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Bucharest, Romania: Where Are The Hotel Investment Opportunities?

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Is Bucharest still one of the markets in Eastern Europe with hotel investment opportunities, or is it already too late? Will future supply growth outpace the projected demand growth? When all the hotels under construction have opened, which market segments will warrant further development?

In this market snapshot we highlight the supply and demand fundamentals of the Bucharest hotel market and analyse the supportable level of new supply in the three- to five-star sectors in the following sections.

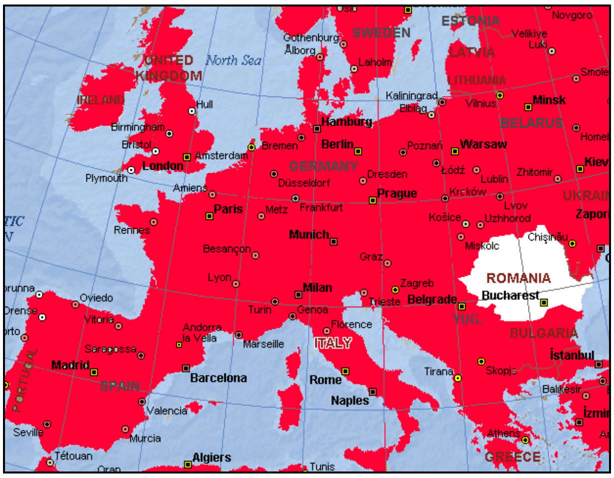
- Overview of Romania
- Political Environment
- Economic Overview
- Tourist Arrivals and Demand
- Estimated Supportable Supply
- Hotel Investment Market Analysis
- Conclusions

Even though demand in Bucharest has grown strongly over the last few years, can the level of supply growth be sustained in the medium term? Almost 900 rooms entered the market in 2005 and early 2006, with approximately 1,300 rooms under construction or part of rumoured projects. Five-star developments are especially high on the rumoured list, as they clearly outperform the rest of the market given that no new additions to supply have been recorded since the opening of the five-star positioned Howard Johnson in 2004 and the JW Marriott in 2000.

Overview of Romania

Romania is situated in southeastern Europe. It borders Bulgaria, Hungary, Moldova, Serbia and Montenegro, and the Ukraine and is on the coast of the Black Sea. Covering a total area of 237,500 km², Romania is the third-largest country in Eastern Europe, with a total population of approximately 21.7 million, a population density of approximately 91 people per km². The country's capital, Bucharest, has a population of approximately 2.1 million (2005 estimate) and is the largest city in Romania.

Location of Romania, showing Bucharest



Source: Lonely Planet

Political Environment

Romania's political history is complex and spans many different eras. The many uprisings and revolutions across Europe during 1848 gave rise to a growing national movement, which culminated in the creation of the national state of Romania in 1862.

Transylvania was finally united with the rest of Romania at the end of World War I; however, this union was relatively short-lived, as during World War II (in August 1940) Romania was forced to cede northern Transylvania to Hungary.

With the help of the Soviet army, Romania drove German and Hungarian forces from Transylvania in October 1944. Indeed, this new alliance with the Soviet Union ultimately led to the rise to power of Romania's Communist Party. In 1947 Romania's monarchy was abolished and a People's Republic declared. In 1948 a law on nationalisation was passed, paving the way for state control and a decade of the 'Russification of Romania'. After 1960 Romania adopted a more independent foreign policy.

During the 1980s, while communist president Nicolae Ceausescu continued to spend millions building the 'House of the People' in Bucharest, the population of Romania was subjected to severe food rationing in order to finance the country's growing debt. In December 1989 the people of Romania finally revolted against the dictator, who was subsequently tried by an anonymous court, condemned, and executed alongside his wife Elena on 25 December 1989.

House of the People, Bucharest

The National Salvation Front was elected to power in 1990, led by Ion Iliescu. They were re-elected in 1992, but in 1996 Iliescu was voted out in favour of Emil Constantinescu, leader of the reform-minded Democratic Convention of Romania; this move marked the start of what has been dubbed Romania's 'Velvet Revolution'. Iliescu (now of the Social Democratic Party) was reinstated as president in November 2000. Elections at the end of 2004 saw the hopes of the SDP government dashed following the defeat of Adrian Nastase by Traian Besecu, who was elected president. Following this, the Humanist Party broke away from the SDP, a move which paved the way for the formation of a four-party coalition under Calin Popescu-Tariceanu, leader of the former opposition Liberal Party, as prime minister.

