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Branded Budget Hotels in Europe:
A Development Guide

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The objective of this article is to provide an up-to-date overview of the Branded Budget Hotel Sector in Europe and provide some useful guidelines on the space requirements, design principles and cost factors associated with the development of branded budget hotels (throughout the article we use the term 'budget hotels' to encompass budget and limited service hotels). We include current development cost estimates provided by global construction consultancy Davis Langdon and a basic viability model based on a simplified version of the methodology used by HVS in feasibility studies globally.

Introduction

Hotel developers, owners and operators are still trying to recover from the economic trough in hotel performance whilst also focusing on an appropriate strategy in terms of brand, product, deal structure and location to be well positioned for the recovery.

Whereas the development of midscale and upscale hotels usually carries a significant amount of development risk owing to the duration and complexity of the development process, the new breed of budget hotels offers (relatively) very efficient development that is clear-cut, cost-effective and quick, allowing developers to reduce development risk and the hotel/brand to become established in the market quicker.

According to Davis Langdon, the possibility to apply off-site modular methods of construction and making use of previously unviable or converted development space has also brought renewed attention to the budget hotel sector. Generally, modular methods of construction are offered at competitive prices while reducing total development time, on-site labour work, waste and contingency. The emergence of ultra-budget brands such as easyHotel with minimum space requirements and no frills has enabled developers to make use of more restrictive sites or buildings in terms of total size, layout or views.

Moreover, while bank loans continue to be challenging to obtain in the current lending environment, the total investment needed to develop, for example, a 125-room branded budget hotel in Europe is typically lower than €7,500,000 (excluding land cost) and therefore considered less risky for financing. That being said, development finance for any hotel development is still rare and comes with stringent conditions attached.

Performance

According to HVS's research and consulting experience, branded budget hotels have been more resilient to the credit crunch and economic downturn, overall experiencing a lower decrease in RevPAR than their midscale and upscale counterparts.

Broadly, we estimate that RevPAR for European branded midscale and upscale hotels dropped by 15-20% on average in 2009. This large decline in RevPAR was caused by a decrease in international and business travel resulting in significant price discounting in an effort to avoid losing important corporate accounts and conference events (which happened anyway) and to attract more price-sensitive leisure demand to replace some of the lost volume during the current economic crisis.

On the other hand, we estimate that European branded budget hotels have experienced an overall decrease in RevPAR of 5-10% throughout the same period. European branded budget hotels have benefited from an increase in the overall volume of room nights as business and leisure travellers traded down from more upscale accommodation.

As of year-to-August 2010, our research indicates that business travel is recovering and midscale and upscale hotels have registered double-figure RevPAR growth. However, this growth has been driven primarily by occupancy, showing that the economic recovery is still fragile and business and leisure travellers remain price-sensitive.

As a result, most international hotel operators have developed, improved or re-launched their budget brands to be able to respond to the growing demand from developers and the marketplace.

We consider that this is the right time to give an overview of the budget hotel sector in Europe and illustrate how the return on investment for a development project is evaluated.

Overview of Budget Hotels and Brands

Budget hotels have traditionally been positioned at the lowest extreme of the value-for-money equation, offering basic accommodation for relatively short periods of time at affordable prices. The main motivations to stay at budget hotels have traditionally been convenience of location and price.

The most suitable locations for the development of budget hotels are usually strategic business and travel locations such as city centres, business parks, motorway junctions/services areas, airports or railway stations. The lower space requirements and higher room-to-total-space ratio of budget hotels have the potential to make the most revenue out of the restricted sites that are frequently available in these locations. Moreover, given the high traffic and excluding market specifics, the lower published (and highly variable) room rate usually translates into very high occupancy levels. The limited extent of other services and public facilities translate into lower staff requirements and higher operating margins. Consequently, most of the revenue flows directly to the bottom line.

The typical space requirements of budget hotels are as follows:

Table 1 Typical Space Requirements (m^2, % of total)

	m^2	%
Bedrooms	1,500-1,700	50-70%
Circulation	350-500	10-20%
Front-of-the-House	100-250	5-10%
Back-of-the-House	250-500	10-20%
Gross Building Area per Room *	15-35	
Net Room Area **	10-20	

* GBA
** NRA

Source: Davis Langdon Research

However, the general increase in guest expectations and the emergence of more upscale budget and design budget hotels such as Holiday Inn Express, Hampton Inn by Hilton, Citizen M, Yotel and Qbic have raised the standards across all sectors. As a result, many budget brands have introduced modern design, up-to-date in-room technology and select F&B facilities in order to appeal to the 'new generation' of guests, attract longer stays, build loyalty and command higher rates.

Table 2 is a non-exhaustive list of the main budget brands in Europe, classified into four categories according to room size, room amenities, on-site facilities, design and service offered.

