2019

Moscow hotel market overview

March 2019

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Summary

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Tourism

2018 is likely to be remembered as the “2018 FIFA World Cup year”, during which Moscow was visited by 4.5 million tourists, including 2.3 million foreigners and 2.2 million Russians. However, regardless of the inflow of tourists during this sporting mega-event, Moscow remains one of the most popular tourist destinations in the country, with a stable positive trend in visitor dynamics. If in 2014 Moscow reported 16.6 million visitors, by the end of 2018 the City of Moscow estimated the annual volume of visitors to have reached 23.5 million. This positive trend in Moscow tourism dynamics is driven by domestic travel. If in 2014, the share of Russian citizens visiting Moscow for various purposes represented 65% of all arrivals, by 2018 their share reached 73% of all visitors.

Supply

By the end of 2018, Moscow’s modern quality hotel stock, in Cushman & Wakefield’s expert opinion, amounted to 20,100 keys, representing just a quarter of the combined room stock in the capital which the city estimated at 81,000 keys. After the market stock increased by nearly 2,500 keys over 2017-2018 (annual growth rates of 9.4% and 4.0%, respectively), the average annual growth rate in 2019-2024 is likely to be capped at 5.6%. Net expected market growth in 2019 – 715 rooms (3.6%).

Operating performance

Operating results of the Moscow hotel market in 2018 were greatly influenced by the 2018 FIFA World Cup. A record growth in RevPAR (44.2%) was driven mainly by the 36.5% increase in ADR, whereas occupancy levels – with the exception of the dates around football matches – generally remained within the norm (76.6%). By the end of the year, however, hoteliers started registering a gradual return in demand for accommodation (and its price sensitivity) to previous volumes. In the absence of significant changes in the economic and political sphere and considering recent hotel stock expansion, hotel players generally expect 2019 to show a very moderate growth of room rates and operating revenue. The situation calls for active work with the client base and rigorous monitoring of operating costs.

Investment market

Investors’ interest in prime hotel properties in Moscow and St. Petersburg remains high, and shortage of such assets, coupled with real existing barriers to entry in these markets, contribute to initial yield compression. At the same time, with a few exceptions (The Pekin and Tsentralnaya Hotel deals, reported in early 2019, both earmarked by new foreign owners for a complete redevelopment), the Russian hotel investment market remains local.

Summary

Russian Federation: main macro indicators	2017	2018	2019	2020	2021
GDP growth, %	1.5	1.6	1.4	1.6	1.5
RUB/USD	58.3	62.7	65.3	63.9	63.1
CPI, %	3.7	2.9	5.2	4.3	3.8
GDP deflator, %	5.2	9.6	6.4	5.1	4.2
Interest rate, %	10.6	9.0	10.0	10.1	9.5
Current Balance, % of GDP	-1.3	1.8	1.6	1.1	0.0
Private consumption, %	3.3	2.2	1.0	1.9	2.3
Government spending, %	0.4	0.2	0.6	0.9	0.9
Capital outflow, bn USD	12.0	-37.2	-89.3	-99.9	-95.4
Unemployment rate, %	5.2	4.8	4.7	4.6	4.6

Source: Oxford Economics 14/01/2019

Demand

Visitation and top feeder markets

Predictably, 2018 turned out to be rich in political and cultural events. In Moscow, however, the year is likely to be remembered as the “2018 FIFA World Cup year”. Initial concerns, ranging from a complete inability for city residents to lead normal lives due to wide-spread traffic jams and/or extreme tourist crowds, to a humiliating failure of the football event due to an international boycott or critically small numbers of visitors because of foreigners’ fears of everything Russian (football hooligans, wild bears on Red Square, cold weather even in summer) as well as complicated access to the country. The overwhelming success of the World Cup, however, was equally unexpected by all. According to the City of Moscow, during the five weeks of the mega-sporting event, Moscow was visited by 4.5 million visitors (2.3 million — foreigners, 2.2 million — Russian citizens). The largest delegations arrived from China (223,200 visitors) and the USA (167,400 visitors).

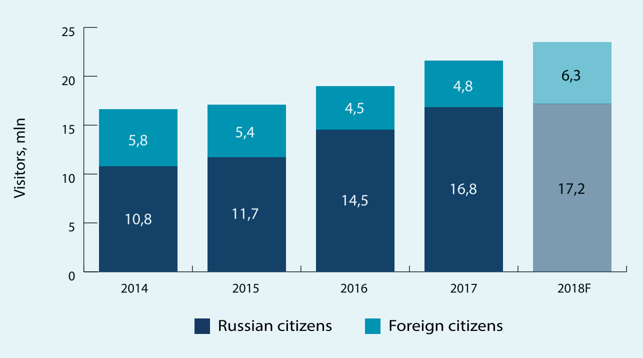
Regardless of tourist inflows during mega-sporting events, however, Moscow remains one of the most popular tourist destinations in the country, with a stable positive trend in visitor dynamics. If in 2014 Moscow reported[1] 16.6 million visitors, by the end of 2018 the City of Moscow estimated the annual visitation volumes to have reached 23.5 million.

Predictably, the volume of foreign tourists is directly linked to external and political factors, so compared to the peak year of 2014 (when the number of foreigners arriving to Moscow reached 5.8 million), the following years saw a declining volume of tourists. This trend reversed in 2018 — initial estimates of the overall number of foreign visitors exceed 6 million.

Meanwhile, it is the growing share of domestic demand that has been driving the positive trend in Moscow tourism dynamics. If in 2014 the share of Russian citizens visiting Moscow on various purposes represented 65% of all arrivals, by 2018 their share reached 73% of all visitors.