However, increasingly rancorous relations between the main government parties, the National Liberal Party (NLP) and the Democratic Party (DP), have sparked speculation about the future of the government coalition and there is a risk that the alliance between the two main government parties will break down in 2006, especially if Romania's EU membership is delayed until 2008. Such a split would most likely result in a stalling of reforms, potentially slowing down the rate of foreign direct investment (FDI).

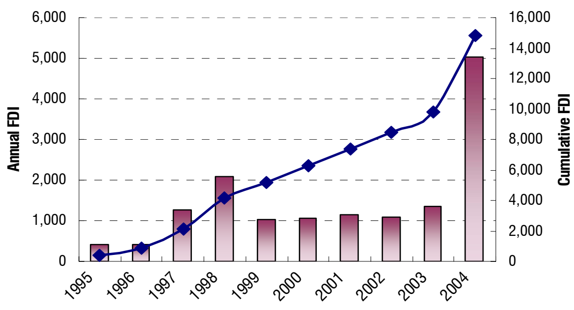
Economic Overview

Following years of communist rule in Romania, the last decade has seen the beginning of structural reform. Having joined NATO in March 2004, the Romanian government is now focused on achieving membership of the EU, which pledged to support Romania in its aim of joining the EU in 2007. However, there is now a much greater risk that this could be postponed until 2008. Membership could be delayed if Romania is deemed by the European Commission to have made insufficient progress in meeting EU standards in key areas, such as competition policy, and justice and home affairs. A final recommendation will be made by the European Commission in May this year.

Following an economic slowdown in 2005, it is expected that a tightening of fiscal, wage and monetary policies will limit recovery in 2006, but stronger real GDP growth is expected to resume from 2007. The Economist Intelligence Unit (EIU) further predicts a renewed slowdown in 2009-10, when expansion rates will be held back by efforts to bring down inflation so as to meet the Maastricht criteria by 2010. The EIU (January 2006) forecasts national GDP growth for Romania at 4.5% in 2007, 5.2% in 2008, 4.8% in 2009 and 3.6% in 2010. It also forecasts consumer price inflation for Romania at 7.4% in 2007 and 5.6% in 2008 with inflation falling to approximately 3.7% by 2010.

The approximate net levels of FDI in Romania over the ten years from 1995 to 2004 are outlined in Graph 1.

Graph 1 Net Foreign Direct Investment in Romania 1995-04 (US$ millions)



Source: EBRD Country Forecast, May 2005

In 2004, the inflow of FDI into Romania picked up sharply, a rise attributed by analysts to the country's successful macroeconomic stabilisation policy and investors' efforts to position themselves in a changing European landscape.

The flow of capital from abroad is expected to continue, albeit at a slower rate. It is estimated that year end figures for FDI in 2005 will be broadly in line with 2003 figures. A large number of additional greenfield and brownfield projects are under consideration, which, if borne out by the facts, could lead to a further firming of FDI in Romania.

The following issues impact the attractiveness of the Romanian investment market.

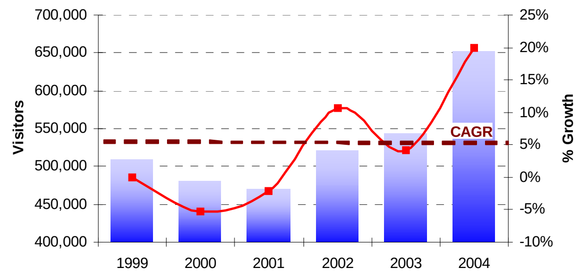
- Comparatively low wages, rising productivity, attractive market size and the market's prospects are key factors for foreign investors willing to relocate production facilities into the country;
- For the next few years, reforms in conjunction with the EU accession process will continue to be a major catalyst for the economic environment in Romania and they are likely to promote further investment in the area;
- The recent political instability poses a potential risk to the outcome of current reforms. Furthermore, despite an overall improvement in the business climate, high levels of bureaucracy and other administrative barriers still exist;
- With investment in greenfield sites and continuing strong merger and acquisition activity, the number of international visitors coming to Romania, and to Bucharest in particular, is likely to continue to grow strongly, resulting in increased demand for hotel accommodation in the city.