Table 2 Sample List of Budget Brands

Sample Brands*

Ultra-budget	Core-budget	Upper-budget	Design-budget
easyHotel	Travelodge	Holiday Inn Express	Yotel
Etap	Premier Inn	Hampton by Hilton	Qbic
Hotel F1	Ibis	All Seasons	Nite-nite
Premiere Classe	Super 8	InterCity Hotels	Sleeperz
Balladins	Motel One	Comfort Inn	The Big Sleep
Tune hotels	B&B	Days Inn	Citizen M
	Sidorme	Campanile	Dakota
		Kyriad	

* This list is not exhaustive

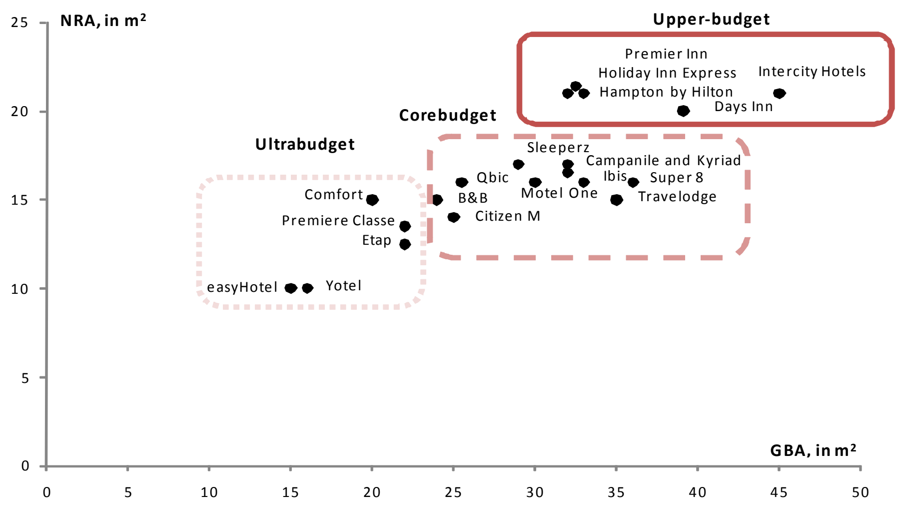
Source: HVS Research

This brand classification is both quantitative and qualitative. We have analysed the space and furniture, fixtures and equipment (FF&E) standards of these brands to gain more insight into their positioning with regards to the total space, level of investment required for development and the degree of in-room and out-of-room comfort provided to guests.

Chart 3 illustrates the typical space requirements of the major brands in Europe, as identified by HVS through research and feasibility studies conducted across Europe. However, we note that these figures are only indicative and many brands are willing to relax their standards for the right project opportunity.

We have plotted the Net Room Area (NRA) in square metres on the vertical axis and the Gross Internal Area of the Building (GBA) in square metres on the horizontal axis. The position of the specific brands in the chart gives an indication of the room size and extent of public and back-of-the-house areas. The ultra-budget brands are positioned in the lower left side with the fewest guest room and public space requirements. The space requirements increase towards the upper right side of the chart, with the core-budget brands positioned in the middle of the chart and upper-budget brands in the upper right-hand corner of the chart. The design hotel brands have been merged into the three-category classification system for illustration purposes.

Chart 3 Space Requirements by Brand (m2)



GBA: Gross Building Area

NRA: Net Room Area

Source: Hotel Groups and HVS estimates

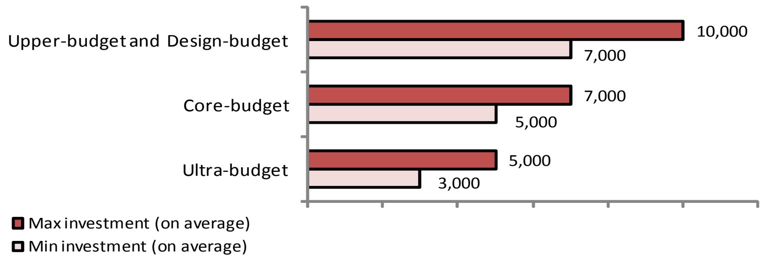
Chart 4 gives an indication of the necessary furniture, fixtures and equipment (FF&E) investment for the major budget brands in Europe, as identified by HVS through our research and feasibility studies. However, we note that these figures are only indicative and depend on the specific negotiations with local suppliers and installers.

FF&E includes all non-permanent, removable items within the hotel areas, such as guest room, restaurant, bar, meeting rooms and back-of-the-house hard and soft furnishings, operating equipment and décor.

These items are the most tangible indication of the degree of comfort and design provided to guests and they need to be replaced frequently. The traditional replacement period for soft items is three to five years and for hard items seven to ten years. Most hotel owners and operators set aside an annual allowance of at least 3-4% of total revenue to provide for the timely replacement of FF&E.

When the property is leased or owned by the operator, the operator would typically be responsible for the installation, replacement and removal of FF&E. On the other hand, when there is a management agreement in place this cost is typically borne by the owner, although the operator might be in charge of setting the budget.

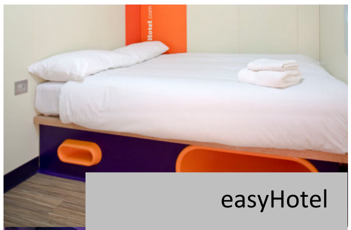
Chart 4 Average FF&E Investment in Branded Budget Hotels (€ per Room)

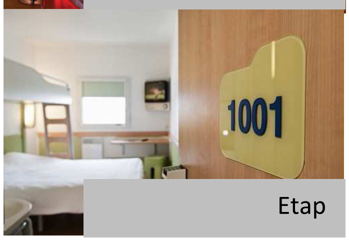


Source: Hotel Groups and HVS estimates

The following cost drivers and trends in FF&E have been identified:

- Brands that require less FF&E investment are typically those with more limited public and back-of-the-house areas;
- Brands and developers that use off-site modular methods of construction (such as Travelodge, Citizen M or Yotel) often include integrated bedroom and/or bathroom pods within the hard construction costs. Integrated bathroom pods usually cost between €2,500 and €3,500. Integrated bedroom and bathroom pods can range from €5,000 to €8,000 per room[1];
- Some of these brands (such as easyHotel and Qbic) target conversion opportunities where the shell of the building can be reutilised. For these brands, site clearance and FF&E represent most of the investment needed;
- Some of the design-budget brands have prioritised in-room technology and comfort over space. Thus, they can be positioned at the lowest extreme regarding net room area and invest as much in the guest room FF&E as upper-budget brands or some of their midscale counterparts.





