this reporter's notebook at a recent Moscow hotel conference. Eventually, Moscow's price categories will look like those of other major cities, with a large number of budget options, a medium amount of mid-market offerings and a smaller amount of luxury hotels, he said.

"Over the next seven years the pyramid will reverse," Jenkins said, predicting 20 new internationally branded budget hotels in Moscow within the next half-decade.

"An Ibis isn't sexy, but it makes money," he added, noting that the Ibis Moscow Paveletskaya is one of the most profitable hotels in the city given its high revenue per available room and low construction cost.

Regional cities are also expecting a wave of mid-market and budget hotels, with international players eyeing not only the *millionniki* — the cities beyond Moscow and St. Petersburg with million-plus populations — but also much smaller cities. Most of the franchise and management companies in these segments are international brands, with the Russian company Azimut forming a notable exception.

Although no universal definitions of each segment exist, three- and four-star hotels are often considered mid-market, and budget hotels often correspond to one- or two-star ratings.

Recent construction deals confirm the trend toward nonluxury hotels. Last month, Hilton Worldwide announced deals for four new hotels in Russia, including a mid-market and a budget hotel in Volgograd. The latter of these will be built as part of a multisite agreement with a Russian developer that includes the future construction of 11 other hotels, most of them in the budget category, in cities such as Novosibirsk, Rostov-on-Don and Ufa. The deals made Russia the biggest growth market for Hilton Worldwide.

"I think the volume's going to be in the focused-service [brands with limited options for food and meeting space], Hilton Garden Inn in the mid-market and Hampton by Hilton in economy," said Mike Collini, Hilton vice president of development for Turkey, Russia and Eastern Europe, about his company's plans for expansion in Russia. "They provide a stronger return on investment and are right for the regions of Russia and the outskirts of Moscow and the suburban markets."

Outside of Moscow, however, brands are wary of repeating the mistake of Yekaterinburg — a regional city oversaturated with a sudden glut of rooms.

Moscow Madness

Mid-market hotels that have opened recently in Moscow include the four-star Ramada Moscow Domodedovo (134 rooms) located near Domodedovo Airport and the three-star Hotel Aminyevskaya (223 rooms) located on Aminyevskoye Shosse in western Moscow. At least three more are planned to open in 2012, and a Hampton Inn budget hotel is scheduled to appear in 2013.

Moscow's shift from upscale to more economical hotels is hardly surprising given how hotel markets in other cities have developed, consultants said. Initially, five-star hotels come into demand, not only for their accommodations but also for their restaurants, bars and event spaces.

"As a rule, the market starts to fill up from the upper end of the scale," said Marina Smirnova, senior vice president of Jones Lang LaSalle Hotels. The mid-market hotel segment follows later, and in Moscow it has been gradually building up since 2005. Now the budget segment is poised to grow, she said.

Except for St. Petersburg and the Black Sea resort towns, most new construction in the regions is mid-market for now, Smirnova added.

The lack of mid-market hotels is hampering the domestic tourism industry, said Kurt Ritter, president and CEO of the management company Rezidor Hotel Group.

The mid-range segment "is really where the future of the market lies because people don't have the budget to pay $300 to $400 to sleep," Ritter said. Rezidor, which manages brands including Radisson and Park Inn, has hotels in Kaliningrad, Moscow, Rostov-on-Don, Sochi and St. Petersburg. The company, already the largest international hotel group in the country, is currently developing 19 new hotels in Russia.

Dynamic pyramid models aside, the financial crisis also acted as a catalyst for the mid-market and budget boom by making customers more sensitive to prices. Corporate demand is driving current mid-market expansion all over Russia and especially in the regions, with Russians accounting for most business-related stays, Smirnova said. In Moscow, however, foreigners make up 60 percent of the pool of business customers, she said.

An Unmet Demand

The concerns of the development side play a more decisive role than customer demand in the nonluxury boom, since even the more-developed Moscow upscale hotel market still hasn't exhausted demand, Jenkins said. Investors are looking to make their money back faster in light of the higher lending rates that appeared after the crisis, and budget hotels are the cheapest hotel projects to build and the fastest to pay off.

Smirnova estimated that a hotel built with 20 percent borrowed funds would take six to eight years to pay off. Meanwhile, Ibis hotels, which have the cheapest room rates but cost the least to build, usually pay themselves off in five to six years, according to Accor, the French management company that owns Ibis.

The basis of the shift toward economical lodging options is the huge overall demand in Moscow. The capital currently has 10,000 to 12,000 branded hotel rooms and 40,000 unbranded rooms, and even if 5,000 budget rooms appear over the next five years, it will barely make a dent in demand, Jenkins said. Although the entry level here is higher due to land costs, hotels can be successful almost immediately, as long as they're near the metro — and can make higher profits than in the regions, consultants and hoteliers said.

