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KPMG IN RUSSIA AND THE CIS

International hotel operators in Russia and the CIS

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Hospitality & Leisure Advisory Services

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FRANCHISING

A few words about franchising

10–15 years ago franchising agreements were seldom seen in the hospitality industry in Russia and the CIS. This was chiefly due to the existence of an immature market that lacked professional players who were prepared to run a hotel business according to high international standards. These days, however, international hotel operators view expansion via franchising as being almost as appealing as direct management.

Franchising began in the US in the late 1940s, when the concept was applied as a distinct means of launching a new business, as opposed to a way of distributing an existing product.

The franchising format involves the owner of a brand name and business (the franchisor) transferring through a contract (the franchise agreement) the right to use a name and format to another party (the franchisee), typically for a fixed period and in an agreed location. In return, the franchisee pays an initial fee and subsequently a royalty based on a percentage of revenue generated. Essentially, the concept involves a transfer of intellectual property rights (in the form of trademarks and technical know-how) which benefits both parties to the transaction.

For franchisors, the gains mainly come from achieving rapid growth at a minimum level of investment – this helps create the critical mass ("minimum efficient scale") that is necessary to gain access to the core benefits of running a chain of hotels. Franchising provides increased business activity with lower capital risk, and as an option is usually preferable to company ownership in cases where a high level of initial investment is required, or where there is high growth. The scale effect combined with a flat organisational structure help ensure lower operating and administrative costs, as well as improved purchasing power with suppliers through increased sales volumes.

In franchising the primary advantage for the franchisor is that franchisees are more highly motivated than paid managers. Hence franchising can help turn franchisees into bona-fide entrepreneurs. "Independent" business owners that are close to markets are in the best position to

"Franchising provides increased business activity with lower capital risk...

nurture such markets and to flexibly operate the business to meet the demands of their business. The franchising structure enables the chain to be more responsive to customers and to be more flexible in terms of service needs. Many organisations believe that franchisees at a local level can better identify opportunities, cultivate key relationships, ascertain customer requirements, and more effectively manage costs. Franchising paves the way for new ideas, products and services that come about as a result of the innovative and creative approaches that tend to be used in this concept.

The franchisee in turn benefits from acquiring the rights to own and run a proven format while at the same time gaining access to a support structure usually available only to major hospitality chains. The franchise has already created a brand name, and the franchisee reaps the benefits from this, in addition to attendant extensive promotional campaigns. Franchisors often provide both operational and business management training to franchisees, as well as site selection and general start-up assistance. Franchisors typically provide pre-opening staff training, comprehensive operating manuals, and ongoing support. In contrast to an independent entrepreneur, a franchisee has the option of calling on the support of a large, experienced franchisor. In addition, compared to other small start-ups, the franchisee is exposed to a significantly lower risk of failure.

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Components of successful franchising

Many branded hospitality service organisations have achieved growth through deploying techniques borrowed from manufacturing to establish uniform, reliable and standardised brands. In connection with this, a common issue for franchise organisations is that they must manage the tension that exists between standardisation and control on the one hand and business freedom and flexibility on the other. At the same time, the franchise should be sufficiently decentralised to foster creativity and be responsive to local service needs.

The franchise should be both stable (so that all members – both direct employees and franchisees – know its mission and aims) and dynamic so that services reflect and meet changes in customer needs and environmental circumstances. Many hospitality service organisations offer brands that are uniform and meet customer security needs; however, increasingly, services should reflect the "customer as individual" – thus they need to appreciate individual and regional variations and tastes.

Franchisors have no single base of power and decision making. Unlike a traditional command and control organisation, franchises have multiple centres, as individually franchisees have rights and commitments which restrict the franchisor's capacity to exercise controls. Although the franchisor initially has specific knowledge and capabilities and can provide support to franchisees, franchising entails layers of expertise rather than a centralised group of self-contained professionals typically found within traditional structures. Franchisees have immediate, front-line knowledge of the business, as well as knowledge of the various business functions and how they affect the business. Hence an interdependent relationship exists in which franchisor and franchisee are both skilled and proficient practitioners. The franchisee exists not only as a client, but also as a partner who runs and grows the business for the franchisor.

Most franchisor organisations stipulate that franchisees work according to set brand standards. The actual brand not only establishes a market presence, but it also involves adhering to a level of conformity that constrains independence: as a result, franchisor organisations must monitor the franchisee operation. Customers these days expect a brand to deliver a consistent and reliable service, and the franchisor organisation must ensure that customers know what to expect and have their expectations satisfactorily met. Franchisors are responsible for the overall brand offer, while franchisees deal with decisions governing more day-to-day operations (recruitment, quality standards, advertising, etc.)

In order to reduce the threat of opportunism and to respect the closely aligned interests of the franchisor and franchisee, detailed franchising contracts are created. In a survey (National Westminster Bank/FBA Survey, British Franchise Association), around half of all franchisees globally opined that such contracts favour the franchisor, while the other half stated that they felt they were neutral. That said, franchisees are usually prepared to tolerate any constraints in view of the benefits that they secure from the relationship (essentially, a franchisee is buying into a business concept that has been tested in practice and shown to work). This means that the level of risk to the franchisee is lower than that associated with starting a new business. As with "empowered" managers or employees, a franchisee must be ready to work within a system designed by the franchisor's management and accept the constraints which it sets.

> **Franchisors are responsible for the overall brand offer, while franchisees deal with decisions governing more day-to-day operations...**

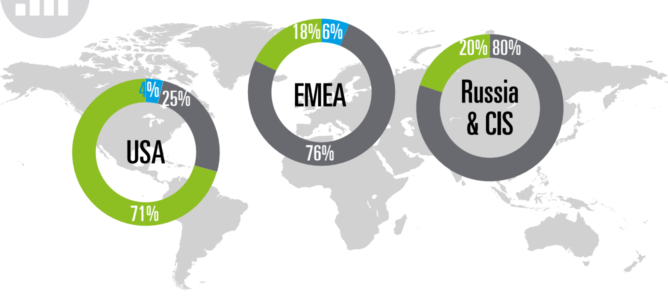
Franchising in Russia and the CIS

Russia and the CIS vs. other global regions

Franchising has in recent years become a hot topic in the Russian and CIS hotel market. Many investors have now gained sufficient experience and are seeking to manage their own properties, but under an established brand name. Some brands are prepared to cooperate on these initiatives and are willing to expand their network via franchising, while other international chains still favour developing through direct management contracts. In addition, local third-party management companies are expanding in the region, and international operators are entering the market.

Compared to mature markets in the US and Europe, regional markets in Russia and the CIS are at an early stage of franchising development. Figures also show that in terms of the proportion of franchised vs. managed hotels within major hotel chains, there is a trend of underdevelopment related to franchise models in the Russia and CIS region.

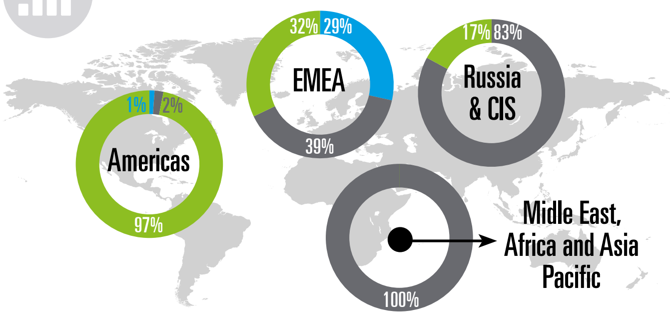
Starwood Hotels & Resorts Hotels



Owned Managed Franchised

Source: Starwoodhotels.com

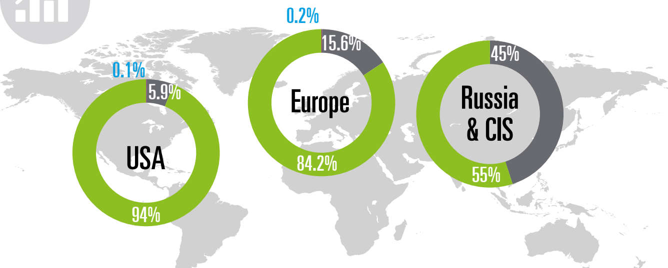
Carlson Rezidor



Owned Managed Franchised

Source: Carlson Rezidor data

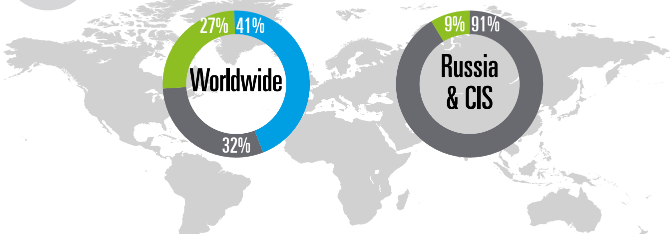
InterContinental Hotel Group



Owned/Leased Managed Franchised

Source: ihgplc.com

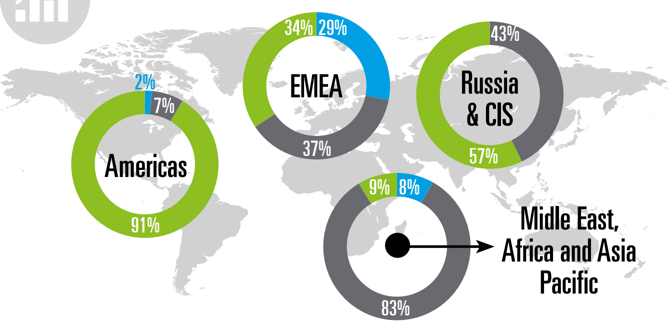
Accor Hotels



Owned/Leased Managed Franchised

Source: accor.com

Hilton Worldwide



Owned/Leased Managed Franchised

Source: ir.hiltonworldwide.com

Russia and the CIS specifics

As the market matures, more investors are showing a willingness to get into hotel management and to structure their own professional teams. Representatives of major hotel chains operating in the Russian market claim that in recent years more owners have been requesting franchising agreements and not management contracts. The majority of international hotel chains in Russia and the CIS are still not ready to entrust the management of hotels under their brand to investors with no related industry experience. That said, the degree of strictness applied in reviewing investor profiles varies from one hotel company to the next; for example, Marriott International Inc. accepts the franchising model only if the management company that will run the hotel is on the list of Marriott's approved companies. Such approved companies currently include professional international third-party management companies (for example, Interstate Hotels & Resorts) with a proven record of managing successful hotel projects in the region and management teams nurtured by Marriott via a process of direct management during the initial years of operation, such as Comfort Hotel Management. Marriott is willing to consider other companies, as long as they can demonstrate the necessary level of experience and expertise. Wyndham prefers to expand its presence in the region by opening hotels under its brands in collaboration with known-in-the-market Russian and international third-party operators, while Intercontinental Hotel Group, Accor and some other chains are prepared to consider entering into franchise agreements with less experienced owners.