[1] For the purposes of this comparison, we have reallocated these 'hard' costs to FF&E

Existing Supply of Branded Budget Hotels in Europe

According to Otus Analytics, there are more than 14,700 hotels in Europe operated by the major international chains, which is approximately 34% of the total hotel supply. This figure indicates that there is still a significant gap in hotel chain penetration compared to the US market, where branded hotels represent approximately 70% of the total.

Out of the nearly 15,000 branded hotels in Europe, 5,674 operate as budget or economy hotels which equates to 38% of the total number of branded hotels and 21% of the total number of branded hotel rooms. Table 5 illustrates what are the main budget brands in Europe by number of hotels and hotel rooms.

Table 5 Main Budget Brands in Europe

	Hotels	Rooms
Ibis	692	72,813
Premier Inn	583	41,146
Etap	405	33,868
Travelodge	389	26,017
Campanile	387	24,671
Formule 1	295	21,802
Holiday Inn Express	188	21,648
Premiere Classe	227	16,313

Source: Otus Overview Report – Europe 2010

The European Hotel Pipeline – Current Trends and Future Prospects

We have interviewed Pat Ford, President of Lodging Econometrics, Portsmouth, NH-USA to get his views on the future of the budget hotel's supply going forward and the specific role played by branded budget hotels throughout the crisis and future prospects.

According to Lodging Econometrics, hotel development has been in decline since the second half of 2008, which was the peak of the most recent hotel development cycle. Since then, the European hotel pipeline has declined at a compound annual rate of 4% owing to a lack of available lending for new projects and lower confidence in the hotel investment market.

Lodging Econometrics expects this declining trend to last until 2013 or 2014, until development lending becomes available again. For that to happen, additions to supply that were planned and developed at the peak of the market (and which opened in more recent years) need to have been absorbed by the market, enabling higher operating and financial results and making projects more attractive to investors, developers and lenders. We note that this might vary from market to market, but budget hotels are likely to be the first to recover.

Special Focus on the Budget Hotels Pipeline

Table 6 summarises the most recent data on the active European hotel pipeline provided by Lodging Econometrics as of Q1 2010. These data indicate that the number of branded budget hotels planned or under construction currently stands at 242, which is nearly 33% of the total projects in the pipeline.

Growing interest from developers and investors in these properties during the recession has boosted the number of branded budget hotel projects in the early planning stage to 102 (53% of the total project count at this stage of development).

The distribution of branded budget hotels varies greatly between European countries. Of the just over 475,000 branded budget hotel rooms in Europe, three quarters are in France, the UK and Spain. France has the largest number of rooms at 168,000, or 35% of Europe's supply.

Chart 7 illustrates that most future projects in the budget sector are planned in the UK (38% of the total budget hotel rooms planned), Germany (13%), Spain (13%) and Russia (10%).

The high proportion of branded budget hotels in mature hotel markets can be explained by the fact that an international operator usually seeks to establish the core upscale brand in the capital and selected secondary cities before developing midscale, limited service and budget properties to create critical mass. Consequently, emerging markets usually have more upscale than budget properties in the active pipeline.

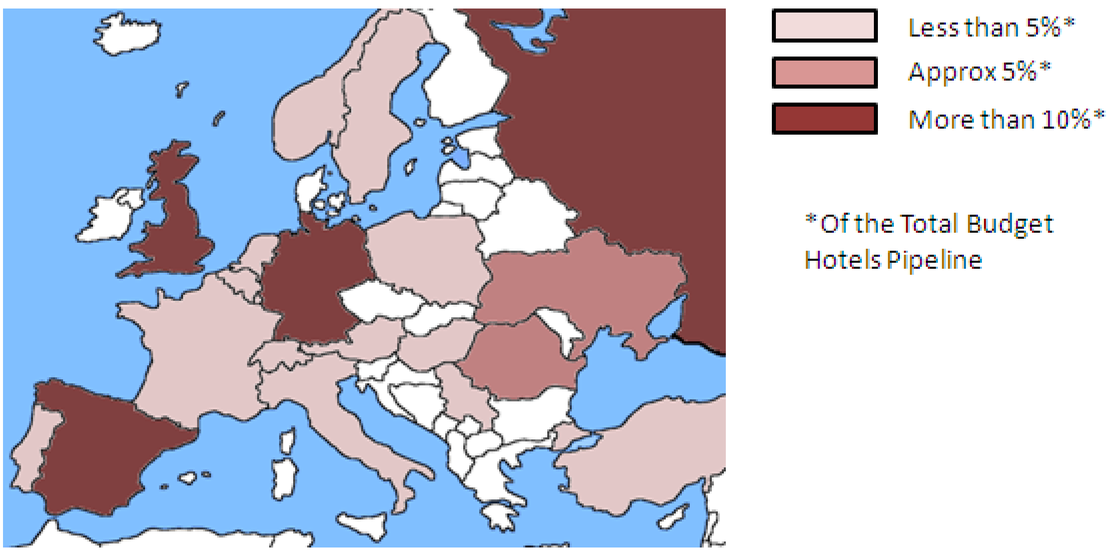
Table 6 European Pipeline by International Chain Scale at Q1 2010