A sharp increase in the number of guests accommodated by the Moscow hotels (from 5.6 million in 2015 to 8.5 million in 2016 and 9.8 million — in 2017) shown in Diagram 2, in Cushman & Wakefield’s opinion, is reflective not so much of a sudden surge in hotel demand as of a change in the number of lodging facilities tracked by the Federal Statistical Bureau which, starting from 2016, surveys a wider range of hotels. One hopes that such an expansion will ultimately paint a more adequate picture of the Moscow lodging landscape. However, the visible data updates in 2016–2017 should be treated as ‘work-in-progress’, and the City of Moscow continued its methodical work to account for and classify various means

Diagram 1. Moscow arrivals



Source: Tourism Committee, City of Moscow, 2018

[1] To account for tourist arrivals, the City of Moscow uses various methods, including mobile phone roaming data

of collective accommodation in 2018 — in preparation for the 2018 FIFA World Cup.

Nevertheless, when analysing the hotel accommodation demand in 2016–2017, one spots a slight decline in the number of Russian clients lodged in hotels: from 66% on average in 2012–2016 to 62% in 2017. The share of accommodated foreigners, accordingly, increases from the average of 34% in 2012–2016 to 38% in 2017. At the same time, if the number of accommodated Russian citizens in 2016 and 2017 remained practically unchanged (6.1 million each year), the total number of accommodated foreigners over the same period jumped by 49%. Among the large number of possible explanations of this phenomenon, one of the most plausible is the ultimate 'legalisation' of the formerly 'grey business' of small-size hotels which, in 2016, finally started providing accurate data to the Federal Migration Service.

Overall, however, dynamics of accommodated hotel guests in 2016–2017 was in line with the growth in the number of bed nights (14.5% and 15.6%, respectively), which meant that the average stay remains practically unchanged at 2.7–2.8 nights.

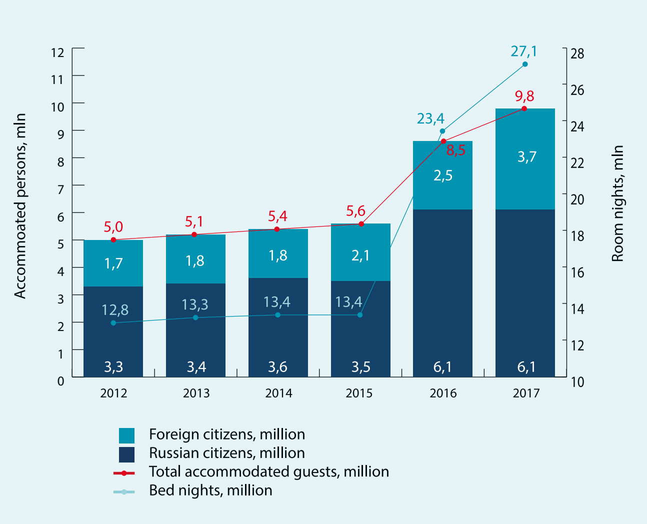
The reshuffle in the main feeder markets registered in 2014 on the back of the political and economic sanctions shows little signs of recovery. Of the top-8 countries historically producing the highest volumes of visitors to Moscow, only China and Israel continue to demonstrate positive growth rates, with China being the clear front-runner in growth. Between 2016-2017, the number of Chinese tourists visiting Moscow grew by 23%, and in comparison to 2012, more than doubled (137%).

Demand structure

Even though the growth in the share of leisure visitors to Moscow (particularly, during the long weekends, summer vacations, and other seasonal holidays) over the last decade has been obvious to all, Moscow remains, first and foremost, the political and economic centre of the Russian Federation, with hotel demand thus being typical for a business destination. On the positive side, business demand has a low elasticity factor, which has traditionally limited occupancy drops in Moscow hotels by 10%. It was this inelastic demand, typical for business clientele (FITs as well as corporate travellers), that historically generated up to 80% of room nights in modern quality hotels. As a logical consequence, however, business-driven demand caused half-empty weekends and low occupancies during traditional holiday seasons (New Year, May holidays, summer breaks).

The current revival of the city, the direct result of a series of urban development initiatives launched in 2012 by current mayor Sergey Sobyanin, gradually led not only to the complete modernization of its infrastructure, but also greatly increased

