KPMG IN RUSSIA AND THE CIS

International hotel operators in Russia

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Hospitality & Leisure Advisory Services

The photo is provided by Ritz Carlton Hotel

Contents

General overview

Main functions of the hotel operator

The main function of a hotel operator is the direct management of the operating activity of hotels. Companies that provide such services include both small local Russian companies that provide management services for one or two properties and major corporations that are national or international in scope. The functions of a hotel operator are frequently performed by international hotel chains, which in addition to operational management may provide their trademark and reservation system services, which in turn are considered an integral part of the services provided.

Different operators may represent one or several brands simultaneously. A single operator may divide services into brands, due to its desire not to mix accommodation of different quality levels under a single name, which may have a negative effect on consumer perception of the brand.

Brands are divided within a single operator in different segments, similar to the segmentation of accommodation: the budget (economy) segment, the medium priced segment, and the upscale segment. For greater understanding of the difference in quality, such segments as the mid-upscale and premium/luxury segments are sometimes added.

Main options for cooperation with a hotel operator

Relations with international operators may be based on direct management contracts or franchising, and in rare cases on lease agreements.

In each specific case, the choice of cooperation depends to a significant extent on the initiator of the project, which should clearly understand its goals regarding the benefits to be received and the risks associated with them. This will make it possible for the initiator to determine the key terms and conditions necessary to achieve its goals. Low risk for long-term capital investments involves selecting such forms of doing business as concluding a lease agreement or a management agreement. Higher income also involves higher risk, in which case the option of a franchise agreement or independent development may be considered.

To date, direct management agreements have been the most widespread form of relations between business owners and operators. To a significant extent this is due to the demands of operators regarding compliance with the quality standards of a chain. In the majority of cases, this form remains the sole possible option for hotels in the four- and five-star categories.

At the same time, over the past several years one can note the growth in the number of projects of midscale brands, specifically through franchise agreements. However, this is frequently accompanied by a situation where the transaction includes an additional company, which will be responsible for the direct management of the facility.

A more detailed description of direct management agreements is given below.

The influence of the hotel operator on the operations of the hotel and value of the asset

When concluding a direct management agreement, the owner transfers the hotel to the management of the operator, which then runs the hotel using the facilities provided by the owner. In this case, the operator's activity includes both the sale of hotel services and their provision. In turn, this means that the operator has control over the formation of the product, management of the promotional strategy and pricing policy, personnel, business processes, procurement and deliveries, and maintaining the property in the appropriate condition. In accepting management of a project, the hotel operator guarantees the use of advanced technologies in all of these areas.

The most obvious effect of engaging an international operator compared to independent management is the increase in the overall profitability of the business through a high-quality sales system using corporate reservation networks and club programs, and also through the implementation of optimal business processes that help to reduce costs. One may also consider that the specific facility may reach first cost recovery and then stabilization at an earlier date.

An additional effect is related to the positive influence on the company's capitalisation. It is generally recognized that having a management agreement with a professional international operator reduces operating risks; this in turn affects the discount rate and capitalisation, and also increases the value of the asset and the business.

Main steps in hiring an international hotel operator

The selection of an international operator is traditionally carried out in the same way as a closed tender.

Analysis of hotel positioning and the concept for defining an appropriate range of brands
After the decision is made that an operator should be engaged to manage the hotel, the process of determining the key criteria for the selection begins, which to a significant degree is predetermined by the anticipated positioning and concept of the property.

Starting from the hotel's location, category, range of services and the quality of their provision, the hotel should determine which brands of the various operators are the most appropriate. It will then be necessary to conduct a preliminary analysis of the potential interest of operators in developing a specific brand in the given location, taking into account the presence of other properties of this brand in the region and the immediate vicinity of the hotel.

Establishing primary commercial terms
After determining the broad range of operators whose brands are most appropriate for the management of the hotel, initial meetings are held with each of them. These involve a brief presentation of the project, and also the provision of more detailed information, for example, an economic feasibility study prepared by an independent consultant, a description of the hotel concept, existing floor plans or the design of future floor plans, if available, and also the cadastral plan for the land plot.

Based on these meetings, interested operators submit commercial proposals setting out in brief the main terms and conditions that will later underlie the future management agreement.

Agreement of commercial terms with a limited range of operators
On the basis of the submitted commercial proposals, the range of

candidates narrows. The effect of the terms and conditions proposed in the commercial proposals of selected operators is tested using financial modeling, including a review of the effects on the overall capitalisation of the project and its profit as a function of time. Based on the conclusions made, the maximum acceptable bounds of the terms and conditions are determined for each specific brand. Subsequent negotiations with operators take into account both material and intangible concessions.

Signing of a letter of intent with the selected operator

Based on the results of the tender the developer of the project and the selected operator sign a letter of intent, setting out the agreements reached by the parties on the main parameters of future cooperation with the hotel operator (including the parameters of agreements on technical support, management, transfer of trademark rights, structured payments, planned hotel brand, etc.)

Drafting and signing of the package of management agreements

The process of drafting and agreeing on contracts always involves the participation of professional lawyers. Their duties include an analysis of how well the draft agreements provided by the hotel operator comply with the overall commercial understandings and interests of the parties and also the norms of Russian legislation, the identification of legal risks, and the development of recommendations on mitigating them. Among other things, lawyers attend negotiations with the operator to agree on changes to draft agreements in the interests of the client, and also to edit and comment on agreements for the most legally correct and complete description of the relations of the parties, in order to protect the client's interests.