The majority of franchise agreements in Russia and the CIS are signed for budget/midscale brands, such as Hampton by Hilton, Holiday Inn Express, Days Inn, Ramada Encore, Ibis, Novotel, and Courtyard by Marriott. It is very unlikely that hotel chains would entrust to individual investors the management of their top

> **The majority of franchise agreements in Russia and the CIS are signed for budget/midscale brands...**

brands (Ritz Carlton, Sofitel, MGallery, Planet Hollywood, W, St. Regis, Intercontinental, etc.) This can be explained not only by the reputational risks involved in such a move, but also by the higher margins that luxury hotels generate for management teams.

Each hotel company has its own strategic priorities in terms of the geographical location of their managed/franchised properties, and not all markets in Russia and the CIS are equally attractive for brands. The majority of companies agree that the most promising CIS countries in terms of development are Azerbaijan, Kazakhstan, Georgia, Armenia and Ukraine (as soon as the current geopolitical situation stabilises). Attitudes vary among hotel chains when it comes to entering new markets. Some are ready to expand into unexplored locations only through franchises, due to the lower operational risks franchise agreements provide; however, some chains are prepared to manage properties in such destinations to ensure that the brand's reputation and standards do not suffer under local management. Countries such as Uzbekistan, Tadzhikistan, Kyrgyzstan and Turkmenistan are of interest for hotel operators primarily in terms of getting established in the capitals of these countries.

In Russia, hotel companies are interested in significantly expanding into regional cities. As the targets of hotel companies in terms of the number of operating hotels in regions grow, smaller cities are becoming more interesting for brands. Regional cities have a cap that can be achieved for ADR, consequently there is a business rationale for developing mainly midscale and budget brands in such destinations. The potential margins of such properties do not always motivate hotel chains to take full responsibility for operations; in addition, paying a fee to engage a hotel chain to run the property will not necessarily bring added value to the owner. Thus franchising represents the most optimal method for brands to develop in regions.

The need to raise debt financing for hotel projects can act as an additional incentive for a franchising practice to expand. As hotel projects are not normally a top priority for Russian bankers, having the name of an international brand adorning the hotel property constitutes an advantage for financial institutions potentially interested in financing such projects.

> **Franchising represents the most optimal method for brands to develop in regions.**

How much does it cost?

Key issues to consider during the property franchising decision-making process is fee structure and amounts to be paid. Some structures differ from operator to operator; we have consolidated the general conditions an investor may come across in the majority of franchise contracts. Most of the figures are confidential; for convenience we cite some ranges.

A typical fee structure involves:

- An initial fee payable by the franchisee on the execution of the Franchise Agreement associated with the initial granting of rights and costs incurred by the franchisor. Its aim is to cover the operator's initial costs, (i.e. from reviewing the site, market potential analysis, evaluation of the hotel's plans / existing layout). The initial fee typically takes the form of either an amount based on the hotel's room count or a fixed amount. This fee is sometimes non-refundable.
- The royalty fee is a recurring fee the franchisee pays to the franchisor, and covers the use of a trademark and a trade name, as well as continuing franchise services. The fee is typically based on room revenue and usually varies between 4 and 5 percent of gross room revenue. Some operators add 2 percent of F&B revenue to room revenue.
- The technical services fee covers the brand's costs during the provision of ground support to the franchisee development team related to the design and development of the hotel. A technical service agreement (TSA) ensures that after a project has been completed it complies with brand standards and is operationally efficient. Technical fees usually range from USD500 per room for rebranding projects to USD1,000 for greenfield projects.
- The marketing fee covers an operator's various promotional activities related to increasing brand awareness among the target audience and developing new brand initiatives. The fee, which is usually based on gross room revenue and sometimes on total revenue, typically ranges between 2 and 3 percent of room revenue or 1 and 2 percent of total revenue.
- The reservation fee covers costs associated with an operator's reservation system, such as central office operations, respective personnel, and all distribution-related fees. Rates and the way they are calculated vary between different operators and depending on which systems they use. Rates may be charged as a percentage or a fixed amount charged per booking, depending on the brand.
- The loyalty fee is part of a franchisor loyalty programme. Often the fee is calculated as a percentage of total revenue generated by loyal guests, and typically ranges from 3 to 5 percent.

Depending on the operator and project there may be additional system and technical support services provided by the hotel chain and related fees stipulated in a contract. Another common requirement, cited by all hotel chains, is that the general manager of a property must be approved by the brand. Some franchisors offer extra services for franchised properties. IHG, for example, provides staff outsourcing services for such key hotel positions as revenue manager or general manager, as well as hotel performance support (several visits per year, assistance on reviewing marketing / sales plans and strategies etc., in order to maximise owner profit).

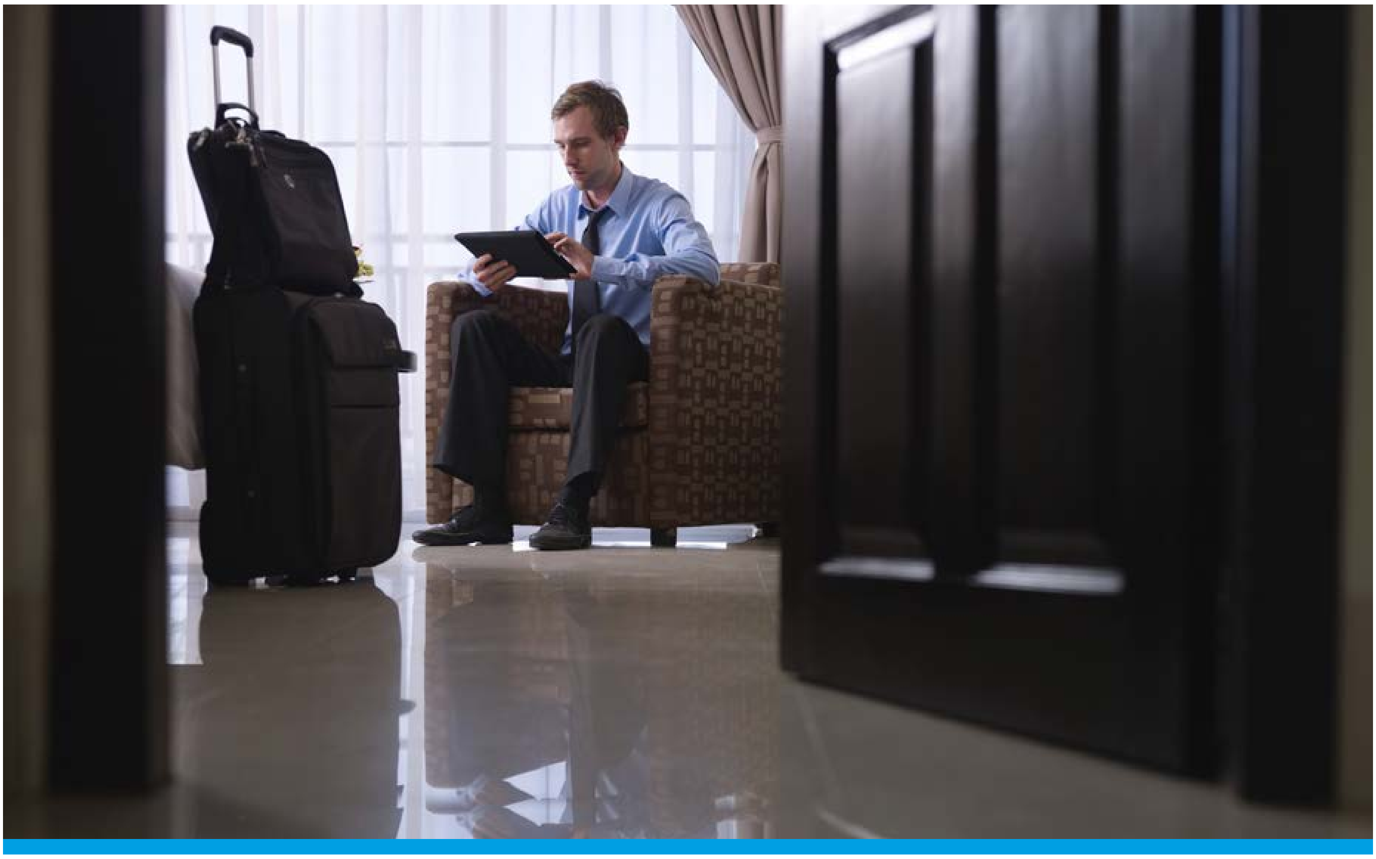
Manchising – An option to consider?

> Manchising agreements also give owners flexibility in terms of being able to cut expenses in the subsequent years of a property's operation, after management teams have gained sufficient experience.

In addition to traditional franchise agreements, hotel chains operating in the Russia and CIS region have begun to implement the practice of "Manchising", which involves the following:

- owners engage an operator for an initial period until the performance of the property stabilises (around five years)
- the contract then reverts to a franchise contract under which the owner assumes management responsibility and retains the operator's brand, for which he pays an annual franchise fee

Despite the hotel management model changing, there is no impact on the external running of the hotel. Such structures are particularly useful in terms of helping hotel operating companies to launch new brands and to exercise a degree of operational control in the initial years as the brand undergoes a 'ramping up' period. These agreements also give owners flexibility in terms of being able to cut expenses in the subsequent years of a property's operation, after management teams have gained sufficient experience.



Third-party operators – Extra benefits or extra costs?

