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MARKET REPORT

Hotel Development Bottlenecks in Russia

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As investors are looking to get into Russian hotel markets, they will no doubt be cautious. Hotel development can be quite a complex process. What are the main bottlenecks potential investors could face when developing hotels in Russia?

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As we discussed in our previous article (*Importance of Feasibility Studies in Developing Hotel Markets of Russia and CIS*), investors are looking to get back into hotel markets, admittedly with greater caution. In this article we would like to explore some of the risks that are associated with development of hotels. Development risk is the economic threat that a developer/investor is exposed to upon converting a vacant piece of land or an existing building into a fully operational hotel asset. Let us note that the risks described in this article are in our opinion the most common across Russia; however each city will certainly have its own challenges.

We will address the following topics in this article:

- Land acquisition
- Zoning, Planning and Permits
- Brand standards versus Local Market Needs
- Asset Positioning
- Architecture and Design
- Construction

Land Acquisition

The processes described below are complex and time consuming. Any foreign investor or company would be strongly advised to obtain a reliable Russian partner to assist in such matters.

According to Marat Khusainov, Managing Partner, Capital Consult Realty Hotels, in Russia investors' first choice would be to obtain vacant land plots and build hotels according to the specification of a chosen brand or management company. There are two ways to obtain vacant plots of land from the government.

1. A vacant plot of land can be bought at a government held tender, which is open for Russian and foreign companies as well as individuals. This tender is awarded either through an auction or through a competitive bid. The latter has the distinctive feature of government conditions to be met along with the highest bid. The winner of the tender will buy out the plot or enter into a lease agreement with the state authorities.

2. Investors can also acquire plots through provision of land on targeted basis, which does not involve a tender. In this case the investor applies to the state authorities for a plot of land required for specific construction purposes. If the investor plans to build a hotel the following two steps must be followed: "*Lease of the land plot for executing exploratory works aimed at defining the possibility of a hotel being allocated there*" and "*Provision of a land plot on a lease basis for hotel design and construction*".

As vacant plots in prime city locations are rare, they are valued highly, notwithstanding the global economic slowdown. On the other hand, the rest of land's prices have plummeted dramatically. Even though vacant plots are the preferred choice, foreign investors rarely commit sole development of such land plots due to risks associated when dealing with the authorities directly, argues Irene Engel, Partner, CMS Russia.

Investors can also purchase land with existing buildings. It is then possible to either demolish or restore those buildings, depending on the government conditions associated with that plot. For example currently St Petersburg administration is releasing plots of land with heritage buildings, which of course can only be restored. The process of land acquisition is similar to vacant plot acquisition described above.

Zoning, Planning and Permits

Subsequent to obtaining land for hotel construction via one of the various possibilities described above, the accompanying documents will differ. Instead of compiling these various lists, we outline the various state authorities involved, simply to give you an understanding of the complexity of permit acquisition. We will use St Petersburg as an example, where the city's Investment Department maintains a website about hotel investments (http://www.hotelinvest.ru/). We have referred to information provided on this website to outline some of the agencies that a potential investor has to deal with:

- *Committee for Urban Development and Architecture*
- *Committee for the State Inspection and Protection of Historic Monuments*
- *Committee for Land Resources and Land Management of St. Petersburg*
- *Department of the Federal Registration Service of St. Petersburg and The Leningrad region*
- *City Property Management Committee*
- *District Administration of St. Petersburg at the location of the requested land plot*
- *Committee for Energy and Engineering*

During the decision process the authorities will refer to various documents to support the decision. Some of these documents include:

- *The General plan of St. Petersburg*
- *The land use and development rules of St. Petersburg*
- *Various other laws and regulations*

The content of permits can vary greatly and also constantly changes. What is important to understand is the complexity of the process. Investors are advised to retain a professional advisor/broker in this area to assist during the process.