Diagram 2. Accommodation demand, 2012–2017

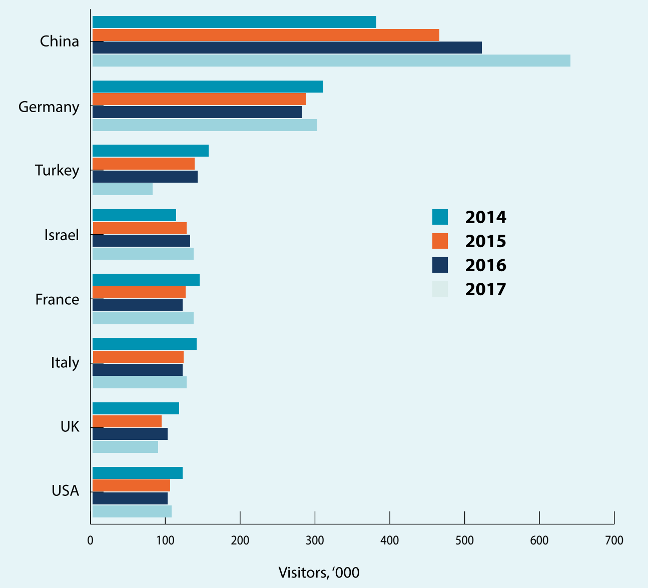


Source: Moscow Statistical Bureau, 2019 the number of organized public events regularly hosted in Moscow. This directly contributed to the current boost in inbound visitations, as well as the growing share of trips undertaken for leisure purposes. One of the most successful street projects launched by the city is the 'Moscow Seasons' festival which combines a series of fairs, festivals, concerts, including the 'Journey to Christmas', 'Moscow Spring', 'Moscow Summer', and 'Golden Autumn' festivals, all extremely popular with visitors. According to Sergey Sobyanin, in 2018 alone, 'Moscow Seasons' attracted 66 million guests, boosting the popularity of the city with visitors. Naturally, not all visitors are non-residents, and only a share of them generate hotel stays, but the growing attractiveness of Moscow's cultural life allows local hotels to expect additional demand, particularly, in periods of traditional slowdown in business activity. Market players note, however, that leisure visitors paying for their stays out of their own pockets, are very sensitivity to hotel rates. In practical terms, leisure-driven occupancy levels of any given hotel are directly linked to the hotel's price policy. The 2018-2019 New Year/Christmas season demonstrated this very clearly — while the Moscow hotel market showed a very high occupancy level (up to 90% overall, according to the Mayor), the highest occupancies were registered in hotels offering the steepest discounts and promotional rates. Such a price-dumping strategy, however, back-fired, as rate-sensitive hotel guests chose to save on meals, buying ready-made food from the local grocery stores and cooking sausages in the kettles provided in hotel rooms.

Nevertheless, a noticeable increase in the number of non-business-related trips (including shopping and leisure) potentially allows hotels to grow the overall share of room nights sold at 'open tariffs' (include best available rates as well as tariffs offered through OTAs — booking.com, etc.) which change dynamically in response to any fluctuations in demand. To reduce the level of booking charges payable to OTAs, branded hotels actively try to maximize the volume of room nights sold through their direct channels. Thus, if used with skill, open tariffs can be the tool for hotels to drive their Average Daily Rate (ADR) up.

Transient business demand (both for individual travellers and corporate accounts) remains flat, reflective of a lack of significant improvements (actual and expected) in the Russian economy and political life. This effectively strengthens the negotiation positions of large corporate users, thereby creating a basis for price wars between hotels (including those of different formats / categories) and preventing corporate rates from increasing. All market players surveyed for this study noted a minimal change in corporate rates both in 2018 and 2019. When accounting for inflation and the 2-pp growth of VAT effective from 1 January 2019, the net room revenue contributed by corporate accounts may actually shrink. The booking window in the transient segment remains short and rarely exceeds one week. Such a short booking window is caused by several factors, including increased market supply which allows a

Diagram 3. Top feeder markets



Source: Tourism Committee, City of Moscow, 2018 prospective traveller to find an available hotel room practically any day of the year. Another reason is the reduced share of foreigners among business travellers (meaning fewer foreigners need to obtain a Russian visa which might require hotel booking confirmation), as a direct consequence of the 'import-replacement strategy', whereby many foreign companies opened/moved manufacturing facilities to Russia.

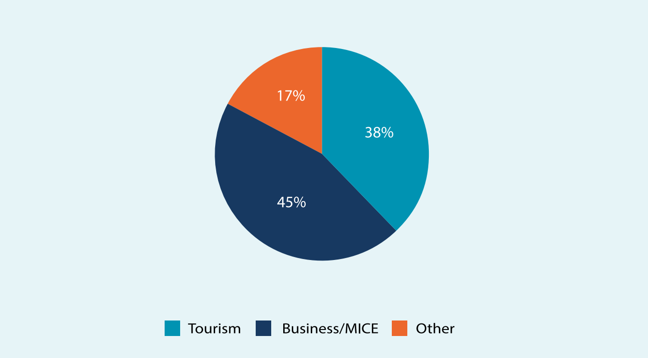
The increase in guest room supply over 2017—2018 (see the following section) created a situation whereby the booking window may become even shorter both for individual travellers and for medium-size business groups. Market players are concerned that even in the MICE-segment, business groups of up to 100 delegates can delay arranging accommodation and meeting space until 4—5 days ahead of an event, without experiencing any undue price pressure.

On the topic of the MICE-segment, the number of large-size annual trade fairs featuring at least 1000 exhibitors/delegates (4–5 events per year) as well as "one-offs" (1-2 events per year) remains unchanged, and they still generate enough accommodation demand, enabling hotels to improve their profits during the business season. With respect to smaller-size business-related and private events usually held in hotels, their budgets still do not show signs of growing, however, their volumes do. To mitigate the still-stagnant situation with flat conference & meeting package rates, city hotels start diversifying their menus, coming out with more economic options suitable to budget-conscious companies, betting on the 'lower package/higher volume of repeat business' strategy.

Accommodation demand from organized leisure groups remained stable in 2018, except for the 2018 FIFA World Cup period and the weeks surrounding it, providing stable occupancies in hotels traditionally working with these clients from late April to late September. Global tour operators continue to bundle up Moscow with St. Petersburg, so any unexpected change in the "rules of the game" in the Northern capital (including but not limited to: changing dates for the St. Petersburg Investment Economic Forum — SPIEF, significant increase in hotel rates demanded by the St. Petersburg hotels, etc.) has a direct impact on the summer season for the Moscow hotel market. Still, the market players confirm that the 2019 summer season is actively booked by the global tour operators, although with minimal changes to the previous year's rates.

In summary, the surge of demand registered by Moscow hotels, around the 2018 FIFA World Cup and events directly relating to it, displaced the activity more traditional for this period of the year to the shoulders of the mega-sporting event. This effect, however, turned out to be short-lived, and by the end of 2018 the market was back at usual volumes of room night sales, with no substantial increase in demand anticipated over 2019.