Another option for managing a hotel property is to attract a third-party management company which specialises in providing such services for hotels. A professional third-party management company can benefit inexperienced owners who do not wish to be involved in the hotel's day-to-day operations, and engaging such a company does not necessarily mean in practice having a three-sided arrangement between the brand providing the franchise, the management company running the hotel, and the owner. Third-party management companies are able to more objectively advise owners on whether they should brand their property – some hotel projects may not obtain any added value by having an international brand name; however, having an experienced management team in place, whose remuneration is linked to hotel performance, will most likely benefit the owner.

Such third-party companies generally work with a number of hotel chains and brands and may propose a number of options to owners suitable to each project. When suggesting a brand, they tend to be more interested in the potential performance of a project than in promoting a particular hotel chain. During the construction phase, the third-party management company can help owners avoid unnecessary costs and align a property to the standards of several brands if a brand has not been chosen. Investors that plan to operate a number of properties, and are unsure about committing to a particular brand, would be better suited working with one third-party operator that manages their properties under various brands, or no brands at all. This would also allow the management company to cluster some positions, and thus improve the operational efficiency of the managed hotels.

The combined fees of a third-party operating company and the franchise fees for the brand will most likely equal or exceed those of signing one direct management contract with a hotel company. However, such a dual structure gives extra flexibility to owners, since the terms of management contracts with third-party companies are usually shorter than those with hotel chains (10-15 years, vs. 20-25). In addition, management contract termination clauses are usually less stringent, and if an owner is not happy with the brand or management company it is easier to replace one of them rather than terminate the direct management contract with the hotel chain. In such cases any negative impact on the hotel's day-to-day operations will be minimal and the investor will incur fewer losses.

> **Third-party management companies are able to more objectively advise owners on whether they should brand their property**

> **...the third-party management company can help owners avoid unnecessary costs and align a property to the standards of several brands ...**

A number of international companies operate hotels in Russia and CIS, including Interstate Hotels & Resorts (the largest global third-party hotel management company, operating properties all over the world under 40 brands). The company was the first to establish in the region and has the biggest portfolio of brands and hotels under management (13 properties, with over 4,000 rooms). Hotel chains are keener to entrust upper-scale brands to international management companies (Interstate Hotels & Resorts, Sophos Hotels, Vienna International) when signing franchise agreements. However, local competitors are also gaining in terms of both experience and in the number of properties they manage. Companies such as BS Hospitality management and IFK Hotel Management currently operate properties under the brands of one hotel company (Hilton and Louvre Hotels, respectively); however, IFK in a recent interview with us stated that to become more competitive in the market it plans to expand in the near future its portfolio of brands.

Conclusion

Franchising has become a development priority for all hotel chains.

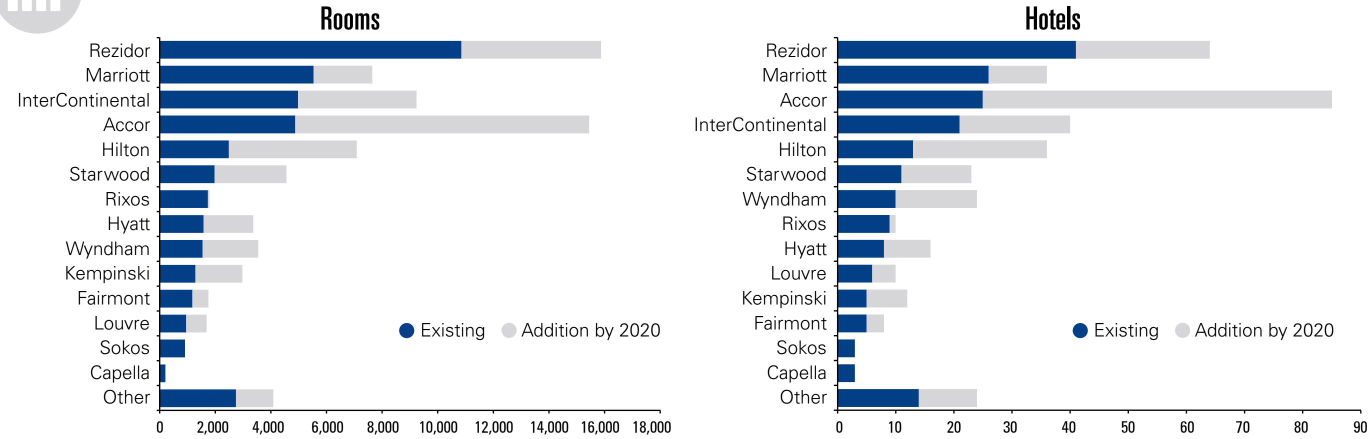
In order to arrive at a conclusion on the expansion of franchising in Russia and the CIS, we analysed operator pipelines in terms of the number of franchised vs. managed hotels. No specific trend appears to unite all brands operating in the market or clearly demonstrates that franchising has become a development priority for all hotel chains. Some hotel companies are more proactive in implementing this structure than others, but, that said, an overall increase in the number of franchised hotels in the market pipeline can be observed. The introduction of so-called "Manchise" contracts also reflects that hotel chains in Russia and the CIS are beginning to get more confident about the ability of owners to manage properties.

COUNTRIES REPORT

Introduction

The expansion of international hotel operators in Russia and the CIS is progressing quite rapidly, with approximately 200 hotels now operating in the whole region and 70 operating in CIS countries (excluding Russia). Even though the current economic climate is creating uncertainty in relation to the potential economic growth of some countries, another 194 hotels with a total room stock of nearly 37,300 units are due to open in the region by 2020 (59 hotels / 10,400 rooms in the CIS, excluding Russia) according to the pipeline of international hotel chains.

Rating of international operators by presence in Russia and CIS market



Source: KPMG analysis

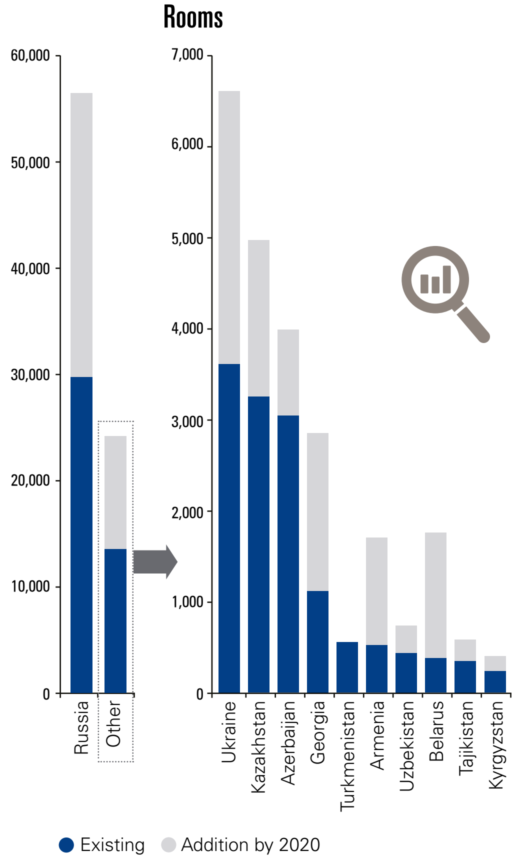
Rating of international operators by presence in Russia and CIS market

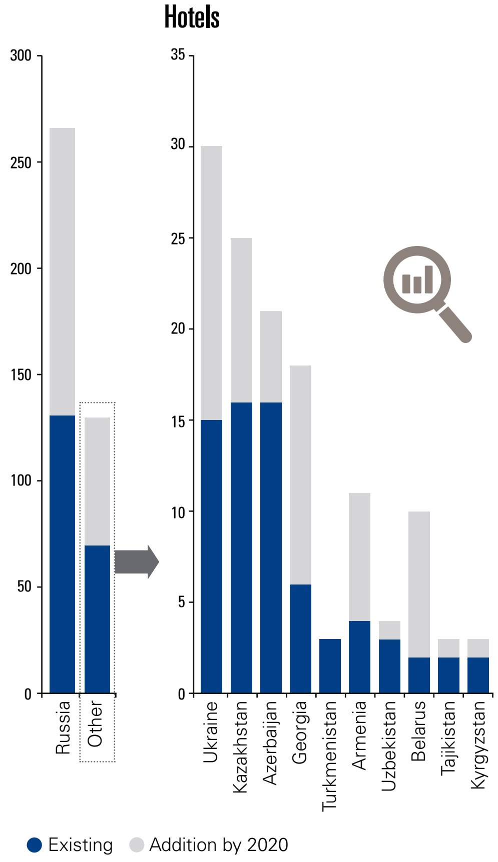
Source: KPMG analysis

Currently the leading hotel company in the region is Carlson Rezidor Hotel Group, with 41 hotels and a total inventory of nearly 11,000 rooms operating under its brands in Russia and the CIS. By 2020 the leader in terms of number of operating hotels is projected to change to Accor Hotels, which is forecast to have 85 properties with a total inventory of 15,400 rooms.

Based on our interviews conducted within the frame of the survey with the representatives of major hotel chains in Russia and the CIS, there has been no considerable drop-off in investor interest towards the hotel market, who plan to continue implementation of already started projects, despite adverse geopolitical and economic conditions. However we believe that projects on early stage of development may be frozen and initiation of new construction may be put on hold until the situation stabilizes.