International	Construction Pipeline								Diff vs. Q2 2008	
	Under Construction		Starts Next 12 months		Early Planning		Total Pipeline			
Chain Scale	Projects	Rooms	Projects	Rooms	Projects	Rooms	Projects	Rooms	Projects	Rooms
Upscale	162	31,470	67	12,526	56	10,211	285	54,207		
Midscale	56	8,458	29	4,790	15	3,474	100	16,722		
Budget	**76**	**10,728**	**64**	**8,744**	**102**	**12,866**	**242**	**32,338**	**15%**	**18%**
Unbranded	76	15,940	14	2,150	21	2,878	111	20,968		
Europe Total	**370**	**66,596**	**174**	**28,210**	**194**	**29,429**	**738**	**124,235**	**-28%**	**-28%**

Upscale: Luxury, Upper Upscale and Upscale
Budget: Economy and Midscale w/o food and beverage

Source: Lodging Econometrics, Portsmouth, NH-USA at Q1 2010

Chart 7 Geographic Distribution of European Budget Hotels Pipeline



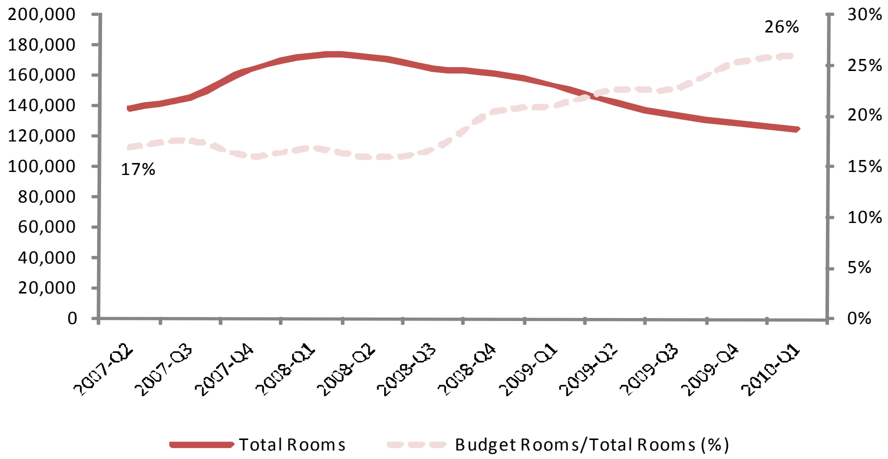
Note: The budget hotels category corresponds to Economy and Midscale w/o food and beverage according to Lodging Econometrics terminology

Source: Lodging Econometrics, at Q1 2010

There is evidence to suggest that the relative share of budget hotels of the total European development pipeline has increased throughout the crisis; as shown in the following graph for the period from 2007 to 2009 (Chart 8).

We consider that this trend is likely to continue into the future as we expect access to finance for larger projects to continue to be challenging in the short to medium term. Moreover, according to Lodging Econometrics, budget hotels are likely to grow relatively faster than midscale and upscale hotels as we move into a recovery phase of the development cycle in 2013/14. One reason being that budget hotels generally have a shorter development timescale and will be able to reap the benefits of a growing market faster.

Chart 8 Share of Budget Hotels (%) of Total European Pipeline



Budget: Economy and Midscale w/o food and beverage

Source: Lodging Econometrics, Q1 2010

Success Factors of Budget Hotels

The main reasons for the success of budget hotel brands during the economic downturn have been as follows.

- The emergence and revitalisation of national and international budget hotel brands with an attractive and consistent product that is successful with guests;
- Budget hotels have shown more resilience to the economic downturn, capturing business and leisure clients trading down from more upscale accommodation as available income and travel budgets shrank;
- Internationally branded hotels have been favoured by investors, lenders and developers as they are perceived to be less risky than independent hotels owing to the more powerful recognition, know-how and global distribution systems (GDS);
- Budget hotels are less cost intensive to build owing to lower space requirements, lower quality of building materials and specifications, and potential use of off-site modular methods of construction. This translates into lower development risk and relatively easier access to new finance;
- Brands with a critical mass in the market are able to capitalise on a variety of economies of scale to offer cost effective solutions throughout

the development process and operations procurement;

- Many budget hotel brands operate under lease agreements and in some cases offer strong covenants to risk-adverse freehold owners and loan providers;
- There is an established investment market for branded budget hotels in good locations, trading at strong and stable yields. The lower acquisition cost and high income return of this type of hotels facilitate early exit strategies. Other potential pool of investors are private equity firms interested in the development of the brand, as the acquisition of Travelodge by Dubai International Capital in September 2006 and the most recent acquisition of B&B Hotels by Carlyle Group in September 2010 illustrate;
- Operators are prioritising growth through asset-light strategies such as franchise agreements, which are particularly well suited for quick expansion of budget brands. This is because budget hotels are simpler to run independently with a license than more upscale hotels owing to the limited service offer and larger degree of standardisation;
- Budget hotels also have leaner fixed cost structures which offer higher flexibility, higher operating margins and therefore higher relative returns. The staff ratio required in a budget and economy hotel ranges from 0.1 to 0.2 per room, depending on the extent of on-site F&B and leisure facilities and contact points with guests;
- Budget hotels usually penetrate the market quicker and reach a stabilised level of operation earlier than midscale or upscale hotels. The ramp-up risk is therefore decreased;
- Charts 9 and 10 illustrate the relative level of development and operating risk involved in the project depending on the hotel's positioning.