Diagram 4. Hotel demand structure, 2017



Source: Moscow Statistical Bureau, 2019

Moscow airports

Moscow airports

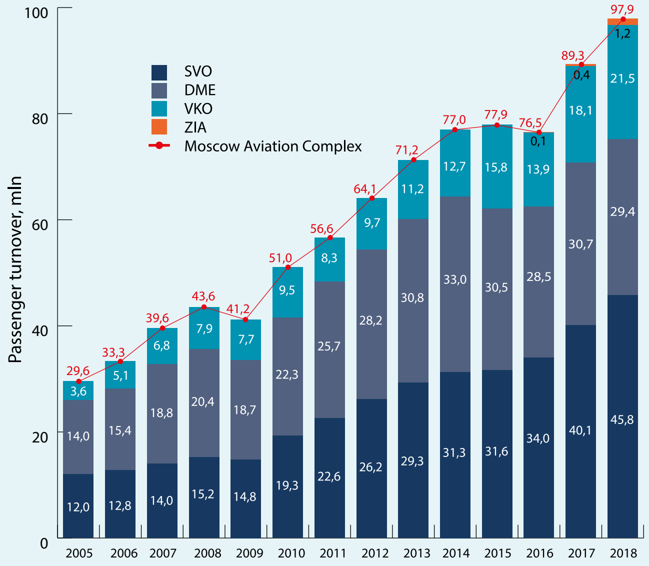
Moscow is served by four civil airports (Sheremetyevo, Domodedovo, Vnukovo, and Zhukovsky) with a combined transport capacity of some 100 million passengers a year. Moscow is the main hub of all domestic and international air transportation in the country. In 2018, according to Rosaviatsia (the federal agency regulating aviation transport), passenger turnover in the Moscow airports reached 97.9 million, or 47% of all commercial passenger flows to/from Russia.

For four years in a row, Sheremetyevo has occupied the number one spot, being the main hub for the largest national air carrier, Aeroflot – Russian Airlines. Over this period, Sheremetyevo managed to grow its share of total passenger turnover from 41% in 2015 to 47% in 2018. Over the same period, the share of the second-largest airport, Domodedovo, which traditionally works with large-scale charter companies, has declined from 39% in 2015 to 30% in 2018, although in absolute terms, the passenger volumes processed by this airport changed only slightly. The number of passengers flying to/from Vnukovo continues to increase, but even the 22-percent share in the passenger turnover held by the 3rd largest airport (2018 data) makes it hard to compete with the two main gateways to Moscow. Finally, Zhukovsky, opened in May 2016 and still the only airport without a direct Aeroexpress train to the centre of Moscow, is showing a rapid growth in passengers (from 425,000 in 2017 to 1.16 million in 2018), but its impact on the overall passenger dynamics of the Moscow aviation complex is still minimal.

Overall, the 10-percent improvement in the annual passenger turnover registered in 2018 is an impressive result. Having said that, the 10% growth is an aggregate indicator, and individual airports showed very different dynamics. For example, while Sheremetyevo and Vnukovo posted double-digit growth (14% and 18%, respectively), Domodedovo has lost volume (-4% year-on-year).

How will Moscow airports grow their business after 2018? After impressive progress with infrastructure upgrades to Sheremetyevo and Domodedovo, both of which managed to improve the level of passenger comfort over 2017-2018, the next big step is the long-awaited opening of new (additional) runways, needed to increase the number of flights and boost passenger turnover. It is generally expected that the new runways in Sheremetyevo and Domodedovo will open in 2019 and 2021, respectively.

Diagram 5. Moscow Aviation Complex – passenger turnover dynamics



Source: web-sites of Moscow airports, 2019

Moscow hotel market — growth will have to wait

Moscow hotel market — growth will have to wait

As part of the preparations for the 2018 FIFA World Cup, the City of Moscow completed a truly Herculean task of cataloguing and grading all available collective means of accommodation in the city. As of late 2018, the city officially counted 1,646 lodging facilities of all types with a combined capacity of 80,700 rooms and 224,000 beds. Of these, the room stock offered in 955 hotels of various grades comprised 62,900 keys, and the balance was split between hostels (672 lodging facilities with 17,600 rooms) and furnished apartments (19 apartments, 194 guest rooms).

Due to the wide diversity of the officially registered lodging establishments, however, Cushman & Wakefield maintains its own databased focusing on 'modern quality hotel stock'[2]. In late 2018, Moscow modern quality hotel stock, in Cushman & Wakefield's opinion, amounted to 20,100 keys, still representing just a quarter of the combined room stock in the collective means of accommodation in the capital.

Between 2009-2018, Moscow modern quality stock increased by 202%[3], growing at an average rate of 8.1% per annum, with peaks in 2010 (21.1%), 2011 (10.1%), and 2017 (9.4%). Obviously, the largest increases in supply take place as the economy bottoms out after a crisis, when it becomes possible for investors to complete development schemes that had been experiencing delays due to reduced demand and/or project financing deficits.

In Cushman & Wakefield's view, it is the lack of positive news about growth prospects for the national economy over the foreseeable future, among other factors, which is to blame for the meagre expected supply growth rates in 2019–2024, during which the average annual increase is not expected to exceed 5.6% per year. In 2019, assuming all announced projects reach completion, the market is projected to grow by 3.6%, roughly in line with the previous year's results (4%).

Modern quality hotels completed in 2017–2018 are listed in Table 1.

According to Cushman & Wakefield's research, in early 2019 there were as many as 3,100 guest rooms under development or construction and due for completion between 2019–2021, with over 4,600 rooms scheduled to hit the market between 2022–2024.

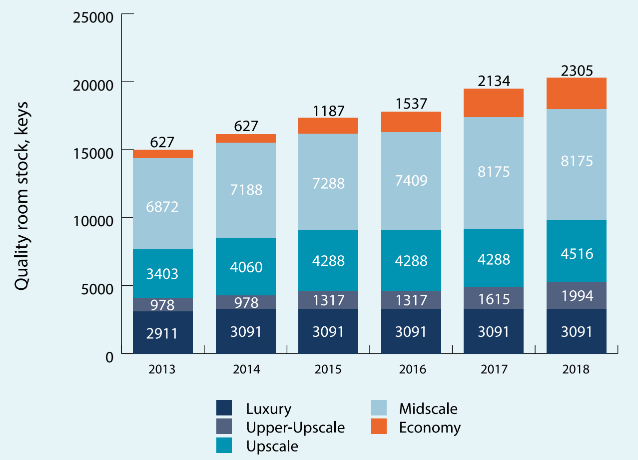
Table 2 lists the hotel projects with a high probability of completion over the mid-term.