Brand standards versus Local Market Needs

International operators create brand standards to ensure that their guests experience the same level of comfort and service at any of the brand's hotels. As global hotel markets become more accessible to the traveler, brands realize that there is no "standard" solution to brand standards in different markets. The challenge that operators face is to keep to their desired brand direction, while catering to the specific needs of the market. One aspect the brand has to adhere to is compliance with local laws, but in many cases these legal requirements are already met by the brand. Michael Cooper, VP

Strategic Development Russia and CIS, IHG gives an example of the Russian law requiring the hotels to have only smoke detectors, whereas IHG will additionally install sprinklers (as demanded by their internal standards). Anatoly Kondratenko, Director Development Russia, Starwood Hotels and Resorts, tells us about currency exchange booths in the hotel lobby. These are not in the Starwood brand standards, but since currency exchange is not allowed at the reception desk, such booths are placed in the lobby. Local hygiene laws may also require the brand to adjust certain standards. The final goal for the brand is to adapt its standards to local laws and regulations while keeping with the brand philosophy.

FF&E standards do not seem to differ between Europe and Russia and the brand will normally provide the owner with reputable suppliers. Anatoly Kondratenko also suggests that Starwood does not restrict buying local furniture and equipment provided the quality corresponds to the brand standard.

Asset Positioning

Normally, when commissioning a feasibility study, the potential investor will be advised on the appropriate positioning of the proposed hotel. Nevertheless, it is important to understand some general risks, associated with development of hotels across various positions. Almost every investor historically wanted to own a luxury hotel, which will be featured on magazine covers and talked about on TV travel programs. Let us first look at some risk elements associated with development of luxury properties:

- *High capital intensive* – luxury developments require high amounts of initial investments;
- *Construction term* – complexity of luxury development can increase the construction period, thus delaying commencement of operations;
- *Operations* – luxury properties require a consistently high level of service and product standards to reflect their positioning, thus increasing operating costs;
- *Management* – luxury properties are complicated to manage and require professional management companies to carry out day to day operations.

Lower positioned hotels would normally experience lower levels of risk associated with the elements described above. Thus as we go down the positioning scale, risks associated with development would normally decrease. It is important though not to confuse Development Risk with Return on Investment. As we mentioned above, development of a lower positioned hotel is normally perceived as less risky. However, in Moscow for example, experts agree that due to high value of land in prime locations, development of limited service hotels may not be profitable.

Investors should conduct full market research and develop their asset based on the market needs and projected returns on investment.

Architecture and Design

It is very important for the potential hotel investor to conduct the necessary due-diligence prior to employing the architect. Studying the market will allow investors to better understand their own needs for the hotel. Max Koutchinski, Deputy General Director, Aukett Fitzroy Vostok says that one of the challenges is when an architect is employed to design a “beautiful” or “great” asset, which unfortunately does not specify size or positioning of the hotel. Another challenge is to tame the investors’ appetite for overspending, which applies both to individual and chain hotels. Individual asset owners have no strict guidelines and might be tempted to “buy better beds” or “larger TVs”, not realizing that such spending might not necessarily translate into higher rates and subsequently better returns. When the chain is involved, the architect has to balance between the brand standards and investor’s (who pays the architects fees) requirements.

Hotel brands not only have service but also product standards, which allow guests to expect consistency in various hotels under the same brand. In today’s world, design is crucial, but it is important to remember that the hotel is for use by guests. A hotel should be designed to maximize both guest comfort and operational efficiency. Not every hotel needs to be an architectural wonder of the world. Space wastage leads to unnecessary costs and impacts the bottom line.

Construction

As the topic of construction is highly technical and specific, we only name some of the common challenges construction companies face. As indicated by Alexey Afanasiev, Project Manager, Akademproekt, harsh weather conditions (such as the cold Russian winters) are no longer a construction stopping factor. Modern equipment and materials allow the companies to conduct certain phases of construction even in the most extreme weather conditions. It is agreed though, that no matter how advanced your materials or equipments are, commencing interior work if the building shell is not sealed, will only lead to poor results. Absence of necessary permits or delayed raw materials coupled with an erratic payment schedule will delay construction more than adverse weather conditions will.

Do not waste a good opportunity

The issues described in this article should not deter investors from entering the hotel market. Even though acquiring land and required permits can be a tough process, investors should explore all options. With proper due-diligence, expert consulting and keeping financial feasibility of the project in mind, investors will be able to find profitable opportunities in hotel markets in Russia.

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