Distribution of branded room stock and hotel supply in Russia and CIS market





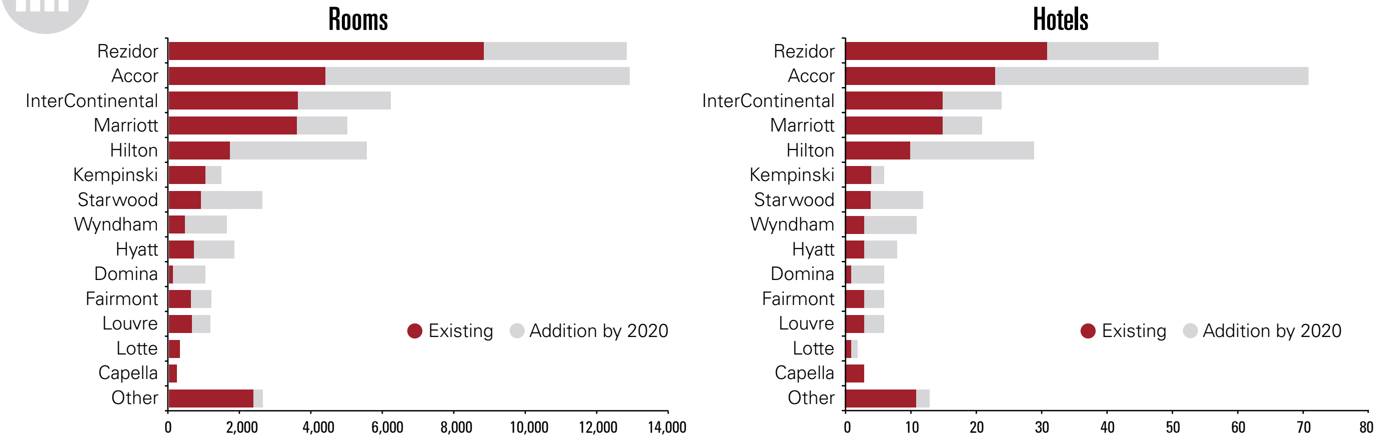
Source: KPMG analysis

Russia

In terms of hotel network Russia is the most developed country in the CIS, with 131 hotels in operation and around 136 in the pipeline. Recent geopolitical and economic events have worsened the business environment outlook, and as a result of banking sanctions financing costs could increase.

After recent economic and geopolitical developments and an attendant slowdown in tourism activity, Moscow remains the most attractive market in the country for hotel development, although regional markets are also seeing active development. Whereas in the past hotel operators preferred to establish a presence in cities with a population exceeding one million, now they are actively seeking to expand their networks into regional centres with more than 300 thousand inhabitants.

Rating of international operators by presence in Russia



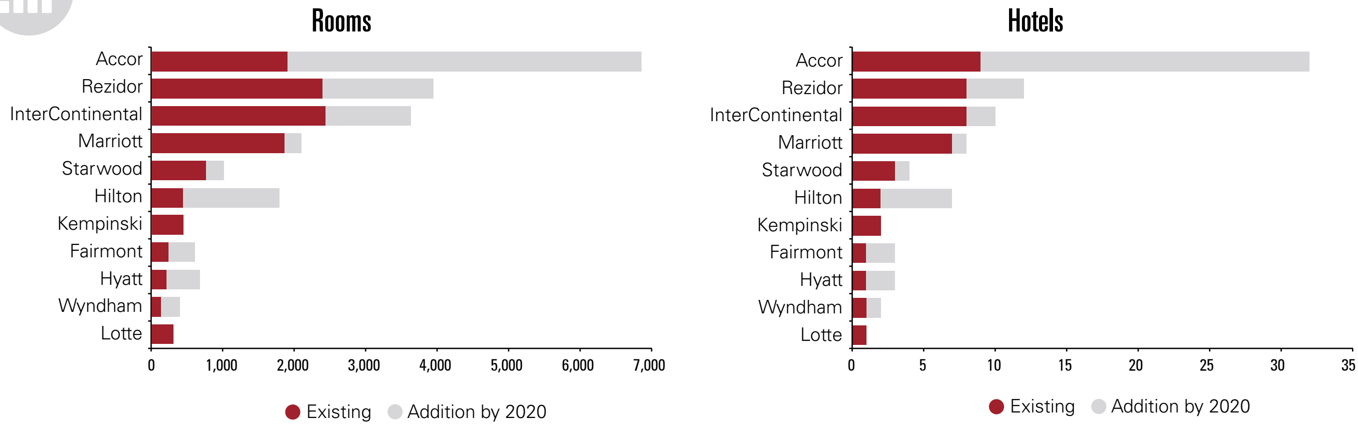
Source: KPMG analysis

The majority of Russian room stock and hotels under international brands are concentrated in Moscow (38% of current Russian room stock of international operators). At present, 44 out of 340 hotels in Moscow, or 11,192 of 46,989 rooms, operate under various international brands. Upscale and luxury hotels currently account for the bulk of the hotel supply in Moscow, while there remains a lack of international-quality hotel rooms priced in the mid range. No new midscale hotels are expected this year, and the budget and midscale markets currently comprises only 12 hotels, with a total inventory of approximately 2,700 rooms.

Each year more and more international hotel chains are opening or assuming the operation of properties in Moscow, from established brands such as Marriott and Radisson, to relative newcomers such as Four Seasons. Hotel Nikolskaya, which opened last spring under the Kempinski brand, has changed operator to Starwood Hotels & Resorts and launched a new brand on the Russian market, St. Regis. Another trend witnessed this year is the expansion of international hotel brands into the Moscow region, with Radisson Zavidovo (239 rooms) and Hilton Garden Inn Moscow New Riga (162) open in the first half of 2014. Two more hotels were open in Q3 2014 in the Russian capital: Four Seasons Hotel Moscow (180 rooms) and Double Tree by Hilton Moscow Marina (270).

By 2020 the room stock of hotel chains in Moscow is expected to rise to nearly 22 thousand, with 42 new properties creating almost 11 thousand rooms, making the capital's share of room stock in the future supply of Russia 39%.

Rating of international operators by presence in Moscow



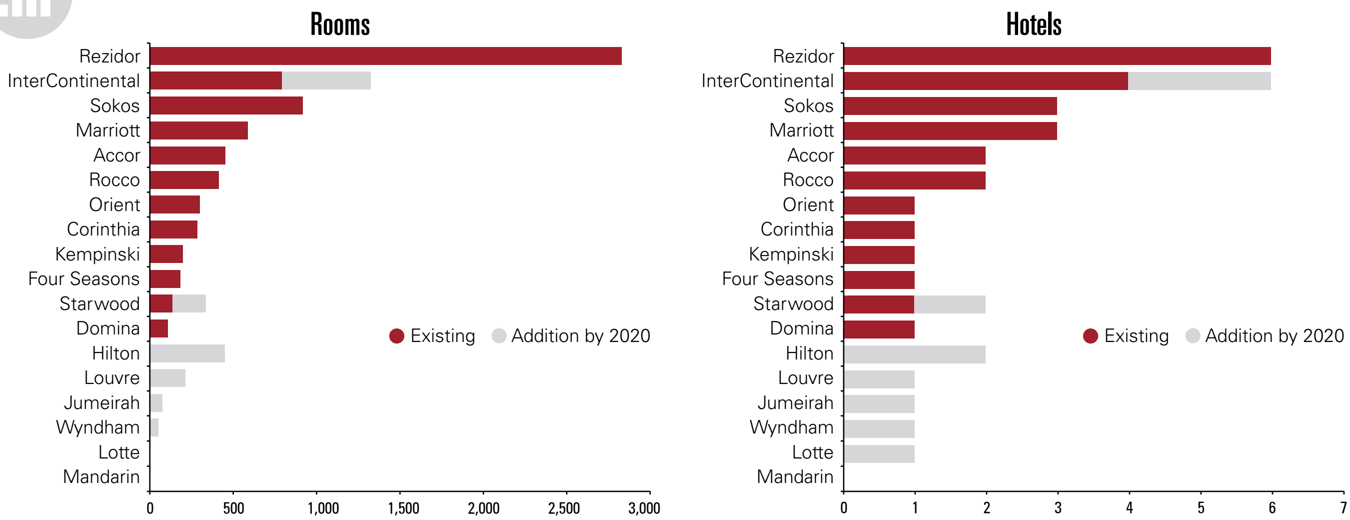
Source: KPMG analysis

St. Petersburg, the second-most popular city in Russia for hotel operators and investors, is less stable than Moscow in terms of tourist flow, due to its high dependence on leisure travellers in summer, the peak season for the city. Geopolitical and economic events this year have had an adverse impact on the number of tourists visiting the city, mostly represented by a decline in European and American travellers. Consequently, hotel occupancy in St. Petersburg has been negatively affected. Nevertheless, hotel chains, which have not yet established a presence in Russia's second-largest city, are still looking for opportunities to enter the market.

Two branded hotels opened in the first six months of 2014: Indigo by IHG and Park Inn by Radisson Pulkovo Airport. Currently over 70% of branded hotels in St. Petersburg belong to the upscale or luxury segments, while almost half of pipeline properties belong to the midscale segment.

New hotel brands are expected to enter the St. Petersburg market in the near future: Hilton and Hampton by Hilton are due to open in 2015 (near the new Expo Center in the city), while Golden Tulip Hotels is scheduled to commence operations in the city in 1Q 2015, and Jumeirah is expected to launch in 2017.

Rating of international operators by presence in St. Petersburg

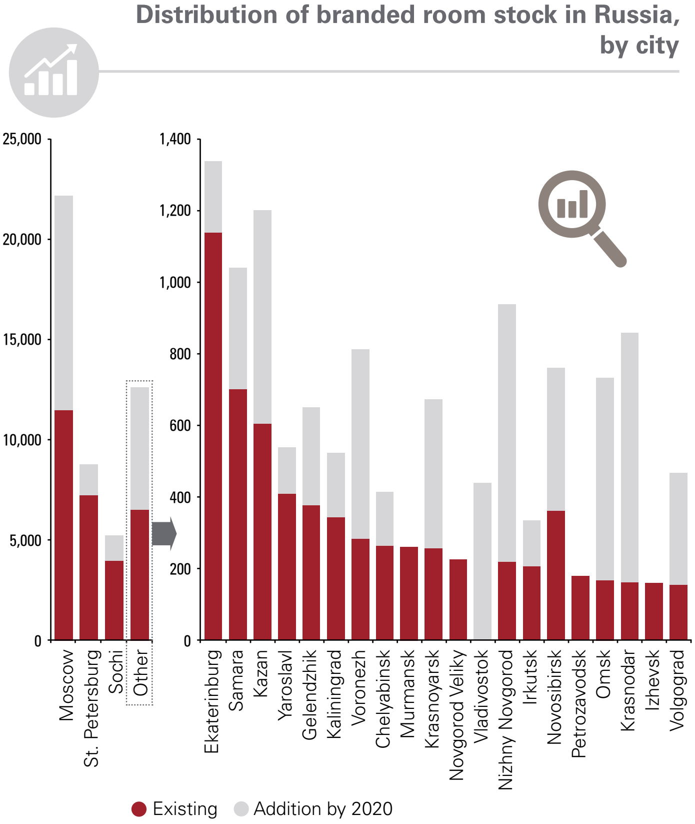


Source: KPMG analysis

After Moscow and St. Petersburg, the most developed city in the country in terms of hotel infrastructure is Sochi, whose leading position is explained by the recent Olympic Games held in the city, which created great demand for international standard hotels. Somewhat surprisingly, Sochi's development continued after the Olympics – five more hotels, operated by Starwood Hotels, Marriott International Inc., Hilton Worldwide, Accor Hotels and Rezidor Hotel Group, are expected to add to the network of 20 existing branded properties in Sochi.