Tourist Arrivals and Demand

At present, the number of tourist attractions within the city is limited and, as such, leisure visitation to Bucharest represents only a minor source of demand for the city's hotels. Nevertheless, in the short to medium term this is likely to change. The history of the country, coupled with an attractive price level and relative security, are likely to result in increased demand from leisure segments. The increasing number of flights to Bucharest and the availability of branded hotels will induce growth in visitor numbers and confirm Bucharest's new status as a leisure destination.

The compound annual growth rate in visitation to Bucharest between 1999 and 2004 was approximately 5.1%, as shown in Graph 2. The highest rate of growth, approximately 20%, occurred in 2004.

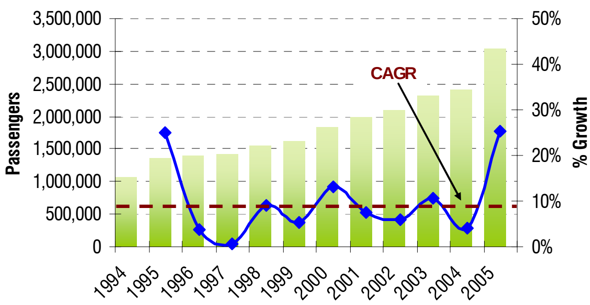
Graph 2 Domestic and International Visitation to Bucharest 1999-04



Source: Romanian Ministry of Tourism, 2005

To further illustrate the tourism potential for the city, Graph 3 shows the evolution of passenger movements at Bucharest's Otopeni Airport.

Graph 3 Passenger Movements – Otopeni Airport, Bucharest 1994-05



Source: Airports Council International, Bucharest Otopeni Airport

The growth in passenger movements over the 12 years from 1994 to 2005 has been significant. The compound annual growth rate in passenger numbers at Otopeni Airport is approximately 9.8%, with particularly strong growth registered in both domestic and international traffic in 2005 (just over 25%). This trend towards increased domestic passenger numbers is perhaps a sign of Romania's current progression towards a more developed market economy.

Estimated Supportable Supply

Bucharest's three-, four-, and five-star hotel market segments, based on 2005 figures, were relatively small with approximately 1,400, 1,000, and 1,500 rooms, respectively. Occupancy rates for these segments were between 65% and 70%.

The current principal question is how many additional hotel rooms the market can support in the short to medium term so that the average marketwide hotel occupancy remains at its current levels. In order to forecast the supportable level of room supply in each of the segments, the estimated amount of hotel supply likely to enter the market in the short to medium term was combined with the projections for room night demand growth over the same period for the three-, four- and five-star markets The results are set out in Graphs 4-6.

Recently opened hotels and projects under construction or planned are summarised in Table 1.

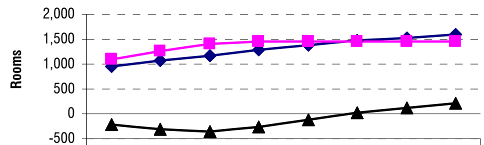
Table1 New Hotel Supply in Bucharest 2005-08

Proposed Property	Number of Rooms	Star Rating	Opening Date	Development Stage
Golden Tulip Bucharest	83	3-4	Mar 2005	Recently Opened
Class	70	3	Apr 2005	Recently Opened
Ibis du Parlement	161	2-3	May 2005	Recently Opened
NH Bucharest	78	4	Aug 2005	Recently Opened
Phoenicia	348	3	Sep 2005	Recently Opened
Tulip Inn	88	3	Nov 2005	Recently Opened
K&K Elisabetha	66	4	Jan 2006	Recently Opened
Novotel	259	4	Jul 2006	Under Construction
ROM EXPO	70	3	Dec 2006	Under Construction
Radisson SAS	432	5	Mar 2007	Under Construction
Triumph	300	3	Aug 2007	Under Construction
Five-Star Project	200	5	Jan 2008	Rumored
Continental Five-Star	54	5	Jul 2008	Approved
Total	**2,209**			

Source: HVS International Research

The three-star hotel market in Bucharest has a significant supply base and the biggest development pipeline. Although the profitability of such hotels is very strong, we consider that it is unlikely that the hotel market in Bucharest will be able to support additional hotels in the three-star segment in the medium term, especially if the marketwide occupancy of 65% is to be maintained. This is due to the substantial increase in new and planned room supply between 2005 and 2008, as seen in Graph 4. From 2011 on it is estimated that it could be feasible to open a three-star hotel with approximately 120 rooms.