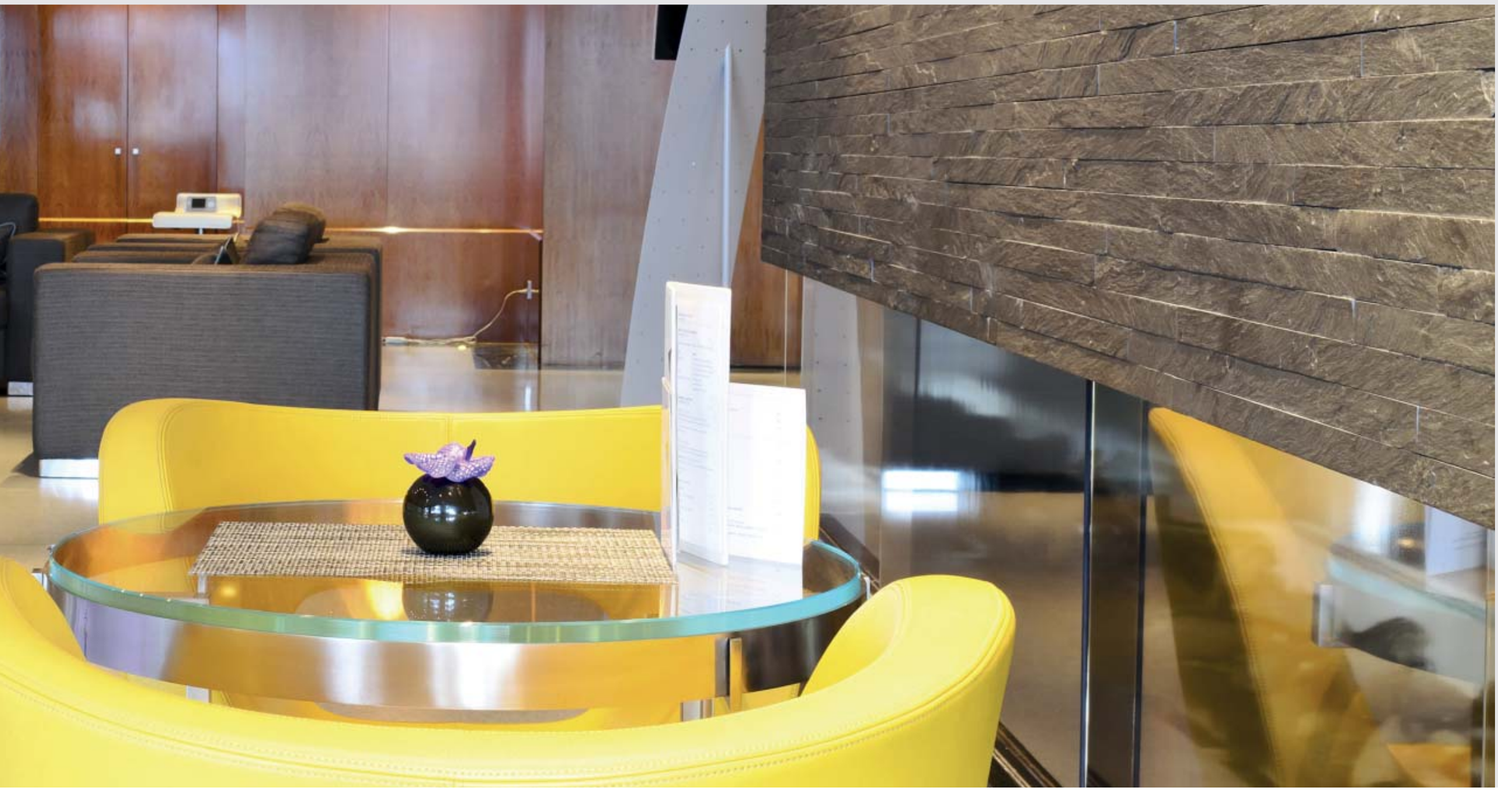
As a rule, the package of documents governing relations on engaging a hotel operator includes the following agreements:

Technical Services Agreement, which sets out the rights and duties of the parties from the design and construction stage up to the opening of the hotel. The purpose of this type of agreement is to ensure that the hotel is designed, built and outfitted in accordance with the standards of the hotel operator (from the standpoint of allocating functional zones, spatial solutions and floor plans, taking into account various operating processes).

Management Agreement, which determines the rights and duties of the parties in connection with the provision by the hotel operator of consulting services on the management and monitoring of the operations of the hotel. This type of agreement is of great significance from the standpoint of doing business with the hotel operator. As a rule, it is concluded for an extended period (15-30 years, with subsequent extension), regulates the conditions for regular payments to the hotel operator, and accordingly requires careful drafting taking into account the interests and expectations of the developer of the project.

Marketing and Reservation Services Agreement, which governs issues of marketing activity, sales, reservations, implementation of client loyalty programs and the provision of other associated services.

License Agreement, governing the transfer by the hotel operator of rights to use its package of intellectual property (including trademark rights, special software, technical support services and implementation of brand standards).



Main commercial terms and conditions of agreements

In accordance with the agreements listed above, the developer makes the following kinds of payments to the operator:

Payment for technical services
This payment depends on the number of rooms in the hotel (ranging from USD500 to USD2,500 per room) and may be paid in stages over the course of the project.

Payment for management in the period before the opening of the hotel
This payment covers the management of the hotel before its opening for its successful functioning after the official start. This stage includes the recruitment and training of personnel, marketing and promotion of the hotel, installation and testing of systems, ensuring supplies, obtaining the necessary licenses, concluding lease agreements for commercial premises that are part of the hotel. This payment depends on the number of rooms in the hotel, ranging from USD1,500 to USD7,000 per room, depending on the category of the hotel. The payment should be remitted not later than six months before the opening of the hotel.

Working capital
This payment is needed for the purchase of the necessary consumables for the uninterrupted operation of the hotel. It depends on the number of rooms in the hotel, ranging from USD1,500 to USD4,000 per room, depending on the category of the hotel. This payment should be made together with the remittance of the payment for management in the pre-opening period.

Basic management fee
The basic management fee is paid on a monthly basis as a share of the overall revenues of the hotel. This payment varies from 1% to 3% on average.

Management incentive
The incentive payment is paid on a monthly basis, as a share of gross operating income. This payment is contingent on the margin of gross operating income to revenue, and may equal from 0 to 10%.