Among regional cities with a population exceeding one million, the most developed in terms of number of hotel properties are Yekaterinburg, Samara, and Kazan, with four or more branded hotels already operating. A further 10 large Russian cities (population > one million) have more properties in the pipeline than are currently operating. Rostov-on-Don has the biggest pipeline among regional cities, with six hotels scheduled to open within the next four-to-five years under the Ibis, Mercure, Hyatt Regency, Le Meridien, Sheraton and Ramada brands and none under international brands currently operating. The second-highest number of projects (four) are being developed in Nizhny Novgorod, where only one branded property, Ibis Centre Nizhny Novgorod, has been opened. Cities with a population exceeding one million are due to have from three-to-eight branded properties up and running by 2020.

Distribution of branded room stock in Russia, by city



Source: KPMG analysis

Among second-tier cities (population over 500 thousand), Yaroslavl has the highest number of hotels operating under international brands (Ibis, Mercure and Park Inn). In other second-tier cities international brands have established a presence only in Krasnodar, Izhevsk and Lipetsk (Hilton Garden Inn and Marriott in Krasnodar; Park Inn in Izhevsk; Mercure in Lipetsk). Cities such as Ufa and Tyumen each have four hotel projects in progress and no hotels operating at present. Other second-tier cities are set to open no more than two properties by 2020, thus creating potential for further development for investors and brands.

Looking at smaller regional centres, Kaluga is attracting significant attention from international hotel operators, and is the only city with a population of less than 500 thousand where one hotel, Hilton Garden Inn, has already opened and three more international hotels (Four Points by Sheraton, Ibis and Adagio) are due to open in the next two years. Such a strong pipeline is explained by the dynamic development of the automotive and related industries in the city.

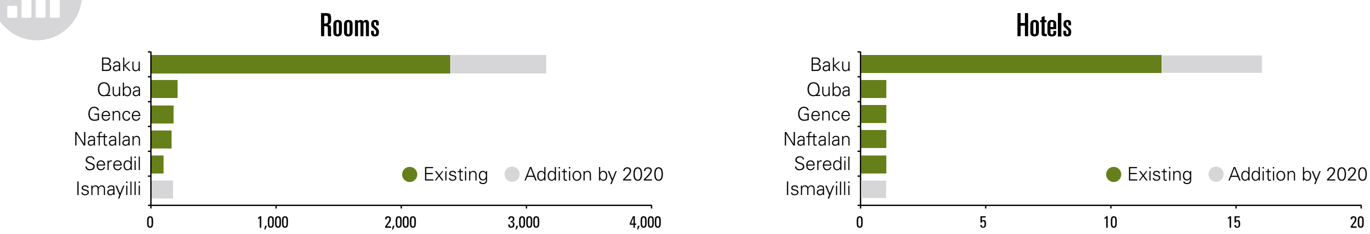
Another interesting case is the resort town Gelenzhik, where Kempinski has already established a presence, and another branded hotel, Radisson Blu Primorye, is due to open. Despite Gelenzhik having a population of only 65 thousand, it attracts many tourists in the summer season. The town is following the Sochi trend (the city is located not far from Sochi), where Soviet-era accommodation is gradually being replaced with international quality facilities.

Azerbaijan

Travel and tourism continues to be one of the most crucial sectors for economic development in Azerbaijan, especially in terms of sustaining employment growth. The tourism industry has made initial steps towards success, as demonstrated by considerable tourist flow growth in 2003–2013, when the number of foreign tourists visiting the country rose from around 600,000 to over 2.5 million. This was followed by a substantial rise in hotel construction. The government forecasts a further increase of up to 3 million tourists annually by 2015.

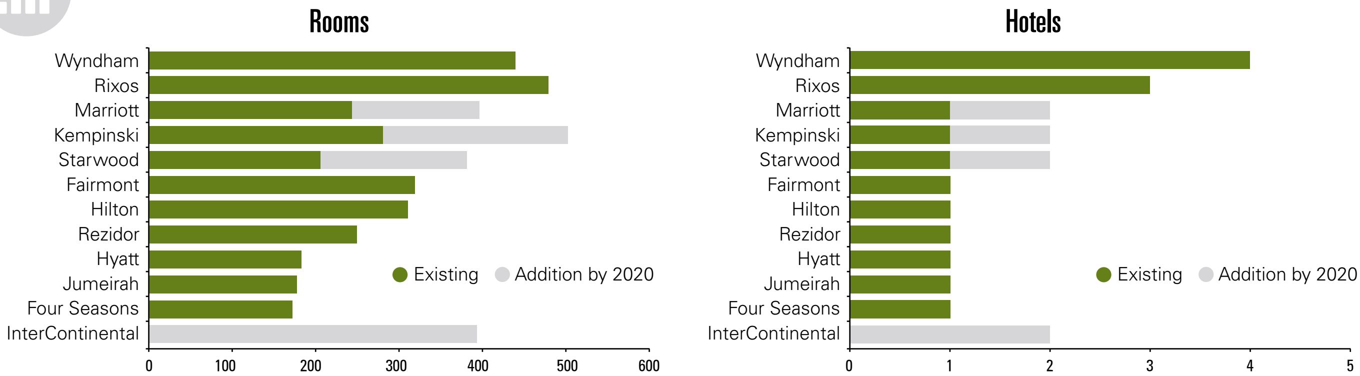
The capital Baku is the most actively evolving market in the region (with 12 out of 16 existing branded hotels in the country, providing 2,390 rooms in the city). The regional market is still not so attractive for investors; Gence currently has a branded hotel Ramada Plaza (180 rooms). Other regional properties are represented by the Rixos brand, which has successfully penetrated the market with three resorts opening in recent years in Quba, Naftalan and Seredil. All major international operators preferred to initially explore the market with luxury brands. Worth noting is that there are some brands present in Azerbaijan that have not yet entered the Russian market (Jumeirah and Rixos). Wyndham Hotel Group is a current leader in the Azeri market, with four properties operating (three in Baku and one in Gence, with a total room stock of 438), while Rixos takes second place with three operating properties in the regional cities of the country. Other operators such as Rezidor, Kempinski, Starwood, Fairmont, Hilton and Hyatt are represented by one operating hotel each and all intend to open one or two properties more. The total branded pipeline of the country is forecast to expand to almost 4,000 rooms in 21 properties by 2020.

Distribution of branded room stock and hotel supply in Azerbaijan, by city



Source: KPMG analysis

Distribution of branded room stock and hotel supply in Azerbaijan, by operator



Source: KPMG analysis

Armenia

Over the past few decades the tourism industry has been a priority economic development area for the Government of Armenia. In February 2008, the government adopted a tourism development concept paper aimed at increasing tourism's contribution to the country's GDP. The number of international tourists to the country has been steadily growing since 2001. The CAGR for the number of incoming tourists for the period 2001–2011 was around 18.74%, while the CAGR for internal tourism during the same period stood at 13.9%. According to the Armenia Ministry of Economy, the total number of tourists in 2013 was approximately 1.08-1.09 million. The government has set a target of 1.5 million international tourist arrivals by 2020.

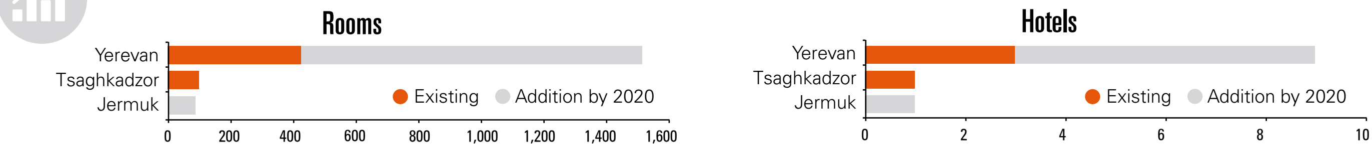
Most international hotel operators in Armenia opened their first hotels in the capital Yerevan, which remains the leader in the country in terms of room stock and number of hotel facilities. However, due to growth in tourist flows to the resort towns of Tsakhkadzor and Jermuk, international hotel operators have begun to expand into these cities too, following the trend of local hoteliers, which have already established a significant presence there.

At present four hotels are operating under international brands in Armenia, with a total of 526 rooms. By 2020 the total branded hotel stock is forecast to increase to 11 facilities and 1,704 rooms. Marriott International Inc. remains the market leader, with two operating hotels and a total of 326 rooms (in Yerevan and Tsakhkadzor) in its portfolio. Louvre Hotels Group manages a property with a total of 104 rooms in Yerevan. Finally, a recent addition (in 2013) to the branded market is a Hyatt facility, with 96 rooms opened in Yerevan. Hyatt Corporation plans in early 2015 to further open a second hotel under the Hyatt Place brand with 88 rooms in the spa resort town of Jermuk.

Wyndham Hotel Group plans to open two properties in the country, both located in Yerevan. The hotels will be open in 2015, both of them are at the final FF&E installation stage. Accor Hotels is also targeting Yerevan and plans to open two new hotels in the capital: one Ibis Yerevan and one Ibis Styles Yerevan, with a room stock of 240 and 110, respectively. Ibis Yerevan is planned to open in 2015, while construction of Ibis Styles Yerevan has been put on hold.