Graph 4 Supportable Rooms Supply – Three-Star Hotel Market, Bucharest 2005-12



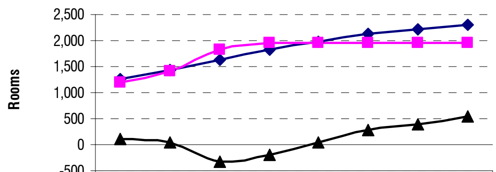
	2005	2006	2007	2008	2009	2010	2011	2012
Projected Demand per Day (Rooms)	951	1,066	1,171	1,283	1,376	1,475	1,533	1,594
Daily Room Supply Available	1,093	1,271	1,410	1,453	1,455	1,455	1,455	1,455
Additional Supportable Number of Rooms	(218)	(315)	(367)	(262)	(122)	31	120	213

Source: HVS International Research

The supportable number of hotel rooms in the four-star segment over the medium term in Bucharest is shown in Graph 5.

We consider that it is unlikely that the market in Bucharest will be able to support additional hotels in the four-star segment between 2007 and 2009 without compromising the marketwide occupancy of 70% due to the opening of the Novotel and other competitors. Based on our forecast demand growth we estimate that the market might be able to support an additional 250-room four-star hotel from 2010 onwards.

Graph 5 Supportable Rooms Supply – Four-Star Hotel Market, Bucharest 2005-12

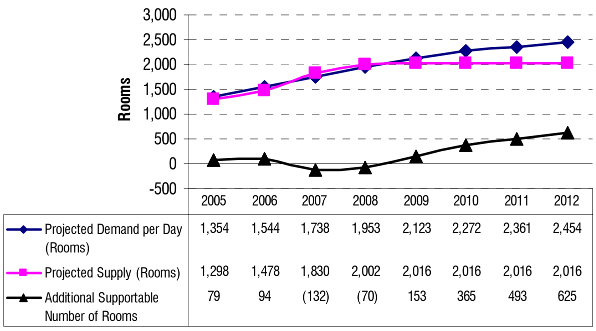


	2005	2006	2007	2008	2009	2010	2011	2012
Projected Demand per Day (Rooms)	1,258	1,437	1,624	1,826	1,987	2,139	2,223	2,310
Projected Supply (Rooms)	1,187	1,413	1,837	1,953	1,962	1,962	1,962	1,962
Additional Supportable Number of Rooms	109	38	(328)	(195)	38	273	402	535

Source: HVS International Research

We also consider that the market in Bucharest cannot support additional hotels in the five-star segment in 2007 or 2008 if the marketwide occupancy of 70% were to remain stable. Nevertheless, from 2009 onwards a 150-room five-star hotel development could be feasible, and by 2012 we estimate, based on our analysis, that more than 600 extra rooms could be supportable in the five-star segment.

Graph 6 Supportable Rooms Supply – Five-Star Hotel Market, Bucharest 2005-12



Source: HVS International Research

Hotel Investment Market Analysis

In Graph 7 we benchmark marketwide RevPAR in Bucharest against other Eastern European cities to provide a comparison of relative earnings potential.

Bucharest is anticipated to demonstrate stable growth patterns in RevPAR over the medium term. Larger capitals (such as Moscow) and markets with more balanced business and leisure demand (such as Prague) will continue to perform considerably better. Budapest, despite being a more mature market than Bucharest, will underperform compared to Bucharest over the coming years due to a much larger supply base and a relative oversupply in the market. Warsaw will remain a highly oversupplied market in the medium term and is likely to underperform this sample in the long term.

As a measure of strength of investment opportunity, we analyse ratios of indicative gross operating profit per available room (GOPPAR) versus average local construction costs per segment in Table 2.