For more information on hotel risk, the HVS article *'Hotel Investment Risk: What are the Chances?'* can be downloaded from www.hvs.com.

Chart 9 Relative Level of Development Risk

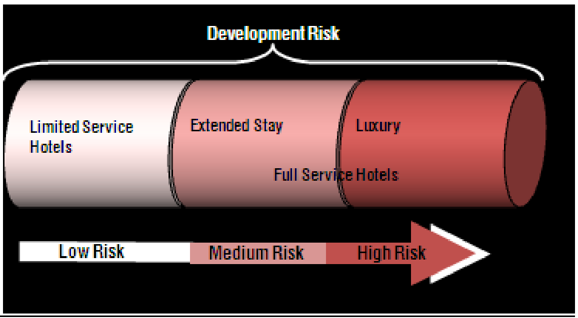
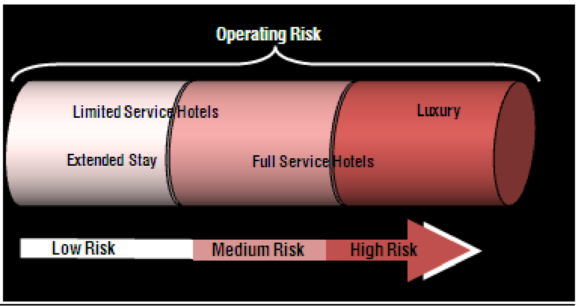


Chart 10 Relative Level of Operating Risk



Comparison of Current Entry Development Costs Across Europe

The construction economies of Europe have all been affected by the recession and consequent fall in workload, although to different degrees. Deep reductions in activity in Portugal, Ireland, Greece and Spain (the so-called 'PIGS' countries) have resulted in dramatic adjustments in prices relative to the European average. The UK, Benelux and Scandinavia have also seen substantial contractions in construction activity, which have led to stronger competition for tendered work and significant price reductions. Few economies, Poland and Switzerland for example, have seen sustained growth over the past 2-3 years, resulting in moderate, input cost driven cost escalation for construction and development work.

Competitive pressures between bidding contractors have been intensified to such a degree that 'below cost' bids are being submitted. When this occurs, there is a risk that contractors are not able to secure profitable work and do not provide for sufficiently robust risk contingencies to absorb the costs of unforeseen events or miscalculation on projects should they occur. A common contractor strategy these days consists of securing work at the lowest entry cost and increasing the exit cost through claims for additional work outside of the initial scope, disruption and other contractual entitlements.

Table 11 sets out a comparison of development cost factors for a 125-room branded budget hotel across Europe compared to the European average as of July 2010. These costs include Construction Costs, Professional Fees, FF&E and Contingency and exclude land, preopening expenses and interest during construction. The entry development cost factors can be used to extrapolate development costs from one location to another.

We note that some of the entry cost factors have been slightly affected by currency fluctuations, such as in the UK, some Scandinavian countries and some accession states.

According to Davis Langdon, straightforward branded budget hotels are usually less expensive to build in locations where the cost of labour is lower. On the other hand, mature construction markets can offer greater benefits from the use of modern methods of construction as mentioned before.

Table 11 Development Cost Factors across Europe (differential against the average)

Country	Differential Cost Factor 3Q 2010	Development Cost (€)* for a 125-room Branded Budget Hotel	Approximate Development Cost (€)* Per Room
Europe (average)	**1.00**	**7,500,000**	**60,000**
Austria	1.20	9,000,000	72,000
Belgium	1.04	7,800,000	62,400
Czech Republic	0.72	5,400,000	43,200
Denmark	1.21	9,075,000	72,600
Finland	1.21	9,075,000	72,600
France	1.17	8,775,000	70,200
Germany	1.17	8,775,000	70,200
Greece	0.69	5,175,000	41,400
Hungary	0.69	5,175,000	41,400
Ireland	0.92	6,900,000	55,200
Italy	0.93	6,975,000	55,800
Netherlands	1.13	8,475,000	67,800
Poland	0.75	5,625,000	45,000
Portugal	0.67	5,025,000	40,200
Spain	0.77	5,775,000	46,200
Sweden	1.15	8,625,000	69,000
UK (average)	0.88	6,600,000	52,800
UK (London & South East)	0.98	7,350,000	58,800

* Excludes land, preopening and interest during construction

Source: Davis Langdon

'Typical' Cost Breakdown, Drivers and Time Involved in the Development of a Branded Budget Hotel

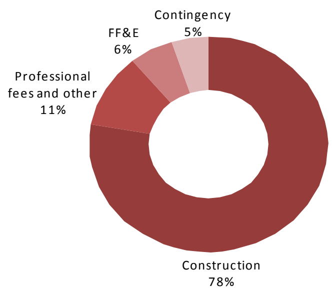
In the following graphs we provide some useful indications and benchmarks to understand the construction costs and time involved in the development of a branded budget hotel in Europe.