[2] Modern quality hotel stock mostly includes hotels built in the post-soviet period, or substantially renovated during that period, which provide the quality of accommodation and service expected by a modern traveler. The majority of modern quality hotel rooms are branded – or comply with the international or domestic brands' standards.

[3] All calculations are based on the room stock nominally opened in any given period.

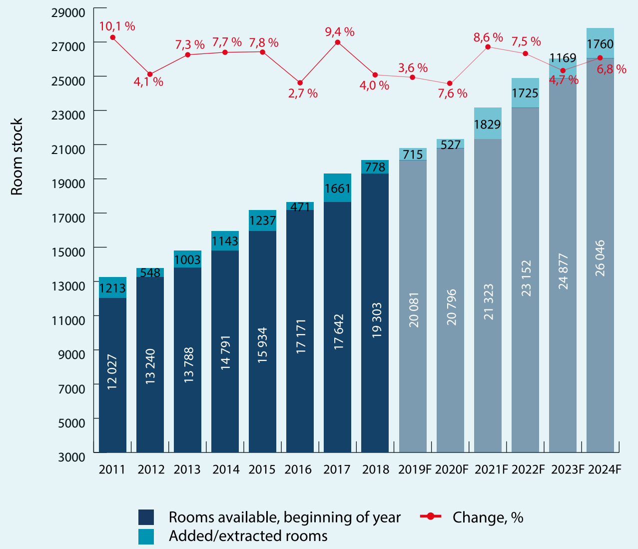
Moscow hotel market — growth will have to wait

Diagram 6. Dynamics of structural change in Moscow quality room stock (2013–2018)



Source: Cushman & Wakefield, 2019

Diagram 7. Moscow hotel stock dynamics – actual and projected



Source: Cushman & Wakefield, 2019

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Table 1. Hotels completed in 2017–2018

Name	Grade	Address	2017	2018
Ibis Oktyabrskoe Pole	Budget	2 Marshal Rybalko St., Bldg. 5	240	
Ibis Budget Oktyabrskoye Pole	Economy	2 Marshal Rybalko St., Bldg. 5	114	
Hilton Garden Inn Krasnoselskaya	Midscale	11a Verkhnyaya Krasnoselskaya St.	292	
Azimut Moscow Smolenskaya Hotel	Midscale	8 Smolenskaya St.	474	
Hyatt Regency Moscow Petrovsky Park	Upper-Upscale	36 Leningradsky Prospect, Bldg. 33	298	
Holiday Inn Express Paveletskaya	Economy	33 Dubiniskaya St.	243	
Holiday Inn Express Khovrino	Economy	12 Levoberezhnaya St.		171
Radisson Blu Olympiyskiy Hotel Moscow	Upper-Upscale	1 Samarskaya St.		379
Pentahotel Moscow	Upscale	15 Novy Arbat St.		228
Total			**1661**	**778**

Source: Cushman & Wakefield, 2019

Table 2. Hotels expected to open in 2019-2021

Name	Grade	Address	2019	2020	2021
Crowne Plaza Park Huaming	Upscale	13-14 Vilhelm Pieck St.	340		
Holiday Inn Express Baumanskaya	Economy	2 Perevedenovskiy Lane	128		
Mercure Neglinnaya	Midscale	Neglinnaya St.	100		
Hampton by Hilton Rogozhskiy val 12	Economy	12 Rogozhskiy val St.,	147		
Marriott Krasnoprudnaya	Upper-Upscale	12 Krasnoprudnaya St.		216	
Novotel Taganskaya	Midscale	70 Zemlyanoy val St.		156	
7 Days Premium Novoalexeevskaya	Midscale	24 Staroalexeevskaya St., Bldg. 1–7		155	
Ibis Tyoply Stan	Economy	N/a			250
AC Hotel by Marriott	Upscale	8 Bolshaya Sadovaya St.			240

See next page >

Moscow hotel market — growth will have to wait

Table 2. Hotels expected to open in 2019-2021

Name	Grade	Address	2019	2020	2021
Toyoko Inn Krasnoselskaya St.	Midscale	15/17 1st Krasnoselsky Lane			220
Ibis Akademicheskaya	Economy	m. Akademicheskaya			220
Mercure Gostiny Dvor	Midscale	4 Ilyunka St.			181
Radisson Blu Leninsky Prospect	Upper-Upscale	2 Udaltsova St.			150
Luxury hotel in Zaryadye	Luxury	Park Zaryadye			148
Fairmont Moscow	Luxury	1st Tverskaya-Yamskaya, 2			145
Ibis Moscow Semenovsky	Economy	34 Velyaminovskaya street, bld 23			120
Zubovsky Square Hotel Roza Rossa	Upper-Upscale	7 Zubovskaya St.			90
Bvlgari Hotel	Luxury	9/15 Bol. Nikitskaya St.			65
Total			**715**	**527**	**1829**

Source: Cushman & Wakefield, 2019

Radical room yield improvements in 2018 — direct consequence of the mega-sporting event

Radical room yield improvements in 2018 — direct consequence of the mega-sporting event

A comparable analysis of markets hosting the 2018 FIFA World Cup demonstrates that Moscow has gained much more than other Russian host cities — thanks to it becoming a hub both for the teams and football fans who chose to shuttle to various locations to attend the games but preferring to return to Moscow in-between. Unsurprisingly therefore, driven by the World Cup, the Moscow hotel market showed outstanding results for 2018.

Comparing the two most active months of the year which registered peak demand and RevPAR (Room Yield) results to the same months a year before, one cannot help but notice that June 2018, over the last two weeks of which all group matches took place and were attended by the highest number of fans from all over the world, exceeded the results of July 2018 (year-on-year RevPAR growth of 212% and 209.6%, respectively).