Payment for centralized marketing, reservation and sales services
The type and structure of payments for centralized services are established by operators individually. For example, payments may be made as an advance payment or on the actual performance of services. The most widespread practice is payments as a percentage of total room revenue, and as a fixed payment for each reservation made through the operator's corporate systems. On average, the payment varies from 2 to 5% of room revenue, and from USD4 to USD15 for each confirmed transaction.

Replacement reserves (depreciation reserve)
A mandatory condition of management agreements is the creation of a replacement reserve for furniture and equipment, to be used in accordance with the schedule for repair and replacement of existing fixed assets. These payments are held on the hotel's current account, after which they are transferred to an interest-bearing savings account. The allocation to the reserve often depends on the operational life of the hotel. On average, the reserves constitute 1 to 6% of the hotel's total revenue.

In addition to the main payments, the following terms and conditions should be kept in mind when signing an agreement:

Key money of the operator
Depending on the commitment to open one facility or another, the operator may propose a payment to the developer, to be transferred on the opening of the hotel on time in the absence of any violations of the terms of the agreement. This payment is established individually, and is usually USD1,000 to USD5,000 per room, depending on the brand and location of the hotel.

Early termination
As a rule, management agreements stipulate fines if early termination is necessary at the wish of the owner. On average, these vary from one to three times the aggregate annual income of the operators.

Competition

Today, most major international hotel operators that provide both direct hotel management and franchising services are present on the Russian market.

However, the total number of facilities operated under the brands of international operators is still extremely small: at present only 107 out of 9,316 hotels in Russia are part of international chains. Including announced projects, 258 facilities will be operating on the market by 2019.

The year 2013 was productive from the standpoint of expansion of international chains in Russia. Over the past year 13 hotels entered the market under international brands.

The leaders on the Russian market remain such chains as Carlson Rezidor Hotel Group, Accor Hotels, InterContinental Hotel Group and Marriott International.

Carlson Rezidor Hotel Group remains the market leader, with a total of 25 operating hotels with 7,720 rooms in its portfolio at the end of 2013. Over the next 5–6 years this operator plans to bring the number of hotels to 48, with 12,854 rooms.

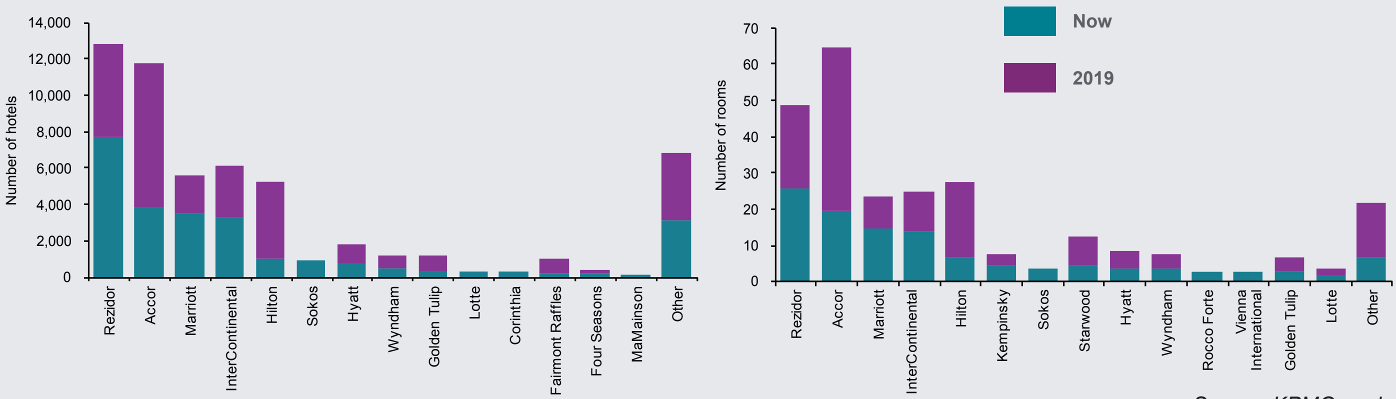
As at 1 January 2014, Accor Hotels manages 19 hotels with 3,788 rooms in Russia. Company management is pursuing the aggressive development strategy announced last year, and plans to open 45 branded hotels with 7,942 rooms over the next five years, which will propel the chain to the top in terms of facilities in operation. Carlson Rezidor Hotel Group will remain the leader in terms of rooms.

At the end of 2013, 14 hotels with 3,482 rooms were operating under the Marriott International chain in Russia. By 2019 the company plans to open an additional 9 hotels with 2,130 rooms.

InterContinental Hotel Group is represented by 13 operating hotels with 3,345 rooms. The Group plans to expand its presence in Russia to 25 hotels, bringing its room stock to 6,339 rooms.

Hilton Worldwide also plans to significantly increase its portfolio of hotels (the opening of 21 projects with 4,206 rooms has been announced).

Rating of international operators with a presence on the Russian market

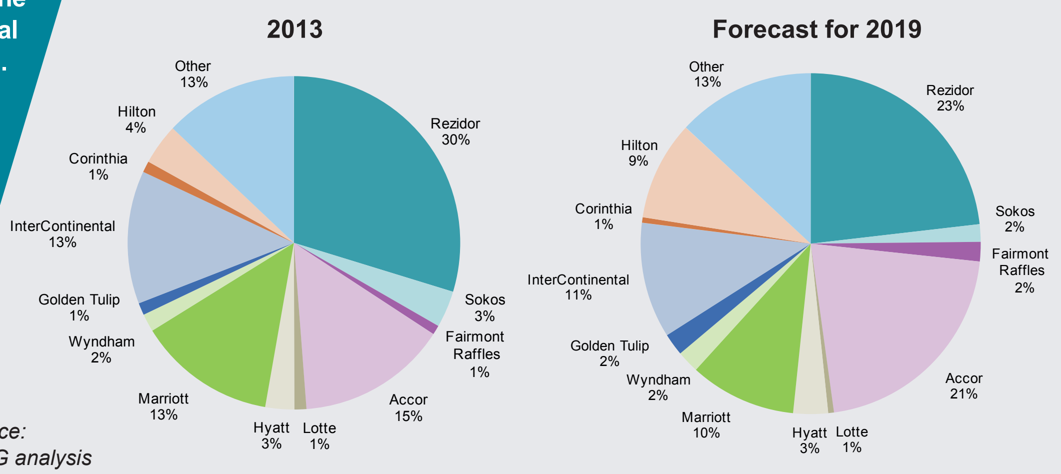


Source: KPMG analysis

At the end of 2013, 107 hotels in Russia were under the management of international chains.