"Moscow is much more interesting from a business point of view and [in terms of] return on investment for the owner," said Philippe Bone, director of development for Russia and the CIS at Accor.

Despite its enthusiasm for Moscow, Ibis does a large part of its business in regional cities. Besides Moscow and St. Petersburg, the company also has hotels in Kazan, Nizhny Novgorod, Omsk and Yaroslavl. Another is set to open in Samara in January.

"We would like to get hotels in all regional capitals and all main industrial cities," Bone said.

Ibis isn't alone. Most of the major international hotel companies in Russia have either built or are planning nonluxury segment hotels in the regions.

Into the Regions

The largest of them, InterContinental Hotels Group, has opened Holiday Inn mid-market hotels in Chelyabinsk and Samara, alongside its hotels in Moscow and St. Petersburg. Those regional cities that are growing and have seen infrastructure investment are ideal locations for mid-market brands such as IHG's Holiday Inn and Holiday Inn Express, said Robert Shepherd, the senior vice president of development in Europe for IHG.

"That's what will really be suited to those locations and in particular because it offers good value for money," Shepherd said. "Consumers these days are very savvy, they're very into understanding what they get for their money," he added. IHG plans to open 100 hotels in CIS countries by 2020.

Hotel brands maintain that the demand exists to support their ambitious expansion plans. One indication of the growing need for accommodations is the doubling of plane flights from Moscow and St. Petersburg to regional cities over the past three years, said Vladimir Ilichev, Hilton's development director for Russia. Travelers are much more eager to stay in internationally branded hotels than the existing Soviet-era hotels, he said.

"In the regions, demand is growing in the economy and mid-market segments. The crisis affected it, but now it is growing," Ilichev said.

The companies are also confident that demand exists outside the million-plus cities. Whereas Hilton previously had considered only the millionniki for new projects, the company is now looking at 20 to 30 cities with populations of 500,000 or even less, Ilichev said. Accor's Bone said his company is also looking at smaller cities.

As for geographic location, Rezidor is interested mainly in the Volga region and West Siberia, since these areas have a lot of industry to sustain business activity, Ritter said. Meanwhile, Venture Investments & Yield Management, which has invested in Park Inns in Kazan and Izhevsk, considers Yaroslavl and the Golden Ring cities to be particularly promising, said Vyacheslav Ivanov, head of hospitality projects.

Room for Success?

Nonetheless, hotel companies have become more cautious in the wake of the crisis, as well as the boom — and subsequent bust — of the Yekaterinburg hotel market. Hotel operators there were complaining about oversaturation even as several new internationally branded hotels, including Hyatt, Novotel, Ramada and Park Inn hotels, opened in the wake of the crisis in 2009 and 2010.

"In 2007, we thought we should go to almost every city in Russia," Ivanov said. "Today, we are revising the pipeline very carefully ... Sometimes we have stories like Yekaterinburg, where we just sold our land plot" to avoid this overly competitive market, he said.

Indeed, one of the main pitfalls of regional hotel markets is their lack of depth, market players said. According to Jenkins, after one or two large hotels open in a regional city, it often takes three to four years for demand to catch up with supply. It's very easy to accidentally develop an oversupply of rooms, Ilichev said, and so Hilton always recommends owners and developers do a feasibility study at the beginning of the process.

Another challenge is profits, which are not likely to be as high without charging the expensive rates of Moscow. Economy and mid-market hotel operators must be especially careful about their overhead, since their margins are not as large. Ilichev warned that excessive food and beverage services could often drive up costs. He also said it's essential to work with a local architect who can optimize the site and who knows local regulations.

"The concept of the design is the most important first step for saving money on operating costs," Ilichev said.

Ibis has perfected a franchise model that minimizes construction costs and maximizes profit for budget hotels in the regions. According to Bone, all projects are large-scale and done with a local partner. At 37 square meters, Ibis rooms are 30 percent to 40 percent smaller than those of other hotel brands. Bone said its construction costs can be as low as 50,000 euros ($68,000) per room — development costs for mid-market and budget hotels usually range from 70,000 to 100,000 euros per room, according to Jenkins.

At the same time, Ibis hotels enjoy high demand and provide steady revenue, increasing the profitability of their owners, Bone said.

"It means this product is right for the Russian market," he said.

This article is part of a business report on Russian hotels. See a table of Moscow hotel openings in 2011-12 and read about trends in hotel training in the other section of this report.

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