Quite logically, the hikes in profitability were driven by the ADR (year-on-year growth – 36.5%), whereas the occupancy levels in the Moscow hotels – with the exception of the dates around the football matches - generally remained within the norm (76.6%, year-on-year growth of 4.1 percentage points). It should be noted that even in June and July 2018 average monthly occupancies failed to reach 90%, exceeding the previous year's results only by 5-6 percentage points.

Despite concerns of an inevitable decline in occupancy levels during weeks between the end of the 2018 FIFA World Cup and the return of the Moscow hotels to a business-as-usual mode, the Aug-Oct operating performance of hotels remained very upbeat. In fact, instead of falling occupancies, demand for accommodation increased to compensate for the business displaced by the mega-sporting event.

The end of 2018, however, witnessed the gradual return of hotel demand to usual levels. Occupancies remained high in Nov-Dec 2018, but the high sensitivity of clients to the cost of accommodation did not allow hotels to increase ADRs by any substantial degree – even compared to 2016-2017.

While 2018 generally was a great success for Moscow hoteliers, it raised serious issues which undermine the sustainability of operating results, which had finally recovered from the latest (2014-2015) economic crisis, over the mid-term. With demand for accommodation returning to its starting position by the end of the year, the Moscow hotel market needs to somehow absorb the room stock added over the last two years (even if one keeps aside tens of thousands of the previously unaccounted for guest rooms/beds in hostels and other quasi-hotels).

To make matters worse, operating margins of hotels in 2017-2018 became increasingly under threat due to the line personnel outsourcing practice. Consistent efforts of the federal tax authorities to outlaw dubious business schemes which permitted outsourcing organizations to "save" on hourly wages of part-time staff (positions, typically taken by citizens of the CIS countries filling vacancies of waiters, maids and other line staff), by not adding social security and other charges, resulted in the gradual dissolution of bad-practice firms and, ultimately, the raising of hourly rates to higher, more realistic levels. On top of that, stagnant hourly rates in the hospitality industry (according to the market players, over the decade they grew by a mere 7%) substantially demotivated line personnel, attracting them to similar-paid yet less labour-intensive positions in the retail sphere (cashiers, sales assistants, etc.).

Combined, these factors caused a creep-up in operating costs for the Moscow hotels, forcing hoteliers to amend their

Radical room yield improvements in 2018 — direct consequence of the mega-sporting event

Table 3. Moscow modern quality hotels – trading performance

	2013	2014	2015	2016	2017	2018
Occupancy, %	68,5	63,7	67,7	72,0	72,5	76,6
change, pp		-4,8	4,0	4,3	0,5	4,1
Average Daily Rate, RUB	6002	5953	6430	6710	6521	8898
% change		-0,8	8,0	4,3	-2,8	36,5
Revenue per Available Room, RUB	4111	3790	4353	4829	4728	6816
% change		-7,8	14,9	10,9	-2,1	44,2

Source: Rosstat, Oxford Economics, Cushman & Wakefield, 2019

Radical room yield improvements in 2018 — direct consequence of the mega-sporting event

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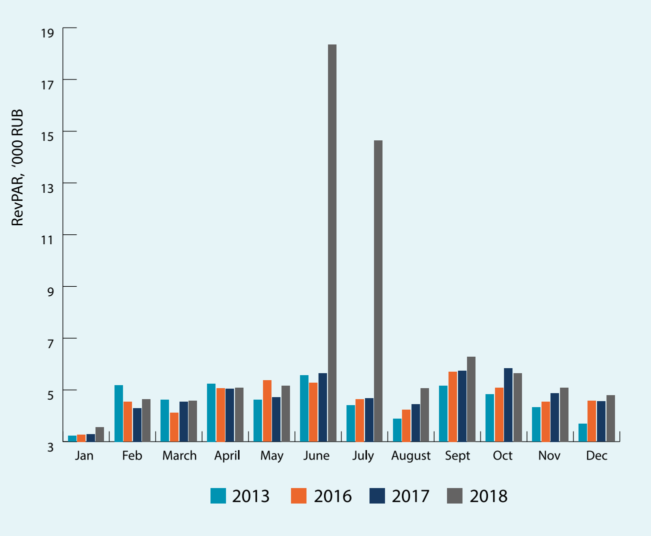
traditional hiring practices. Several Moscow hotels tried to insure themselves against the risk of employing temp staff by increasing their full-time personnel headcount, offering them higher wages (to match those in the industry) and a full range of benefits coming with the FTE status. Other managers ran a serious audit of outsourcing companies, terminating long-term contracts with the less reliable ones and – theoretically, at least — expanding the labour pool to draw from. The hotels affiliated with large hotel chains and/or owned by the same investors contemplated setting up their own outsourcing companies to share line staff between several properties. In a move that would have been unimaginable 5-10 years ago, Moscow hoteliers started talking about providing staff/ancillary housing (i.e. dormitories for line staff). Each of the discussed solutions obviously has its advantages and disadvantages, but what seems certain is that growing labour costs will continue to erode profit margins of hotels — a situation aggravated for hotels with high levels of physical and moral obsolescence which will experience difficulties competing with newer properties on rates.