Chart 12 shows the typical breakdown of construction costs for a hypothetical 125-room branded budget hotel in Europe. The costs involved in a hotel's development budget are as following.

- Construction cost comprises the direct and indirect costs (labour, building supplies, equipment, service contractors and overheads) associated with the transformation of the design plan into a hotel building;
- FF&E includes the moveable furniture, fixtures and other equipment necessary for the operation of the hotel that have no permanent connection to the shell of the building;
- Professional Fees include the fees paid for design, site control, project management and the preliminary studies of the diverse parties involved in the project (architects, engineers, interior designers, technical architects, consultants and so forth);
- Contingency Cost is an allowance set aside to provide for unforeseen work or costs that may, or may not, ultimately be required;
- Pre-opening costs include costs such as the creation and implementation of the pre-opening marketing plan; assembling the pre-opening budgets; recruiting, interviewing and hiring all key management and sales personnel; training the key personnel, establishing definitive objectives and action plans for all departments; obtaining business licenses; developing pricing strategies for room hire and food and beverage; developing an employee benefit programme and policy manual; coordinating the procurement of guest supplies and employee uniforms; and developing specifications and bids on building insurance. For established budget hotel brands, these costs usually range between €150,000 and €250,000. This expense is dependent on the location and specific brand;

  Interest during construction is the ccumulated interest on a development loan and is a cost for the project.

Chart 12 Typical Development Costs Breakdown for a 125-Room Budget Hotel



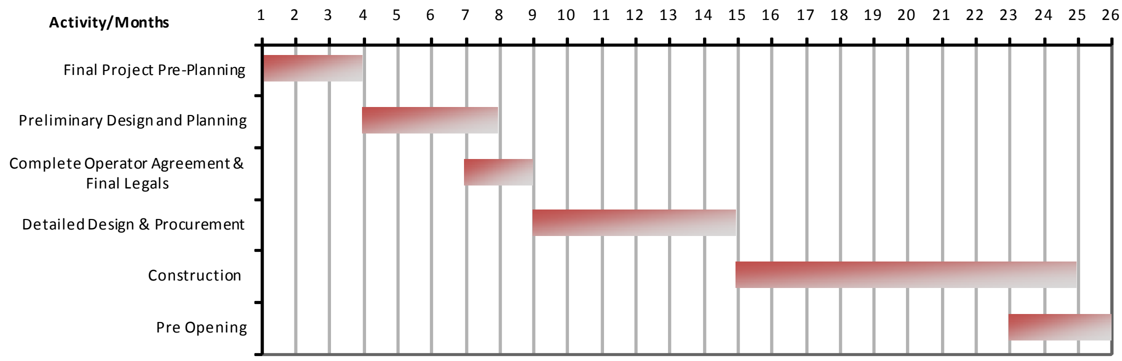
* Based on an Overall Development Cost of €7,500,000

Excludes land, preopening expenses and interest during construction

Source: Davis Langdon

According to Davis Langdon, the developing process for a branded budget hotel typically lasts around two years from site acquisition as illustrated in Chart 13. The more time-intensive development stages are: preliminary design and planning (4 months), detailed design and procurement (6 months) and construction (10 months). The length of the pre-opening period varies depending on the operator's familiarity with the market, availability of trained key personnel and the possibility to cluster some key management and business development positions. Most of the baseline staff is hired one to three months in advance to get ready for the opening, while the management and sales team are hired five to six months in advance.

Chart 13 Typical Development Programme for a 125-room Budget Hotel



Source: Davis Langdon

Cost Drivers & Trends for Budget Hotels

The following factors represent some of the key cost drivers when considering the development and construction of budget hotels in the current market:

- Country – as the previous analysis demonstrates, there is a large variation in development costs across Europe for delivering effectively the same product, and often further variations within a country depending on location can arise;
- Specific location factors – development within a city centre is usually more costly than developing on a 'green field' site out of town;
- Site-based factors – there can often be site-specific factors that influence costs; these can include the level of any remediation or demolition required. High-risk sites and locations will often deter interest from budget hotel developers and operators;
- Budgetary constraints – many budget hotel projects are driven by what is affordable as a build cost once an ROI or development appraisal has been undertaken. This will often drive the target 'cost per guest room';
- Brand standards – within the budget hotel sector there are a wide range of different brand standards which will drive specifications and costs;
- Design configuration – the size of guest rooms, the configuration of floor plates, the number of storeys and the height of the building will all influence costs;
- Extent of public facilities – the extent of front-of-the-house support facilities is a key cost driver although for budget hotels these tend to be minimal (and represent less than 10% of the gross area);
- FF&E and IT facilities – the quality and level of the furniture, fixtures and equipment and the hotel's IT offer will influence costs;
- Modular construction – prefabricated and modular construction methods can help drive construction efficiencies and reduce programme delivery dates, potentially reducing contractors' preliminary costs by around 5%;
- Sustainability – the extent to which a developer or operator wants to embrace the 'green' agenda and drive sustainability could have a significant impact on construction and operating costs. Savings in terms of initial capital cost are still marginal (and could even be slightly higher). However, the reduced operational cost can justify higher rental income or profitability from operations.