The leaders on the Russian market remain such chains as Carlson Rezidor Hotel Group, Accor Hotels, InterContinental Hotel Group and Marriott International.

Presence of international hotel operators in Russia



Source: KPMG analysis

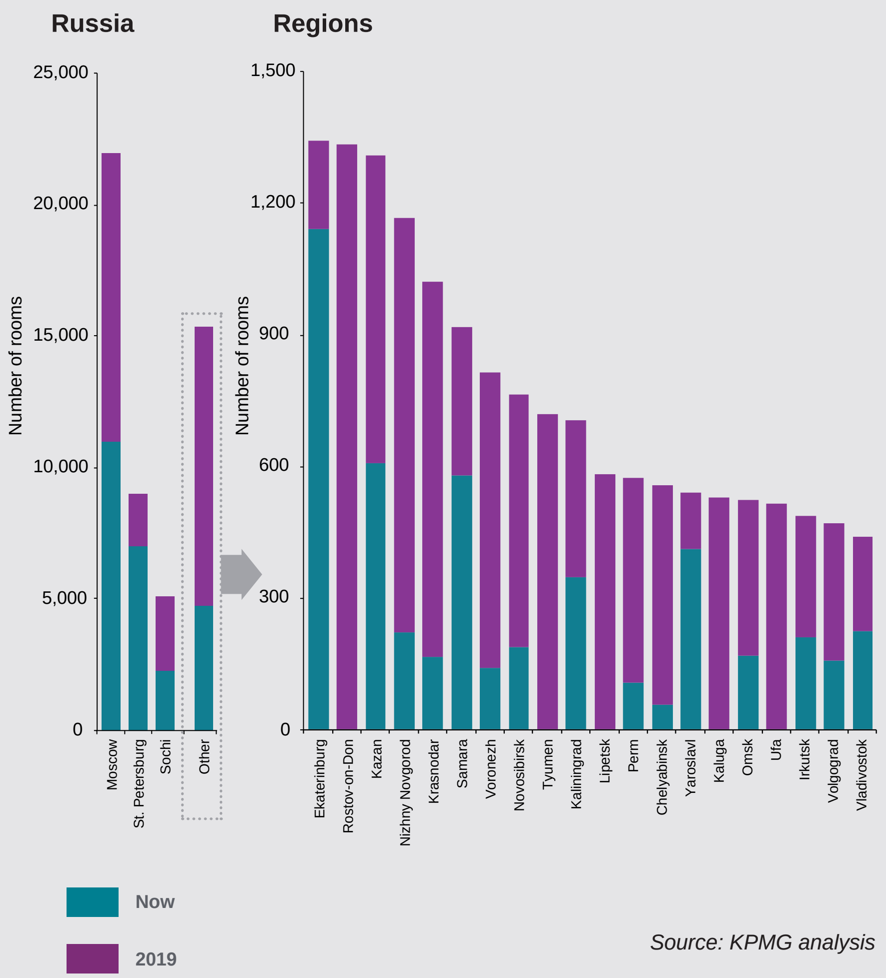
Regions of operation

For a long time, the hotel market of Russia was made up of only two cities, Moscow and Saint Petersburg, where a large share of supply (both existing and future) was concentrated. Investment activity was also chiefly noted in these cities. Moscow and Saint Petersburg remain the leaders in Russia in terms of room stock and the number of hotel facilities. However, after the country won the right to hold such major international events as the Olympics and the World Cup, the issue of developing hotel infrastructure became one of the most pressing.

The existing room stock of regional cities significantly outstrips market demand and the requirements of the international companies organizing the events. However, a significant portion of the supply available on the market does not meet international quality standards.

Since these events will be held in a wide number of locations throughout the country, international operators are concentrating their efforts on the cities where these events will be held, namely Sochi (8.7% of future supply), Rostov-na-Donu (4.7%) and Nizhny Novgorod (3.3%). International brand name hotels are opening in some regional cities such as Rostov-na-Donu, Yaroslavl, Kaluga, Voronezh and others for the first time.

Distribution of existing and future room inventory of international hotel operators