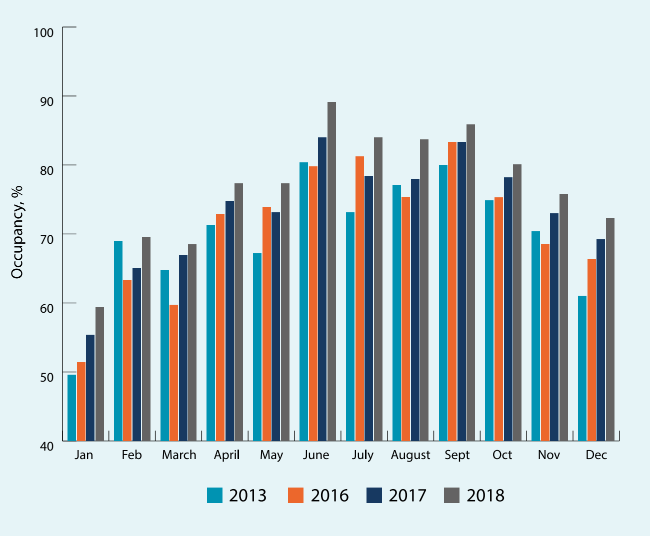
The sword of Damocles in the form of creeping operating costs continues to hang over the hoteliers' heads, forcing

Diagram 8. Wider market: monthly RevPAR in 2013, 2016–2018



Source: Cushman & Wakefield, 2019

Diagram 9. Wider market: monthly Occupancy in 2013, 2016–2018



Source: Cushman & Wakefield, 2019

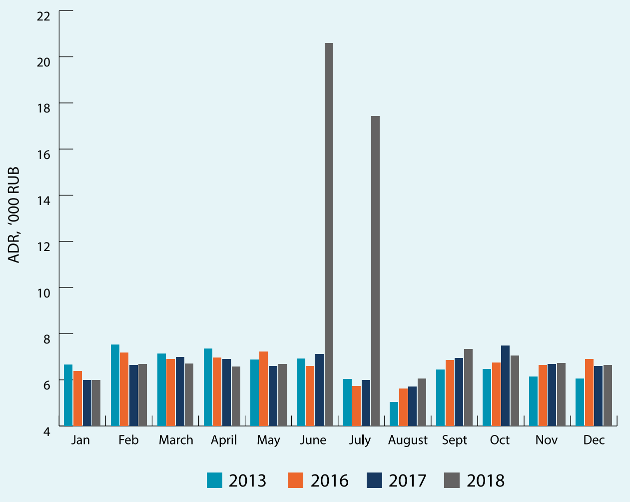
Radical room yield improvements in 2018 — direct consequence of the mega-sporting event

them to rigorously control regular purchases (including the never-ending process of trying to replace the imported items and ingredients with domestically produced ones) and periodically re-assess the staffing plan. To optimize operating processes, more and more hotel companies managing more than one property in Moscow are considering centralizing (also called "complexing", or "clustering") a number of functions (principally, purchasing, sales, HR, finance) among several hotels and then distributing these costs on a pro rata basis.

To summarize the above, despite delivering positive results, 2018 cannot be seen as a year which changed the fundamentals of the hotel business in Moscow. Moreover, due to the factors listed below, 2019 is likely to become a very challenging year:

- Lukewarm growth rates of the national economy, which faces periodic 'pinches' in the form of additional sanctions imposed by the 'collective West', had hoteliers betting on increasing leisure visitation to ultimately push occupancy rates to 75-80% - more typical of key European gateway cities like Paris and London. It was hoped this would reduce Moscow's reliance on business-generated demand. These hopes, however, are yet to materialize.
- Moreover, the visa reforms (able, as per the industry experts' estimates, to increase visitation to Russia's main tourist capitals — Moscow and St. Petersburg — by 10–20% per annum) openly discussed at the governmental level immediately after the end of the 2018 FIFA World Cup, are still to yield any results.
- Increase in modern quality room supply (some 2,500 keys over 2017–2018), not accompanied by a growing demand, puts pressure on room rates in operating hotels.
- A rise in operating costs (driven predominantly by growing labour costs) threatens to erode hotel profit margins further – forcing hotel managers to seek new ways to optimize operating processes.

Diagram 10. Wider market: monthly ADR in 2013, 2016–2018



Source: Cushman & Wakefield, 2019

Hotel investment market — exceptions that prove the rule

Hotel investment market — exceptions that prove the rule

Hotels as an investment product have demonstrated their high agility in periods of economic crises, the latest one registered in 2014–2015. Unlike rental businesses, hotel assets, if managed well, have a minimal risk of a one-time cash flow discontinuance — which explains why hotel yields are not necessarily aligned with yields applied by investors to ‘classical’ rental properties of similar grades. This situation is, naturally, applied to prime properties (modern quality hotels, well located and professionally / efficiently run).

The Russian hotel investment market is currently represented by the following main groups of investors:

- Large Russian specialized companies (including but not limited to Gleden Invest, Soyuz Marins Group, AFK Sistema, Amaks, Kievskaya Ploschad, Safmar Group) which often have their own hotel investment groups or hotel operating companies/brands. These hotel investors have a comprehensive understanding of the local market’s realities and usually control costs well;
- Foreign investors, including those from the CIS countries as well as China, that expect hotel investments in Moscow or St. Petersburg to produce higher returns than comparable investments in their own countries or in Europe;
- Foreign investors owning their own hotel companies/ brands for which buying hotels (or, more frequently, hotel development projects) is often the only way to enter the market. Recent examples of such investors are the Korean Lotte Group (Lotte Hotels & Resorts) and the Maltese International Hotel Investment Plc (Corinthia Hotels) which invested in properties in Moscow and St. Petersburg;
- Non-specialized Russian investors who view hotel investments as a way to save and increase their personal wealth (particularly, on the back of reduced profits and growing risks in other commercial property sectors – offices, retail projects), limit political risks (compared to buying hotels abroad), or pursue other goals (e.g., increasing prices of residential units – generally, high-quality ones - comprising part of the same mixed-use complex).

Logically, investment rationale differs widely from one type of buyer to the next, making it difficult to understand or justify their asset pricing. The fact that the market remains thin also does not help the analysis. According to Cushman & Wakefield, between 2008-2018 the Moscow market registered only 15 hotel investment deals with a total room count of nearly 4,000 keys and a total investment volume just under $2,0 billion (of these, only one transaction was closed in 2018 - the sale of the 154-room Holiday Inn Moscow Vinogradovo). Finally, the closed nature of hotel investment deals whereby, instead of bricks and mortar, a buyer acquires the operating business, and many transactions occur directly on a principal-to-principal basis, makes hotel pricing difficult. The limited amount of data available to hotel buyers to help them make informed decisions creates real risks for deals to fall though when pricing expectations of sellers and buyers do not match.