ROI Case Study

Despite the reduction in construction costs and opportunities for the development of branded budget hotels in the current environment, project viability continues to be challenged owing to a lack of financing, oversupply in some markets and an uncertain demand recovery timeline. Thus, it is important to carry out a detailed feasibility study using accurate development costs and hotel industry knowledge so that the economic potential of the project is not under/over estimated and the development budget can be refined.

In the next tables we provide an example of a basic viability study for a 125-room branded budget hotel in a UK secondary city centre such as Manchester or Liverpool.

Table 14 details the development costs that have been assumed in our case study. These costs have been provided by Davis Langdon for a hypothetical scenario.

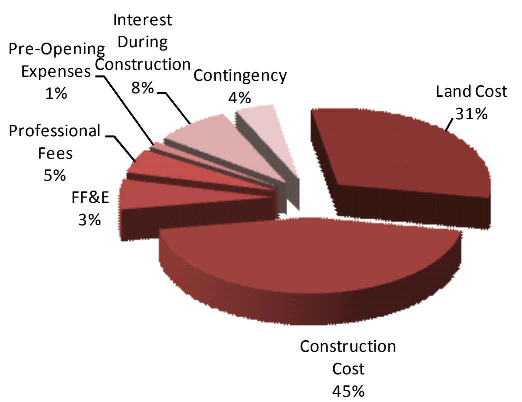
There are two basic methods to evaluate the 'feasibility of a development project'. One consists of calculating the Internal Rate of Return (IRR) and comparing it with the potential risks and returns provided by other investments and the company target rate. The alternative consists of comparing the hotel's estimated value as of the opening date and/or at the stabilised level of trading with its total development cost. Our case study illustrates the calculation of the internal rate of return.

The development process starts with the land acquisition or concession. Land costs vary widely across Europe and even within the same country depending on the demand for real estate in the area. In the UK, land costs are often as high as 35% of the total development cost. In emerging real estate markets land cost can be as low as 10-15% of the total development cost and can even be government subsidised.

Table 14 Development Budget Excluding Developer's Profit (£)

	Amount	Amount per Room	Amount per m²
Land Cost	3,000,000	24,000	938
Construction Cost	4,375,000	35,000	1,367
Furniture, Fixtures and Equipm	625,000	5,000	195
Professional Fees	500,000	4,000	156
Pre-Opening Expenses	125,000	1,000	39
Interest During Construction	780,000	6,000	244
Contingency	400,000	3,000	125
Total Cost (Rounded)	**9,800,000**	**78,000**	**3,064**

Source: HVS London / Davis Langdon



We have considered a construction period of two years starting in January 2010, with a phasing of the development cost of 50% in the first year (2010) and 50% in the second year (2011).

For the purposes of this analysis, we have assumed that the developer in this project is able to obtain a short-term construction loan for 60% of the total development cost in 2010 at an interest rate of 7.0% providing that the equity component is injected first.

Once the Hotel opens, we have assumed that the construction loan and accumulated debt service will be refinanced by a normal ten-year loan at a lower interest rate (5.5%) and twenty years amortisation period.

The next step in the development process consists of estimating the future earnings of the hotel through an analysis of supply and demand in the market area and typical expense ratios for a hotel of this type.

Table 15 shows a summary of the most important operating characteristics assumed for the proposed 125-room branded budget hotel.

We make the following observations.

- This city is a well balanced business and leisure location with stable growth in overnights stays, business and leisure development opportunities and a fair amount of new hotel supply;
- The convenience of this hotel's location translates into a high occupancy;
- Owing to the unique structure of leases, we have assumed a standard management fee of 3.0% (which is still typical in the UK) for the illustrative calculation;
- Room prices have been discounted by 10% and 5% in the first and second years of operation, respectively, to enable the hotel to penetrate the market by offering attractive opening prices;
- The hotel offers limited food and beverage service;
- The vast majority of revenues flows directly to the bottom line owing to the streamlined operations.

Table 15 Summary Operating Statistics

	Forecast		
	2012	2013	2014
Occupancy	67 %	72 %	75 %
Average Rate (£)	57	63	68
Rooms Revenue (£ 000s)	1,742	2,070	2,327
Total Revenue (£ 000s)	2,242	2,602	2,883
GOP [1] (£ 000s)	942	1,223	1,499
Net Operating Income	785	1,041	1,297
GOP %	42.0 %	47.0 %	52.0 %
Net Operating Income %	35.0 %	40.0 %	45.0 %

[1] Gross operating profit after Management Fee of 3%

Source: HVS London

In our illustrative example, the internal rate of return shows a healthy level of 16% (unleveraged) and 18% (leveraged) for a mature Western European market such as the UK. However, we note that target return rates are dependent on the individual developer/ company.

Conclusion

We highlight the following main points that have emerged from our research.

- Although not 'recession proof', budget hotels have fared better during the economic recession than midscale or luxury hotels;
- New, trendy budget brands have emerged that have re-invented the sector by offering affordable accommodation with functional design and the latest technology;
- Modern construction methods (pre-fabrication) have materially changed the time and costs associated with the development of budget hotels;
- The number of budget hotels in the active pipeline has increased throughout the crisis and this trend is expected to continue given comparatively easier access to financing, lower construction costs and shorter development time, which will allow budget hotels to reap the benefits of growing demand faster;
- This trend is also fuelled by the operators' desire to further establish their budget brands at a time when expansion opportunities for midscale and upscale properties are limited;
- Last but not least, there is an established investment market for branded budget hotels with particular appeal to risk-averse and non-specialist investors.

