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# Hotels in MENA: How Much Can You Invest?

NEHME AYOUB, *Consultant & Valuation Analyst*  
HALA MATAR Choufany, *Managing Director*



HVS – Dubai Office  
Dubai Silicon Oasis Headquarters  
Building, 4th Floor, PO Box 341041  
Dubai, UAE  
Tel: +971 4 5015586  
[nayoub@hvs.com](mailto:nayoub@hvs.com)  
[hchoufany@hvs.com](mailto:hchoufany@hvs.com)

With the cost of raw materials fluctuating and with global economic conditions shifting the types and patterns of demand, developers are becoming sceptical about when to build, what to build and whether to commit to construction contracts. Therefore, in this article we have taken into consideration the current demand characteristics of each market and have derived the maximum supportable investment for the development of a certain hotel asset in a certain market. We illustrate our findings for 12 markets in the MENA region across the following four hotel asset classes.

- Five-star – with three food and beverage (F&B) outlets and around 800 m<sup>2</sup> of meeting space;
- Four-star – with two F&B outlets and around 500 m<sup>2</sup> of meeting space;
- Three-star – with one F&B outlets;
- Two-star – with one restaurant/bar and no room service.

We note that although we were in the past accustomed to seeing five-star hotels costing US\$500,000 to US\$800,000 a room in Dubai, for example, current economic conditions globally, and hotel market realignments regionally, would make such investments non-viable for a few years to come. Our estimates of maximum supportable investment aim to test the investment tolerance in the prevailing conditions.

## **Methodology**

In deriving the maximum supportable investment, our starting point was our estimate of the stabilised performance of each hotel category in each market. The estimates made are based on our industry and market experience, the proposed pipeline for each market and, where applicable, imposed cartel agreements and rate caps. We assumed typical operations in each market, the typical facilities listed above and used the financing terms currently available to a developer. Therefore, when a proposed property is designed differently from what we have described, or when a developer enjoys preferred borrowing terms, or both, the maximum supportable investment would drift away from what we derive. The estimates we present are indicative averages only.

1. Stabilised occupancy and average rate in each market and in each hotel asset class are projected, reflecting current market dynamics.
2. Rooms revenue is assigned as a proportion of total revenue, as is typical for each asset class in each market.
3. The percentage of gross operating profit (GOP) is assigned to each market.
4. Net operating income is derived from Steps 2 and 3.
5. Applying equity yields of 17-19% – the actual figure depends on the market and asset class – we calculate the required free cash flow to equity.
6. Assuming a loan to cost ratio of 60% with interest rates of 7-8% – the rate depends on the market – we calculate the average interest expense a year.
7. Having identified the debt/equity split we can calculate the maximum supportable investment per room that would provide investors with acceptable returns. We note that the scale of the investment is a function of occupancy and average rate and thus varies across markets and asset classes accordingly.

We present in Table 1 our derived maximum supportable investments by asset class across the markets, and compare these to the respective RevPAR that would result from our projections of occupancy and average rate. RevPAR would be a direct indicator of current hotel market realignments. If we were to rank these investments, we would note a misalignment between a city's ranking according to its maximum supportable investment and its ranking by RevPAR. This misalignment is a result of the different rooms to revenue ratio that the different markets enjoy; therefore, RevPAR could be misleading were it to be used as a basis for deciding on where to invest.

Although GOPPAR would be the preferred profitability indicator, the revenue mix, departmental expenses and undistributed expenses could change after an operator's reactive strategy to the crisis. Such changes cannot yet be determined and are likely to be temporary: a short-term tactic adopted to weather the storm. Operational norms are likely to be restored as markets stabilise again. Consequently, we have adopted RevPAR instead of GOPPAR.