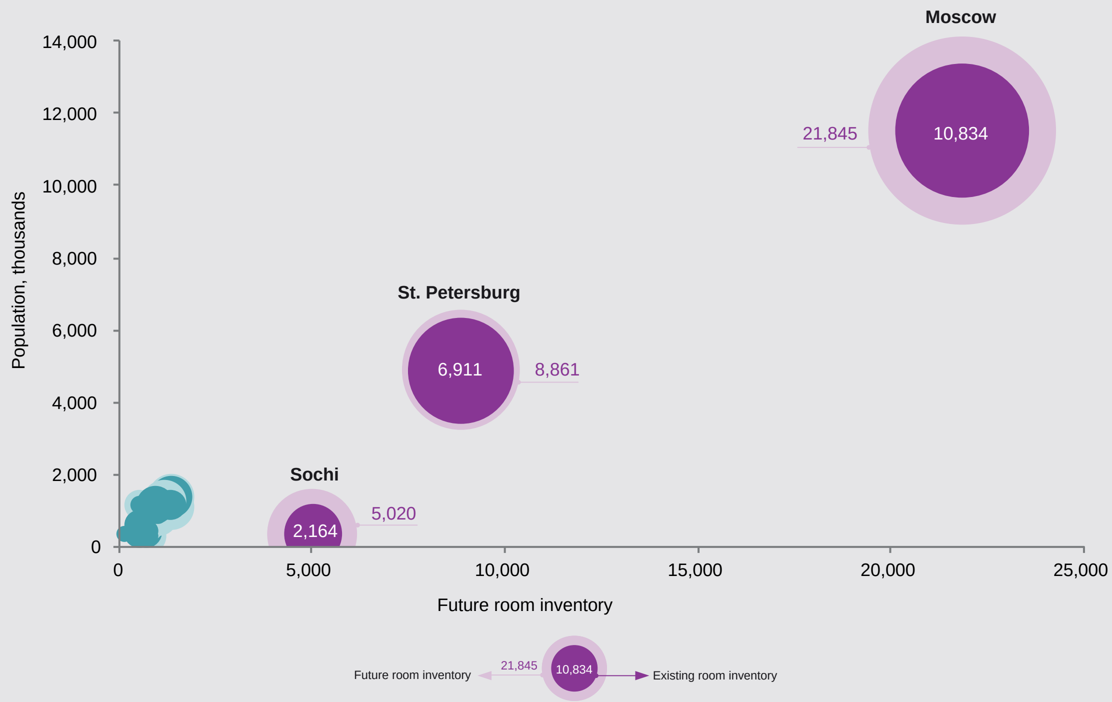


Source: KPMG analysis

At present, 107 hotels with nearly 26 thousand rooms, or 1% of the almost 9.5 thousand hotels, operate under the management or brand of a professional international operator. Only a third of these hotels are three-star hotels. By 2019 around 90 hotels of this level with slightly more than 20 thousand rooms will be built, but this will still not change the balance of the segments. The total number of branded hotels will reach 258 facilities, with an aggregate total of 55.5 thousand rooms.

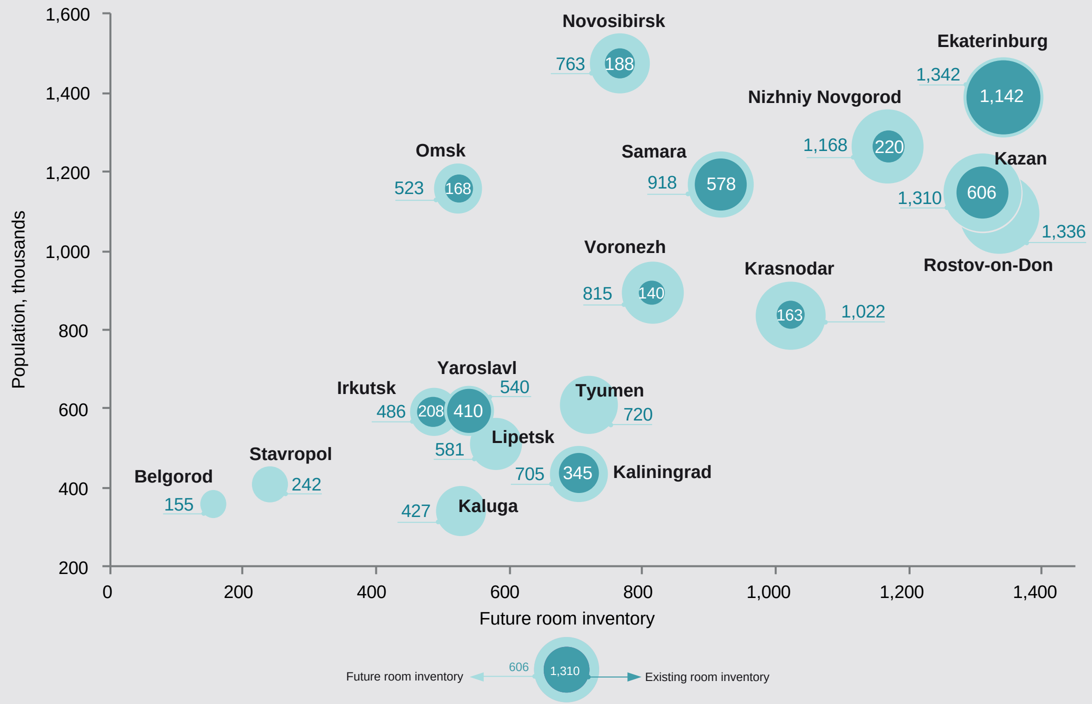
An important difference between the plans for expansion of operators in Moscow and Saint Petersburg and in regional cities is the difference in the star-rating of the hotels to be built. Most of the consumers of hotel services in the regions are Russian companies, which still look first and foremost at the hotel's pricing policy when choosing a place of stay for their employees. This trend has a positive effect on the rate of development of the regions, since the construction of three-star hotels is much less expensive than the construction of luxury hotels.