About the Authors

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Arlett Oehmichen is an Associate Director with HVS's London office. She joined HVS in mid-2006 after working in the hotel investment sector and gaining operational hotel experience with Hilton and NH Hoteles. Arlett studied Business Administration at Dresden University of Technology, Germany, and Universidad de Cordoba, Spain and is now pursuing a postgraduate Real Estate Master programme at Reading University. Since joining HVS, she has conducted numerous valuations and feasibility studies in Europe, North Africa and the Middle East including budget hotels with particular reference to the new breed of design budget hotels.

Stephen Frood is a Partner with Davis Langdon and the Head of the Manchester Office. He also leads Davis Langdon's UK-based Hotel Team and provides a key interface with colleagues within the firm's hotel team across Europe, the Middle East, and the rest of the World. Stephen joined Davis Langdon in 1985 and became a partner in 1995. He has worked within the hotel sector for 20 years and has a wide range of experience across the whole spectrum of hotel-based projects – and in particular on budget and mid range hotels across the UK and mainland Europe.

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HVS

About HVS

HVS is the world's leading consulting and services organisation focused on the hotel, restaurant, shared ownership, gaming and leisure industries. Established in 1980, the company offers a comprehensive scope of services and specialised industry expertise to help you enhance the economic returns and value of your hospitality assets.

Because hotels represent both real property and operating businesses, the founding partners of HVS decided to develop the first comprehensive valuation methodology for appraising these specialised assets. Their initial textbook on this topic entitled *The Valuation of Hotels and Motels*, published by the Appraisal Institute, created the industry standard for valuing hotels and is now used by virtually every appraiser around the world. HVS continues to be at the forefront of hotel valuation methodology, having published six textbooks and hundreds of articles on this subject, which are used in appraisal courses and seminars and at leading hotel schools such as Lausanne, IMHI and Cornell. HVS associates are constantly called upon to teach this methodology to hotel owners, lenders and operators and to participate at industry conferences. HVS principals literally 'wrote the book' on hotel valuation, which significantly enhances the credibility and reliability of our conclusions.

Over the past three decades, HVS has expanded both its range of services and its geographical boundaries. The company's global reach, through a network of 30 offices staffed by 400 seasoned industry professionals, gives you access to an unparalleled range of complementary services for the hospitality industry:

Consulting & Valuation
Investment Banking
Asset Management & Advisory
Shared Ownership Services
Golf Services
Executive Search
Risk Management
Property Tax Services
Convention, Sports & Entertainment Facilities
Interior Design
Sales & Marketing Services
Hotel Management (US only)
Eco Services
Food & Beverage Services
Gaming Services
Hotel Parking Consulting

Our clients include prominent hotel owners, lending institutions, international hotel companies, management entities, governmental agencies, and law and accounting firms from North America, Europe, Asia, Latin America and the Caribbean. HVS principals are regarded as the leading professionals in their respective regions of the globe. We are client driven, entrepreneurial and dedicated to providing the best advice and services in a timely and cost-efficient manner. HVS employees continue to be industry leaders, consistently generating a wide variety of articles, studies, and publications on all aspects of the hospitality industry.

HVS is the industry's primary source of hotel ownership data. Our 2,000+ assignments each year keep us at the forefront of trends and knowledge regarding information on financial operating results, management contracts, franchise agreements, compensation programmes, financing structures and transactions. With access to our industry intelligence and data, you will have the most timely information and the best tools available to make critical decisions about your hospitality assets.

For further information regarding our expertise and specifics about our services, please visit www.hvs.com.

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Davis Langdon is a leading global construction consultancy, providing managed solutions for clients investing in infrastructure, property and construction. The firm has over 5,000 staff in 105 offices worldwide, including over 1,700 staff in 31 offices, operating in the United Kingdom, Europe and the Middle East.

Davis Langdon is currently working on some of the most complex and challenging projects encompassing sectors as diverse as leisure and residential, commercial property, education, health. Past high profile projects include Claridges Hotel, London, the Eden Project Cornwall, and the Buri Al Arab in Dubai.

The firm aims to be the professional advisor to clients from project inception, through design and construction, to completion - extending into the operational life cycle. The firm provides project management and cost consultancy services, complemented by specialist banking tax & finance, building surveying, design project management, engineering services, health & safety services, legal support, management consulting, mixed-use master planning, people, place, performance consulting and specification consulting services.

In addition to being the recipient of a number of industry awards including 'Top International Construction Consultant' for 17 successive years and Building magazine's 'Construction Consultant/Surveyor of the Year' in 2006, 2007, 2008 & 2009 the firm has also received accolades for its training and development.

The firm's Core Purpose is to make a measurable difference to the value, cost and time of its clients' projects. Its Core Values are about creating an environment whereby the firm's people take pride in acting with Integrity as well as being Innovative and Collaborative in the things they do. These combine to form the firm's Core Ideology, which is being passionate about recruiting and developing the best people, working with the best teams and delivering successful solutions that respect the environment.

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