**Table 1 Maximum Supportable Investment per Room and RevPAR across MENA (US\$)**

		<u>5-star</u>	<u>4-star</u>	<u>3-star</u>	<u>2-star</u>
<b>Abu Dhabi</b>	Investment	420,000	335,000	200,000	112,000
	RevPAR	215	172	113	73
<b>Amman</b>	Investment	260,000	170,000	105,000	70,000
	RevPAR	118	88	58	38
<b>Beirut</b>	Investment	350,000	200,000	119,000	61,000
	RevPAR	186	106	68	35
<b>Cairo</b>	Investment	280,000	187,000	113,000	73,000
	RevPAR	111	85	59	38
<b>Damascus</b>	Investment	215,000	150,000	97,000	59,000
	RevPAR	117	85	55	35
<b>Doha</b>	Investment	470,000	365,000	255,000	150,000
	RevPAR	191	173	132	81
<b>Dubai</b>	Investment	390,000	295,000	186,000	111,000
	RevPAR	192	157	113	74
<b>Jeddah</b>	Investment	280,000	200,000	150,000	100,000
	RevPAR	141	106	84	59
<b>Kuwait</b>	Investment	300,000	200,000	130,000	72,000
	RevPAR	156	116	82	51
<b>Manama</b>	Investment	355,000	275,000	172,000	110,000
	RevPAR	161	149	111	70
<b>Muscat</b>	Investment	350,000	240,000	150,000	90,000
	RevPAR	183	133	95	60
<b>Riyadh</b>	Investment	300,000	230,000	150,000	95,000
	RevPAR	162	120	89	61
<b>Min.</b>	Investment	215,000	150,000	97,000	59,000
	RevPAR	111	85	55	35
<b>Max.</b>	Investment	470,000	365,000	255,000	150,000
	RevPAR	215	173	132	81
<b>Average</b>	Investment	330,833	237,250	152,250	91,917
	RevPAR	161	124	88	56

On account of its high average rate and high F&B revenue contribution Doha commands the highest investment among five-star properties, and Damascus the lowest. The average supportable investment for a five-star hotel for this set of cities is US\$330,833 a room. However, Damascus has the second-lowest RevPAR, just ahead of Cairo, which has a RevPAR of US\$117. Abu Dhabi has the highest RevPAR, of US\$215, and Dubai the second-highest (US\$192).

The three most expensive markets in which to develop a four-star hotel (Abu Dhabi, Dubai and Doha) and the three least expensive (Damascus, Amman and Cairo) are the same as they are for the five-star market. There is some variation among the remaining markets. There is a wider variation in RevPAR in the four-star market, yet Damascus has the joint-lowest RevPAR and Doha the highest, in keeping with their rankings in terms of supportable investment.

The wide range of minimum and maximum supportable investments across the asset classes would force a developer to make a compromise between its class of property and its market. For example, an investment of US\$150,000 a room would allow the development of a four-star hotel in Damascus but would be absorbed by a two-star property in Doha.

The three-star category has the widest range of maximum supportable investment per room primarily because most markets witness a huge gap in average rate among this class when compared to the four-star standing. Both two-star and three-star classifications are relatively new, as most markets are used to positioning themselves as luxury destinations, leaving the budget hotel concept to local management companies. However, changing financial times are working in favour of international budget and economy brands which, once inserted in the markets, would raise marketwide average rate.

Moreover, as the MENA region opens up to international investors and businesses, and with intra-regional travel on the rise, we can assume that some convergence in average rate is bound to happen; the relatively cheap destinations of today will be able to retain more of the international traveller's willingness to pay, and presently expensive destinations will have to cut room rates as the competition among cities in the MENA region grows. Therefore, long-term investors developing a hotel today in Damascus, Amman or Cairo will reap the rewards in due course.

*Third party consultants should be consulted before undertaking any investment decision. For questions or enquiries about this article please contact HVS Dubai or the authors.*

**About the Authors**

HVS has a team of experts that conducts our operations in the Middle East and North Africa. The team benefits from international and local backgrounds, diverse academic and hotel-related experience, in-depth expertise in the hotel markets in the Middle East and a broad exposure to international hotel markets. Over the last three years, the team has advised on more than 250 projects in the region for hotel owners, developers, lenders, investors and operators. HVS has advised on more than US\$25 billion worth of hotel real estate in the region.

*For further information, please contact one of the authors. Or visit [www.hvs.com](http://www.hvs.com)*



**Nehme Ayoub – Consultant & Valuation Analyst**

Email: [nayoub@hvs.com](mailto:nayoub@hvs.com); Mobile: +971 50 9024912



**Hala Matar Choufany – Managing Director**

Email: [hchoufany@hvs.com](mailto:hchoufany@hvs.com); Mobile: +971 50 4597930