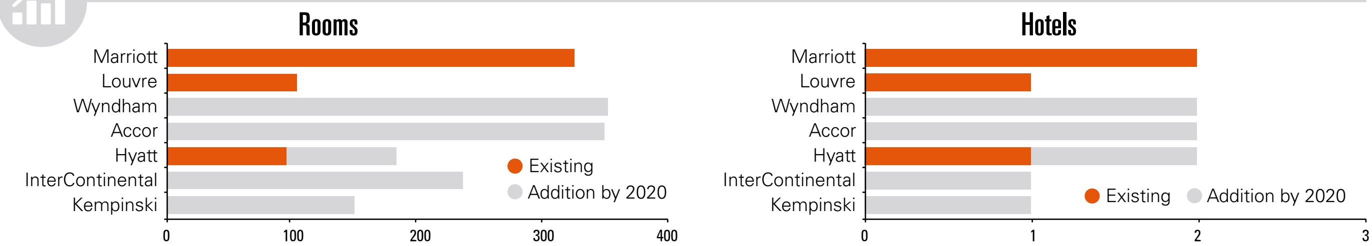
Plans to construct a hotel under the Kempinski brand in Yerevan have been put on hold, and currently there is no publicly available information on the opening.

Distribution of branded room stock and hotel supply in Armenia, by city



Source: KPMG analysis

Distribution of branded room stock and hotel supply in Armenia, by operator



Source: KPMG analysis

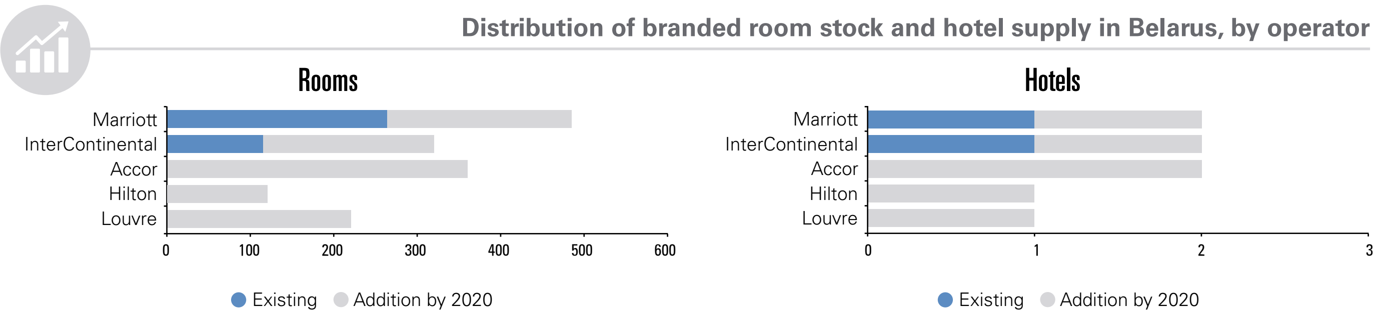
Belarus

In the past three-to-five years the Belarus Government has demonstrated that it is serious about attracting foreign investors into the country, with the travel and tourism industry being a major focus. A number of benefits and tax breaks to stimulate foreign investment activity were announced by the government to improve the image of the country, and in order to prepare for the hosting of the 2014 Ice Hockey World Championship, the Belarusian Government implemented a number of projects aimed at developing the country's travel and tourism infrastructure. These included the construction of new hotels, the redevelopment and reconstruction of existing accommodation and hospitality facilities, improvements to road networks in the capital, and construction of an ice-hockey arena. Minsk National Airport also underwent a thorough refurbishment. The country's tourism market is characterised by a prevalence of business guests and guests attending events. Almost 6.2 million foreign visitor arrivals were registered in 2013, which included a 14% increase in the number of organised tourists.

Prior to the 2014 hockey world championship the Belarus hotel market had only one internationally branded hotel (Crowne Plaza Minsk) operating in the country. However, the holding of the championship stimulated the development of the Minsk hotel market, and Renaissance Hotel opened in 2014, with a room inventory of 264 keys.

Despite the volatile economic situation in the country, it is attracting more attention from international hotel chains, and seven hotel projects under the brands Accor, Hilton, IHG, Louvre Hotels, Marriott and Wyndham, with a total room inventory of 1,176, are due to be completed within the next two-to-three years in Minsk. Accor and Marriott will occupy the leading position in terms of number of properties in the country, with each due to have two hotels operating by 2016. No other cities have been earmarked for hotel openings.

Distribution of branded room stock and hotel supply in Belarus, by operator



Source: KPMG analysis

Georgia

Georgia's Tourism sector is a rapidly growing industry. The government of the country has identified tourism as a key area of investment and development, and has taken measures to attract investment into resort towns, which comprise: Sun-beach resorts: Batumi, Anaklia and Kobuleti; Winter Ski-Mountain resorts: Gudauri, Mestia, Bakuriani, Goderdzi and Kazbegi, and Spa resorts: Tsakhltubo, Borjomi and Akhtala. Tourist inflows and investments are chiefly concentrated in Tbilisi and Batumi, however the government plans to open two free tourism zones in Anaklia and Kobuleti, which will boost investments for Black Sea resorts. In 2012 4.4 million people visited Georgia, representing an increase of 57% on 2011. Georgia had 22% more tourists in 2013 (5.4 million) than in 2012.

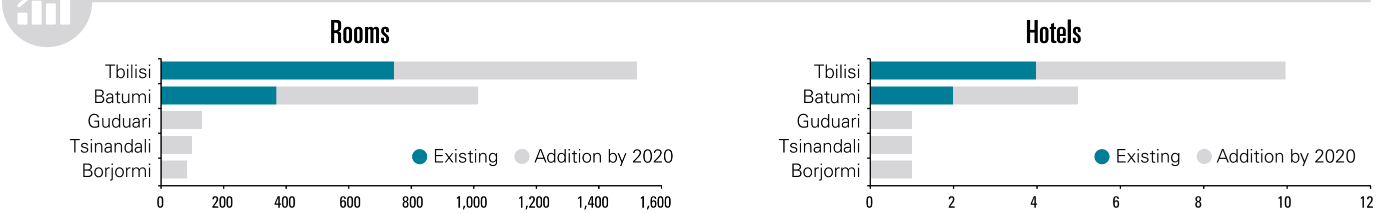
For a long time the majority of branded properties in the country were concentrated in Tbilisi. However, alongside the rapid development of the seaside town of Batumi, international operators began exploring Georgian regions more actively. In addition to Batumi, operators are currently considering opening rather small hotels in other regional towns in Georgia, such as Gudauri, Tsinandali and Borjomi.

At present six hotels operate under international brands in the country, with a total room inventory of 1,116 units. By 2020 this number is forecast to increase to 18 facilities with 2,851 rooms. Carlson Rezidor Hotel Group holds the leading position in terms of room supply, with two operating properties in Tbilisi and Batumi and a total of 417 rooms in its portfolio. InterContinental Hotel Group manages one hotel with 252 rooms in Tbilisi and ranks second in terms of room stock. Marriot International Inc. operates two facilities in Tbilisi, with a total room supply of 245. Starwood Hotels & Resorts has one property under its brand, in Batumi, with 202 rooms. The Ascott chain is currently also represented by one property, the Citadines Freedom Square Tbilisi hotel (66 rooms).

The forecasted openings of hotels under international brands shows a positive trend. Carlson Rezidor Hotel Group plans an expansion by opening three more properties: one in Tbilisi (Park Inn by Radisson Rustaveli Tbilisi) and two Radisson Blue hotels in the towns of Gudauri and Tsinandali. It is expected that the total number of rooms by Carlson Rezidor Hotel Group will reach 848 units, and that the group will thus maintain its current leading position. The InterContinental Hotel Group plans to grow its portfolio by another three new hotels in the country: one with 200 rooms (Intercontinental Tbilisi) to be opened in the capital in 2016, and another two in Borjomi and Batumi. An 84-key Crowne Plaza Borjomi will open in 2015, while the Holliday Inn Batumi (148 rooms) is scheduled for 2020. Hilton Worldwide plans to enter the market with two hotels: one in Batumi and one in Tbilisi, which will provide a total of 412 rooms under its brands by 2015.

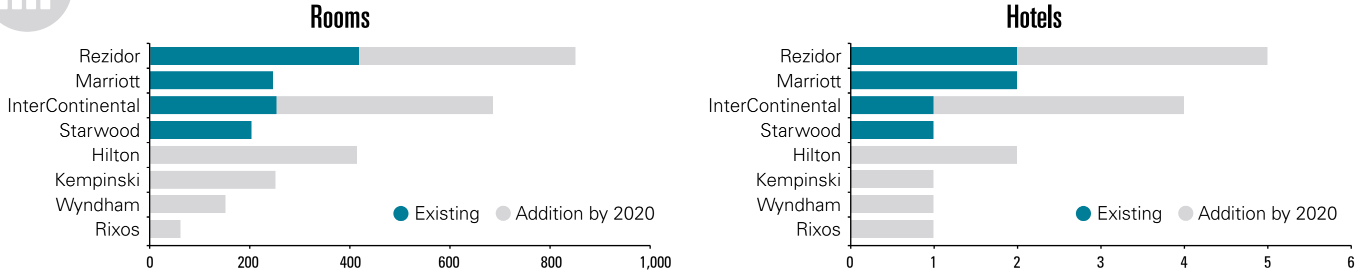
The major international hotel chains Kempinski Hotels, Hyatt Corporation, Wyndham Hotel Group, Rixos Hotels and Accor Hotels plan to open one hotel each in Georgia by 2016; three of these facilities will be located in Tbilisi and the others in Batumi. Together they will provide an additional room supply of more than 643 units. The largest of the properties is planned to be the Grand Hotel Kempinski Batumi, with 250 hotel keys; however, this project has been put on hold.

Distribution of branded room stock and hotel supply in Georgia, by city



Source: KPMG analysis

Distribution of branded room stock and hotel supply in Georgia, by operator



Source: KPMG analysis

Kazakhstan

In May 2014 the Government of Kazakhstan approved a blueprint to raise tourism's share of GDP from the current level of 0.3% to 3% by 2020. Almaty is now participating in a bid to host the 2022 Winter Olympics. The government will allocate USD4 billion of the 2020 blueprint's USD10 billion price tag, with private investors expected to contribute the rest.