The presence of hotel operators in Russia



Source: KPMG analysis

The presence of hotel operators in regions



Source: KPMG analysis

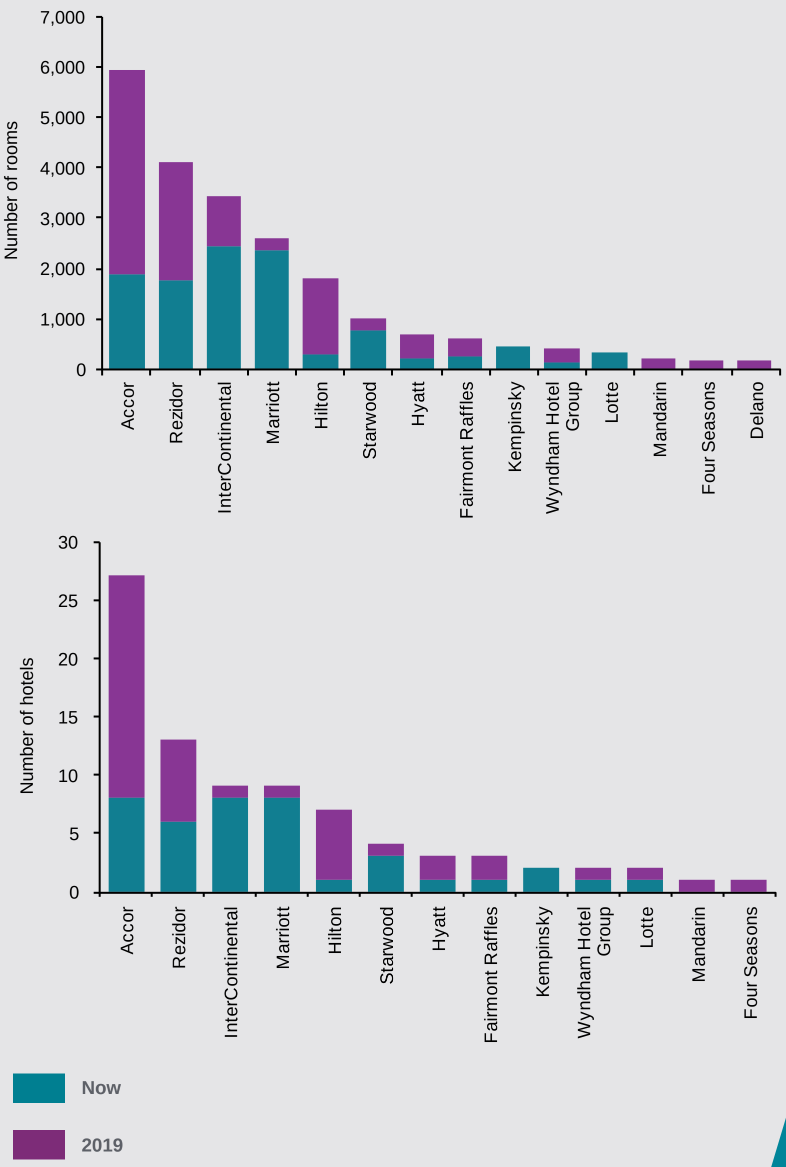
Most of the Russian room stock and hotels under international brands are concentrated in ***Moscow*** (42% of the current Russian room stock of international operators). At present, 41 of 322 hotels in Moscow, or 10,834 of 45,203 functioning rooms, belong to various international chains. 4-5 star hotels account for the majority of supply of hotel services in Moscow. Three-star hotels account for only 12 hotels with 2.7 thousand rooms.

The current leaders by number of hotels in the capital are the Intercontinental Hotel Group, Marriott International and Accor, with 8 facilities operating under the brands of these operators. The market leader by room stock is Intercontinental Hotel Group, outpacing Marriott International by a mere 98 rooms.

In 2013 such hotels as Novotel Moscow City with 360 rooms, Kempinski Nikolskaya with 211 rooms and Sheraton Moscow Sheremetyevo Airport with 342 rooms were opened in Moscow, as were three hotels of the Accor IBIS-Adagio-Mercure Bakhrushina with 190, 149 and 153 rooms, respectively. The opening of hotels managed by such operators as Marriott (Marriott Novy Arbat with 234 rooms), Hilton (DoubleTree by Hilton Mosow Leningradsky Riverside with 270 rooms and Hilton Garden Inn Moscow New Riga with 162 rooms), and Wyndham (Ramada Moscow Kolomenskoe with 260 rooms) is expected in the first two months of 2014.

By 2019 the room stock of chains in Moscow could increase to nearly 22 thousand rooms, making the capital's share of room stock in the future supply of Russia 40%.

Rating of intenrational operators with a presence on the Moscow market



Source: KPMG analysis

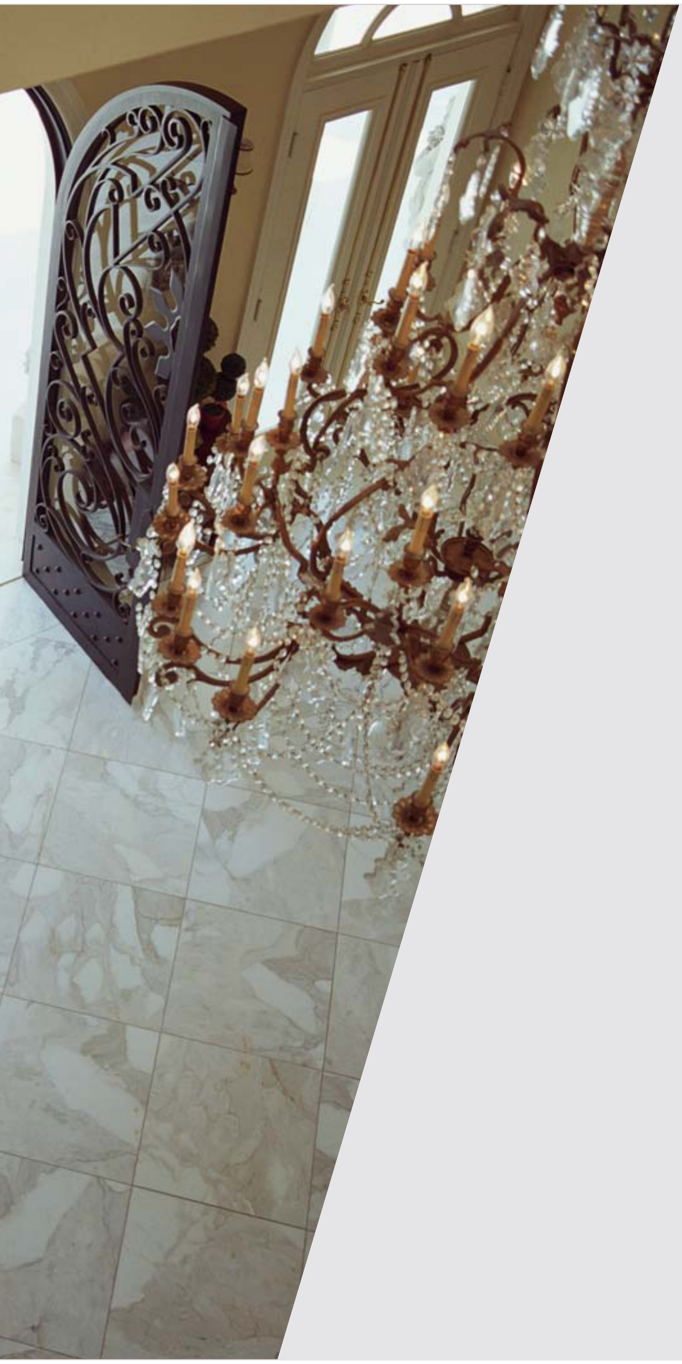
Most invest funds prefer to invest in real estate located in the two largest Russian cities. This trend propels Moscow and Saint Petersburg to the top in all real estate segments. This trend was formed due to the increased political risks of investment in regional real estate.