Nevertheless, drawing upon Cushman & Wakefield’s professional experience in the main European markets and in Russia, as well as relying upon the investment deal data available to us, we assess the expected/required prime hotel yields to be in the following ranges: Moscow - 6-7%, Saint-Petersburg – 8-9%, other large Russian regional markets - 10-12%. Table 4 demonstrates how the prime hotel yields in Moscow and St. Petersburg compare to those in other major European markets.

It should be noted that in several Moscow-based hotel deals registered in 2015-2016, the net initial yield was in the range of 4-7%. Why would investors accept a yield below that of traditional (and more liquid) financial instruments – particularly, after the key rate set by the Central Bank of Russia started showing a tendency for growth (in Dec 2018 – to 7.75%)? In Cushman & Wakefield’s opinion, there may be several factors at play here:

Hotel investment market — exceptions that prove the rule

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- With respect to hotels located in Moscow or St. Petersburg, in Cushman & Wakefield's experience, low levels of net initial yield may be reflective of buyers' expectations of operational upside – either via active asset management or as a result of a renovation / complete overhaul of the property in a 'right location' (with physically deteriorated properties, however, estimating initial yields may be tricky);
- Secondly, continued delay in hotel profitability levels returning to their pre-crisis (before 2014) levels. This means that the net profits generated by the hotels are rarely sufficient to cover the initial investments (or may be sufficient assuming a very long payback period). To put it differently, an investor can still buy an operating hotel property at a price comparable or even lower than its replacement value (this is generally applicable to the hotels in regional markets).
- Finally, a deficit of land parcels suitable for hotel development (especially critical for Upper-Upscale / Luxury properties) as well as high project financing costs create real barriers to entry, making it more logical for investors to buy an operating property rather than build a hotel from scratch.

The factors listed above generally explain the high level of interest from potential buyers for operating properties offered for sale, causing the initial yield compression effect.

Having said that, Cushman & Wakefield does not expect the Russian hotel investment market to see a meaningful increase in the number of hotel deals over the mid-term. The market remains thin and is rather local. Even the two landmark hotel deals closed in 2019, if analysed closely, merely prove this point:

- The historic Pekin Hotel is reported to be in the final stages of being sold by Hals Development, owned by VTB Bank, to a Chinese investor (strongly associated with Sichuan Railway Investment Group). While the deal size is not disclosed, hotel experts estimate it not to be below RUB6 billion.
- Another historic Luxe Hotel, formerly known as the Tsentralnaya, due to be fully redeveloped to feature a 200-key Upper-Upscale/Luxury hotel with 50+ apartments for sale, was sold by Safmar Group to a group of investors including MML (Viktor Rashnikov) and IHI Plc (owns and develops Corinthia Hotels). Deal size estimated by market players - RUB3.5-4.0 billion.

Upon a closer look, both hotel deals are in fact land acquisitions, albeit in landmark locations, where a hotel is just one of elements of a mixed-use scheme. In the ex-Tsentralnaya deal, a return on investment will be improved by the expected sale of the residential units. In the Pekin project, the Chinese investor is rumoured to be harbouring plans to add to the fully renovated Pekin Hotel a Chinese cultural centre – a likely signal of political motives behind the purchase. One way or another, both deals indicate additional factors motivating buyers, which does not allow one to classify them as straightforward, open-market hotel deals.

In Cushman & Wakefield's view, any 'tectonic shifts' in the Russian hotel investment market (mainly, Moscow and St. Petersburg) able to make these markets less inwardly-oriented and more transparent, are likely to take place only if there is an end to Russia's political and economic isolation. This would open it up to institutional-quality investors who could set clear pricing rules and create new demand for this type of asset.

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Table 4. Prime Yield Ranges, %

Market	Management Agreement	Trend
London	4.5–5.00	Stagnating
Paris	4.00–4.50	Stagnating
Berlin	5.00–5.25	Compressing
Barselona	5.00–5.50	De-compressing
Istanbul	9.50–10.00	De-compressing
Moscow	6.00–7.00	Stagnating
Madrid	4.75–5.25	Stagnating
Rome	5.00–5.50	Compressing
Amsterdam	5.50–6.00	Stagnating
Prague	6.00–6.25	Compressing

>

Table 4. Prime Yield Ranges, %

Market	Management Agreement	Trend
Vienna	5.50–5.75	Stagnating
Milan	5.50–6.00	Compressing
SaintPetersburg	8.00–9.00	Stagnating
Brussels	5.75–6.00	Compressing
Dublin	5.50–6.00	Compressing
Budapest	6.50–7.00	Compressing
Frankfurt (centre)	5.25–5.50	Compressing
Athens	6.50–7.00	Compressing
Lisbon	6.00–6.25	Compressing
Warsaw	6.00–6.50	Stagnating

Source: Cushman & Wakefield, 2019

About Cushman & Wakefield

Cushman & Wakefield has been successfully operating in Russia since 1995 and currently employs more than 150 experienced and highly qualified experts. The Moscow office implements projects in all major cities in Russia and the CIS, forming transnational teams for solving complex tasks when necessary. There are 12 key areas of company activity, covering all the sectors of commercial real estate: offices, retail, warehouses, hospitality and tourism, land. The range of services provided includes the leasing of spaces, asset management, investment consulting, real estate operation, services for corporate clients, project management, development consultancy, representing tenant’s interests, valuation, hospitality and tourism.

Cushman & Wakefield is one of the largest companies in the global commercial real estate market, with a turnover of $8.2 billion and a team of more than 51,000 specialists in more than 400 offices in 70 different countries.

For more information, visit our websites – www.cwrussia.ru and www.cushmanwakefield.ru

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