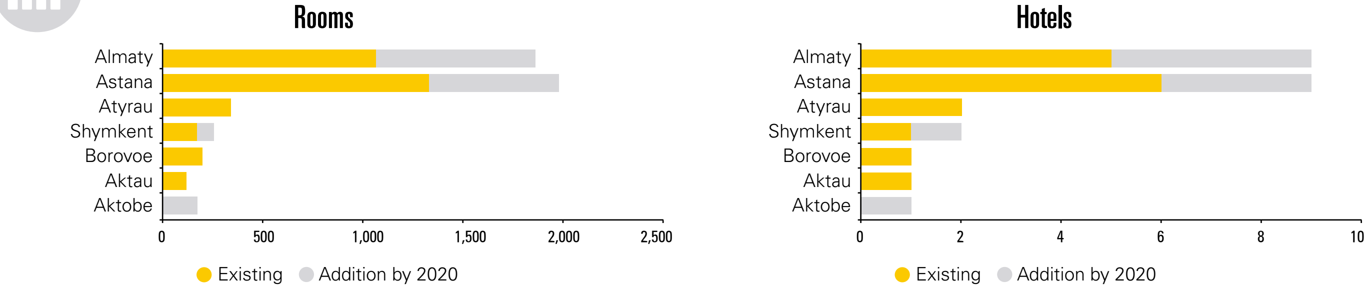
Excluding CIS countries, China and Turkey accounted for the greatest number of arrivals in 2012; in 2013 a total of 6.8 million people visited Kazakhstan, which represents an approximate 11% rise on the previous year. The number of internal tourists rose by 7.3% and reached 3.5 million. A simplification of Kazakhstan's visa policy with Hong Kong and potentially with a number of European countries is expected to attract yet more visitors to the country. One of the drivers of arrivals is increasing awareness of Kazakhstan as a travel destination. Foreigners enjoy the country due to its exotic culture and unique nature. The Shymbulak ski resort, the Medeo ice-skating rink (the highest skating rink in the world) and the Schuchinsk-Borovoye resort area (the so-called "Kazakh Switzerland") are all very popular destinations among tourists.

The majority of branded hotels in Kazakhstan are divided between the cities of Almaty and Astana, representing 31% and 38% shares of the branded hospitality market, respectively. At the same time, there is a shift taking place to develop in other cites. Thus, an active pipeline of hotel construction can be observed in Atyrau, Borovoe, Aktau, Aktobe and Shymkent, where the opening of at least one or two branded properties are planned. Astana in turn also continues a steady growth of its share of branded properties.

16 hotels are currently operating under the brands of six major international hotel chains in Kazakhstan, with a total of 3,257 rooms. With nine new openings the branded hotel market is set to expand to 25 facilities by 2020, and total room occupancy will reach 4,972. As at the end of 2014 Marriot international Inc. was leading the way, operating five hotels in the country (in Astana, Aktau, Almaty and Atyrau), with a total room stock of 881. Rixos Hotels manages four properties, located in Almaty, Astana, Shymkent and Borovoe. With a total of 796 rooms, Rixos Hotels holds second place in terms of room stock. InterContinental Hotel Group is represented by two operating hotels in Almaty, with a total of 528 rooms. Carlson Rezidor Hotel Group is represented by two hotels located in Astana, with a total of 429 rooms. Wyndham Hotel Group manages one hotel in Astana with 228 rooms. Hilton Worldwide is represented by Hilton Garden Inn in Astana, with a room inventory of 229 rooms. And Louvre Hotels Group also has one operating hotel in Almaty, with 166 rooms.

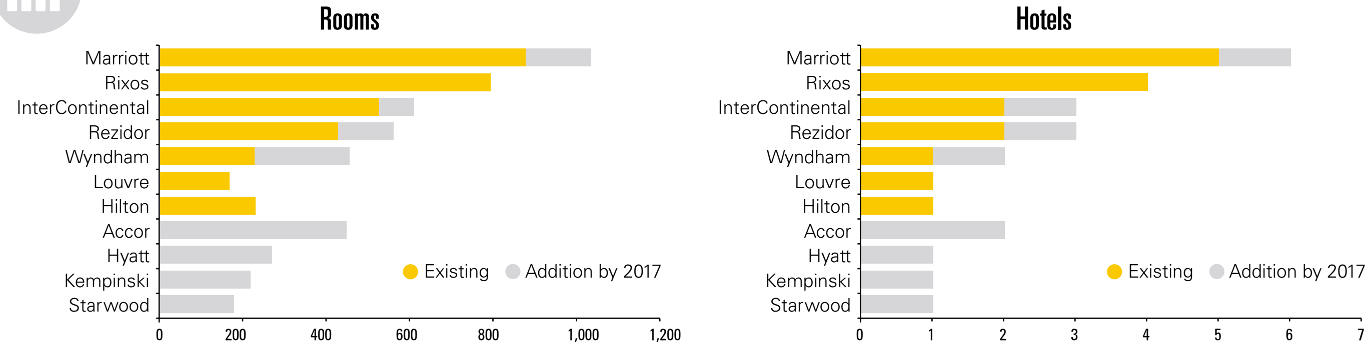
The considerable number of planned openings indicates a positive trend in hospitality development in Kazakhstan. Among others, Marriott International Inc. has announced it intends to increase its presence in the market with another hotel in Astana that will add 157 rooms to its portfolio; the total Kazakhstan room stock of the chain will increase to 1,038, and this will ensure that the chain will retain its leading position in the country. Accor Hotels plans to open two new properties in Almaty and Astana, with a total of 448 rooms. Carlson Rezidor Hotel Group plans to expand with one additional property in Almaty (Park Inn by Radisson Almaty Airport). Wyndham Hotel Group announced an increase of one hotel in Astana, with 228 new rooms. Hyatt Corporation and Starwood Hotels & Resorts plan to each open at least one hotel in Kazakhstan by 2015 – one of the properties will open in Almaty, and another in Aktobe. Together these will add 447 keys to the room stock. Future Hyatt Regency Almaty, with 270 units, will become the largest hotel in the pipeline. Meanwhile, as at the analysis date, the construction of Kempinski Hotel Bayterek (218 units) has been put on hold and there is no publicly available information on its opening.

Distribution of branded room stock and hotel supply in Kazakhstan, by city



Source: KPMG analysis

Distribution of branded room stock and hotel supply in Kazakhstan, by operator



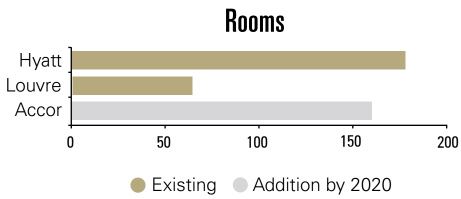
Source: KPMG analysis

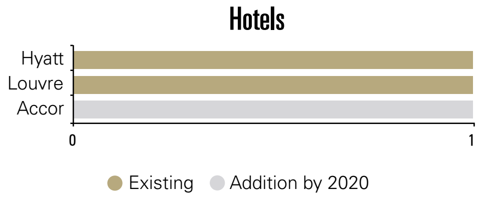
Kyrgyzstan

In recent years, tourism has contributed approximately 4% of Kyrgyz GDP. More than half of tourists visiting Kyrgyzstan go to Lake Issyk-Kul. Last year's visa-free regime for citizens from 44 countries proved a success, since the number of tourists from non-Soviet countries was seen to grow significantly. Last year, Kyrgyzstan attracted 65,000 tourists from outside the former Soviet Union; the figure was 26,000 in 2012.

Branded hotels, providing a room stock of 242 units, are located in the Kyrgyz capital Bishkek. The largest property (178 units) is represented by the Hyatt Regency Bishkek Hotel of the Hyatt Corporation chain. The second operating hotel, with 64 keys, is managed by Louvre Hotels Group. The announced pipeline is rather modest, consisting of Novotel Bishkek (160 rooms) by Accor Hotels. However, this project has been put on hold.

Distribution of branded room stock and hotel supply in Kyrgyzstan, by operator





Source: KPMG analysis

Turkmenistan

Turkmenistan's economy has been growing due to exploration of the country's vast natural resources, with the gas sector playing the major role. The development of the energy sector attracts the majority of foreign investment into the country, with China, Russia and Iran the biggest partners and the main feeder markets for business tourism. As at the end of 1H 2014, two major contracts with South Korean companies had been signed for a total of USD4 billion, and this should have a positive impact on the number of arrivals in the near future. An increase in business arrivals to Ashkhabad has encouraged the improvement of Ashkhabad's infrastructure, as well as the opening of international brand hotels. Starwood Hotels & Resorts has two properties under its brands: Four Points by Sheraton (136 rooms) and Sheraton (120). Accor operates one property under the Sofitel brand (299 rooms). Together these three properties form a rather modest branded market of 555 rooms. At present no other future projects have been announced.

Apart from increasing activity in the energy sector (which drives business tourism), the government understands the importance of recreational tourism. The Avaza Tourism Zone, located on the Caspian Sea coast, was announced in 2007 by the President of Turkmenistan as being a major leisure destination for the country, with several billion US dollars of investment already earmarked. Special tax and legal conditions apply for foreign investors in order to incentivise activity in the Avara Zone. Vast infrastructure and hospitality-related projects have already been implemented and more are planned. Hotels of various categories, cottages, waterparks, golf courses, tennis courts, restaurants, health & spa facilities, and conference centres, are planned to be located along a 16-kilometre stretch of beach.

Currently the development of the Avara Zone only stimulates domestic tourism, thus no international hotel brands have been announced to open in the area. Stringent visa procedures and strict regulations for foreign travellers do no facilitate an inflow of international leisure tourists. The country would be able to attract more foreign tourists if the government relaxed the regulations and made greater efforts in relation to tourism-related marketing.