In ***Saint Petersburg*** there are currently 24 hotels with 6,911 rooms functioning under international chains, accounting for 21% and 43% of the officially registered supply of hotels and rooms, respectively. In total, Saint Petersburg accounts for 27% of the room stock managed by international operators.

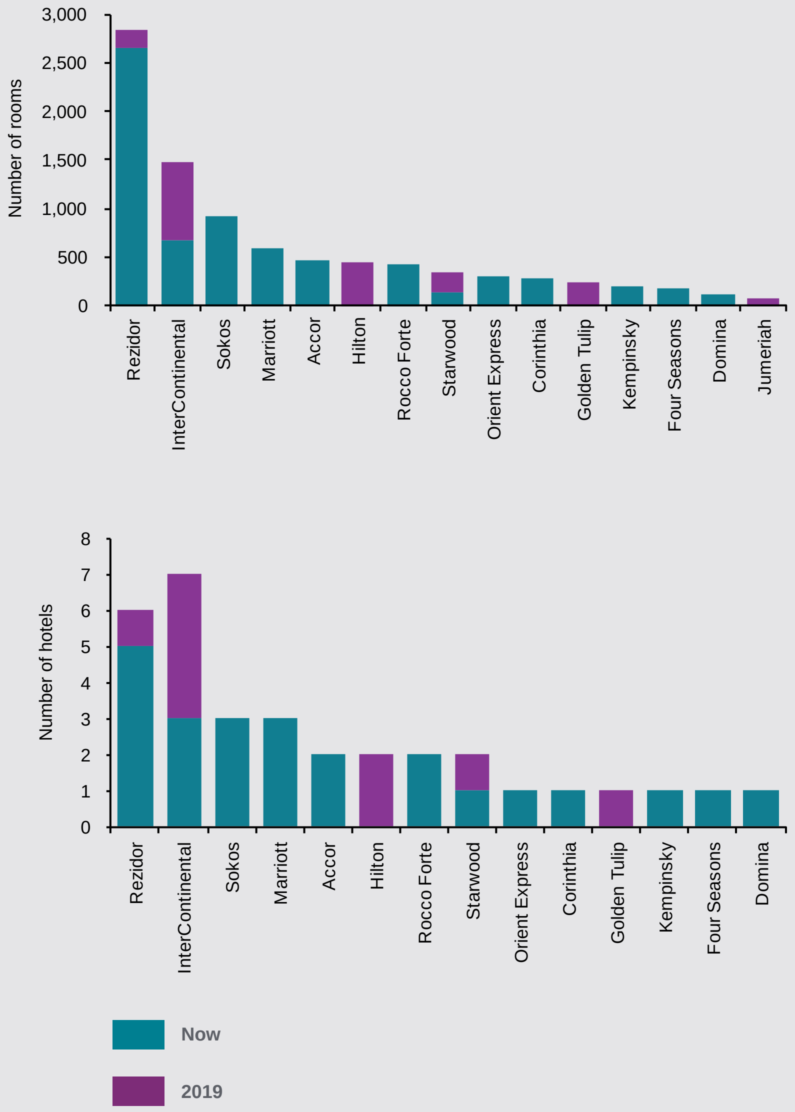
The leader in terms of the number of hotels and room stock on the market in Saint Petersburg is Carson Rezidor. This operator has five facilities with 2,640 rooms. It has more than double the room stock and hotels of its closest competitors. By 2019 the leader on the market in terms of number of facilities is expected to change, with Intercontinental Hotel Group planning to commission four hotels during this period. Nevertheless, Carlson Rezidor will remain the leader in terms of room stock.

In 2013 a Four Seasons Lion Palace with 183 rooms opened in the city. Indigo St. Petersburg is expected to open its doors in early 2014.

By 2019 the room stock of chains in Saint Petersburg will reach 8,861 rooms (16% of the future supply under international brands).



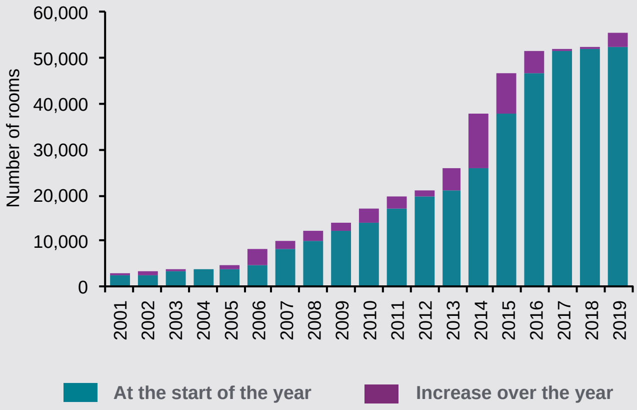
Rating of international operators with a presence on the Saint Petersburg market



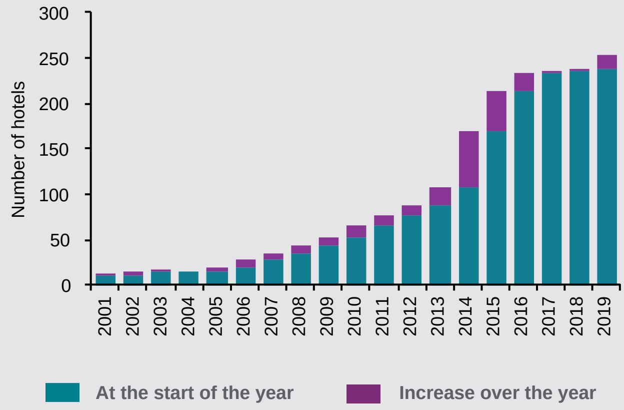
Source: KPMG analysis

Additional materials

Change in the room inventory of Russian hotels under international brands

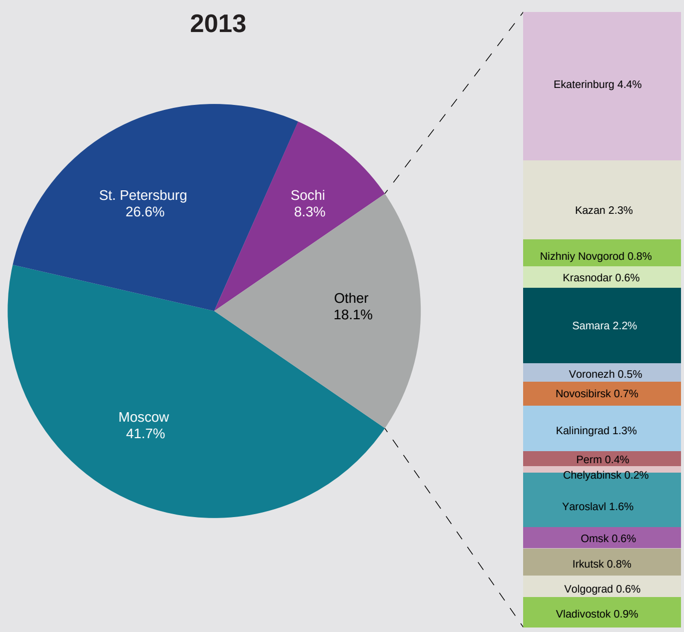


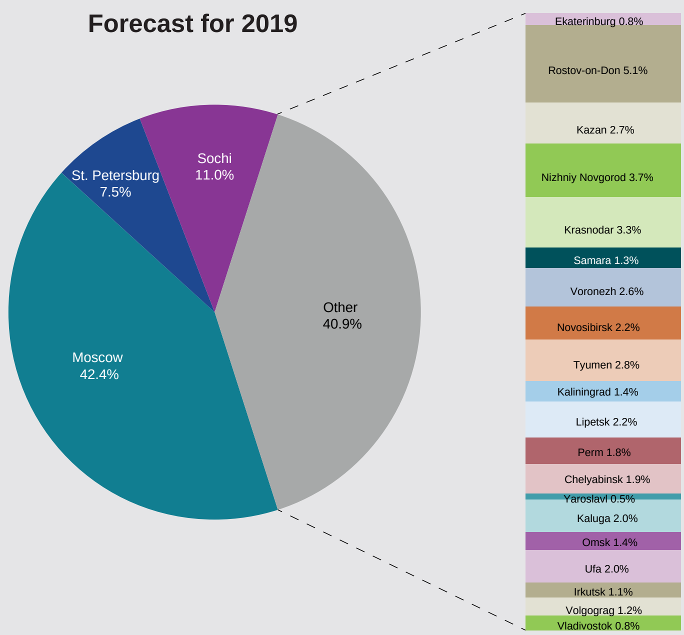
Change in the number of Russian hotels under international management



Source: KPMG analysis

Distribution of room inventory under international brands





Source: KPMG analysis

Distribution of existing and future room stock in Russia, by operator

Brand	In 2013		In 2019	
	Number of rooms	Number of hotels	Number of rooms	Number of hotels
Rezidor Hotel Group	7,720	25	12,854	48
Accor Hotels	3,788	19	11,730	64
InterContinental Hotel Group	3,345	13	6,339	25
Marriott International Inc.	3,482	14	5,612	23
Hilton Worldwide	1,024	6	5,230	27
Starwood Hotels & Resorts	897	4	2,612	12
Hyatt Corporation	726	3	1,830	8
Kempinski Hotels	1,017	4	1,667	7
Wyndham Hotel Group	446	3	1,176	7
Golden Tulip Hospitality Group	310	2	1,161	6
Fairmont Raffles Hotels International	235	1	1,022	5
Domina Hotel Group	108	1	1,013	6
Sokos Hotels	922	3	922	3
Rocco Forte Hotels	416	2	416	2
Four Seasons Hotels & Resorts	183	1	363	2
VIENNA INTERNATIONAL Hotelmanagement AG	359	2	359	2
Lotte Hotels & Resorts	304	1	304+	3
Orient Express Hotels	301	1	301	1
Corinthia Hotels International Ltd	285	1	285	1
Mandarin Oriental Hotel Group	-	-	217	2
Morgans Hotel Group	-	-	160	1
MaMaison Hotels & Apartments	84	1	84	1
Jumeirah Group	-	-	74+	2
Total	**25,952**	**107**	**55,731**	**258**

Hospitality & Leisure KPMG Advisory Services

Advisory services provided by KPMG for the hospitality and leisure industry

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- Concept development and investment planning for hotel and leisure projects
- Assistance in the raising of finance for hospitality and leisure projects
- Financial model development and review
- Marketing strategy development
- International operator selection and negotiating hotel operating agreements on behalf of clients
- Valuation of existing properties and development projects in the hospitality and leisure industry
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Contacts

Sven Osmers
Head of Real Estate Practice
Russia & CIS
Director
T: +7 (495) 937 44 77
F: +7 (495) 937 44 00
E: svenosmers@kpmg.ru

Olga Fazullina
Hospitality and Leisure
Manager
T: +7 (495) 937 44 77
F: +7 (495) 937 44 00
E: ofazullina@kpmg.ru

www.kpmg.ru