Distribution of branded room stock and hotel supply in Turkmenistan, by operator

Source: KPMG analysis

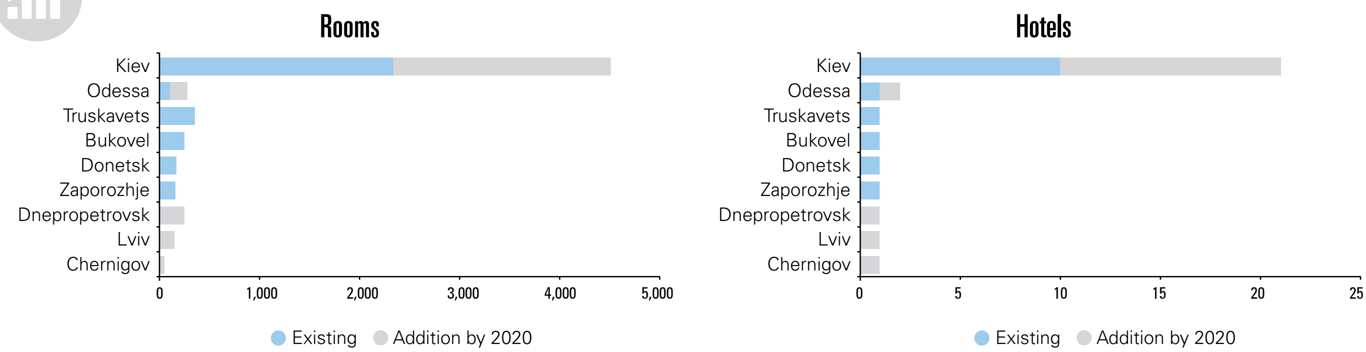
Ukraine

The hospitality industry in Ukraine was stable up until the beginning of 2014. Ukraine has improved its tourist infrastructure and increased its hotel stock in recent years, as a result of hosting the Euro 2012 Football Championship. Despite the prevailing geopolitical situation, the majority of experts agree that the Ukrainian hospitality sector will again become attractive for investors and that the development of the international brand network will pick up once more once the situation stabilises. At the moment, financial and economic risks in Ukraine have risen, owing mainly to further escalation of the conflict in the country's south-eastern regions, as well as tensions in diplomatic and economic relations between Western countries and Russia. These events are playing a major role in the instability of the Ukrainian currency, the hryvnia.

Hotel operational indicators reflect the situation in the country, with occupancy rates in the capital dropping to 20% in the beginning of the year. The capital Kiev is the most developed market in Ukraine in terms of hotel supply. It has approximately 110 hotels, 10 of which are branded (Hyatt, Hilton, Intercontinental, Fairmont, two Radisson Blu, Holiday Inn, Ramada, Ibis and Kosmopolit operated by Warwick International). The total branded room stock in Kiev is more than 2,340 rooms, representing an almost 68% share of the total branded market in the country. Such operators as Accor Hotels, Intercontinental Hotel Group and Carlson Rezidor Hotel Group, represented by one-or-two operating properties in Kiev, plan further expansion in the capital. Marriott International and Starwood Hotels & Resorts are planning to enter the capital in the near future with Renaissance (173 rooms), Sheraton (196) and Aloft hotels (320). The market in the capital, though still being targeted by operators, is now mainly considered to be a long-term option.

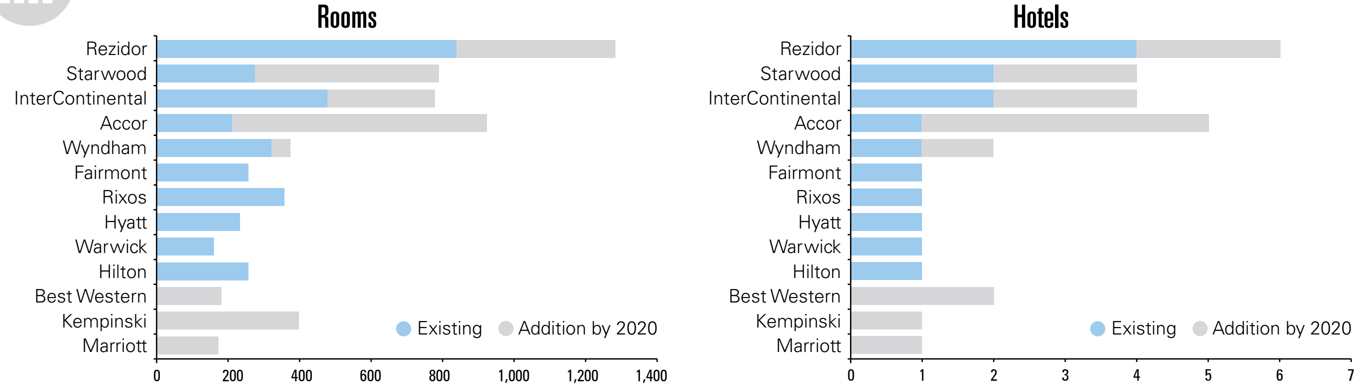
Worth noting is that regional cities are also attracting the attention of international operators and investors. Starwood Hotels & Resorts pioneered the regional Ukrainian hotel market back in 2011, with Four Points by Sheraton in Zaporozhje. In 2014 the chain opened another hotel under the Luxury Collection brand in Odessa (Hotel Bristol, 112 rooms). Carlson Rezidor Hotel Group has one operating hotel in Donetsk (Park Inn, 171 rooms). Accor plans to enter the Odessa market in 2016, with Novotel (170 rooms). Resort cities such as Bukovel and Truskavets each have one international hotel, with a total of 600 rooms.

Distribution of branded room stock and hotel supply in Ukraine, by city



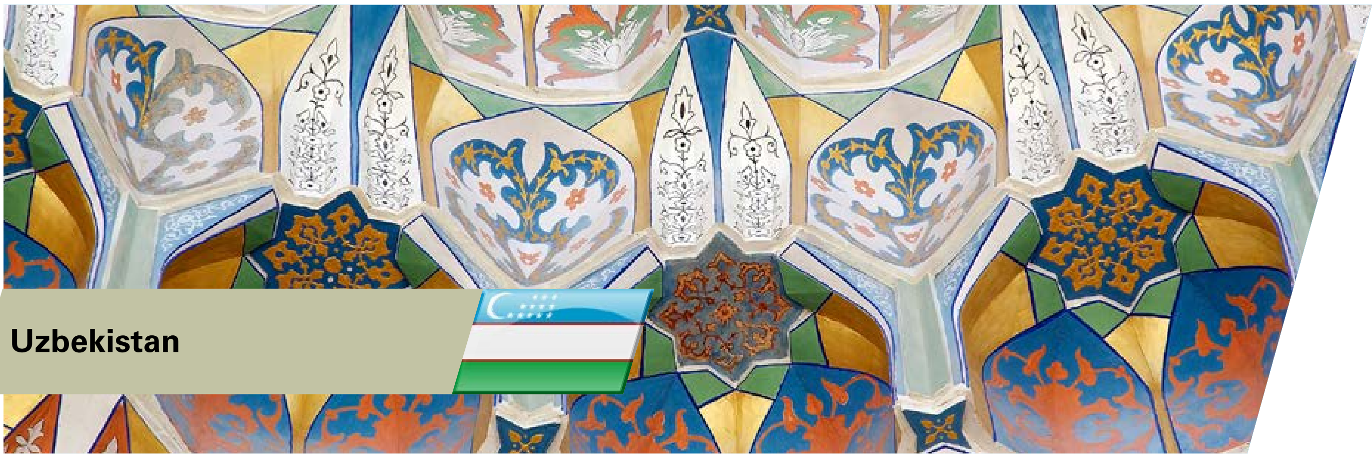
Source: KPMG analysis

Distribution of branded room stock and hotel supply in Ukraine, by operator



Source: KPMG analysis

Despite the geopolitical and economic instability, Ukraine expects such brands as Sheraton, Aloft, Swissotel and Sofitel to join and expand the local hotel market in the coming years. At the moment it is difficult to predict whether hotel projects will be postponed/frozen or completed on time. However, according to information received from operators, it is planned for the hotel number and room stock in the country to double, from 15 hotels with 3,400 rooms currently to 30 hotels and 6,188 rooms in 2020.



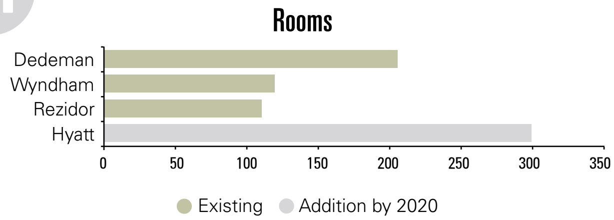
Uzbekistan

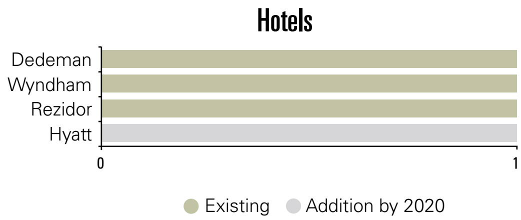
Uzbekistan's location and rich history make it an attractive destination for foreign tourists. The ancient cities of Samarkand, Bukhara and Khiva and the historic Silk Road are the most popular attractions. The number of tourists who visit the country is constantly growing. The government recognises the importance of tourism as a revenue stream and is constantly investing in programmes to develop the industry. Last year nearly two million foreigners visited Uzbekistan, a 16% increase on 2012. In 2013, the Uzbek Government also introduced tax incentives and offered low-interest loans to incentivise the creation of more tourism-orientated businesses.

Three international hotel operators are currently represented in the Uzbek market: Dedeman Hotels & Resorts International, Carlson Rezidor Hotel Group and Wyndham Hotel Group, with a total room supply of 437 units. All branded properties are concentrated in the capital Tashkent: Dedeman Hotels & Resorts International (the biggest branded hotel in the country) with 206 rooms; Wyndham Hotel Group (one property, 120 rooms); and Carlson Rezidor Hotel Group, (also one property, 111 rooms).

By 2015, Hyatt Corporation plans to open a new facility, Hyatt Regency Tashkent, which in turn will increase the room supply of international hotels by 300 units, and will become the largest international hotel in Uzbekistan.

Distribution of branded room stock and hotel supply in Uzbekistan, by operator





Source: KPMG analysis

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