Table 2 GOPPAR Levels Compared to Hotel Construction Costs, Bucharest (€)

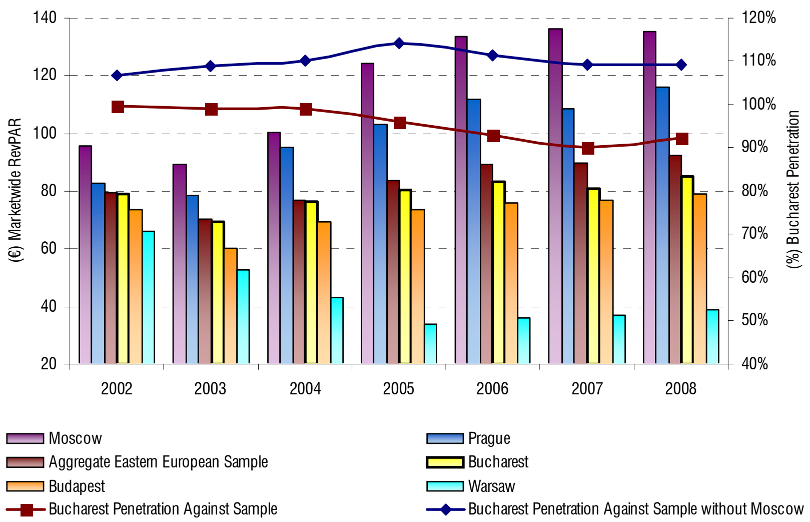
	Three-Star	Four-Star	Five-Star
Number of Rooms	150	250	250
GOPPAR [1]	15,000	26,000	30,000
Construction Costs per Room [2]	90,000	120,000	160,000
Ratio	**0.17**	**0.22**	**0.19**

[1] GOP per available room in a stabilised year of operation
[2] Construction cost including FF&E, excluding land acquisition costs

Source: HVS International Research

The ratios suggest that investments in four-star and five-star hotels in the Bucharest market are more lucrative than investments in three-star hotels. Four-star hotel investments are expected to remain the most profitable because five-star properties are not likely to increase their GOP potential to such an extent over the short to medium term that the relatively large difference in construction costs would be compensated for. The construction cost estimate for the five-star segment is based on an international branded five-star conference hotel at the lower end of the construction cost range for five-star hotels. It must also be considered that the current average room rate in the five-star segment is, on average, only €40 higher than that of quality four-star hotels.

Graph 7 Quality Hotel RevPAR Benchmark – Bucharest vs. Eastern European Markets (€)



Source: HVS International Research

The attractiveness of the Bucharest hotel investment market can be summarized in the analysis of the prevalent strengths, weaknesses, opportunities and threats, as outlined in Table 3.

Conclusions

Bucharest has a fairly immature hotel market when considering the size of the Romanian economy. It is likely to offer good potential for hotel developments in the medium term. We would recommend favouring four- and five-star opportunities rather than three-star hotel developments. Despite strong growth in demand, there is a slight risk of temporary oversupply in the short-term at the current estimated levels of supply growth in all considered segments.

Following are additional points to consider for hotel developments in Bucharest.

- Three-star hotel investments in Bucharest are the least attractive, especially due to the large development pipeline and the relatively small difference in construction costs between three-star and four-star hotels;
- Investment in the four-star segment is considered to be secure and attractive in the mid-term, especially given the ratio between relative operating performance and construction cost estimates;
- Investment in the five-star segment could ensure superior operating performance over all other segments from 2008/09 onwards; however, based on a ratio of operating performance to construction costs these investments are viewed as being inferior to four-star hotels;
- A real barrier to entry for the four- and five-star markets in Bucharest, despite their attractiveness to investors, is the scarcity of land in the city centre;
- The refurbishment and rebranding of old communist era hotels might present some opportunities, but only if the necessary capital expenditure proves to be justifiable;
- Hotel developments have been scarce in the high-quality segments because of a shortage of Grade A office space in the centre of Bucharest. Initial yields for quality offices are reportedly in the area of 7-8%, whereas hotels have so far fared around 9-10%;
- Business activity in the city is gravitating to the north. In this area, some plots of land for hotel development might already have been secured by investors when land prices were cheaper. As a result, we might expect hotel developments to materialise as soon as room night demand picks up.

Table 3 SWOT Analysis – Bucharest Hotel Investment Market

Strengths	Weaknesses
• Major metropolis in a large country in eastern Europe • Capital in booming economy and acceptable inflation • Investment-friendly environment • Legal and taxation system being harmonised with EU • Good RevPAR compared to other eastern European capital cities • International demand is diversified (nationalities) • Barriers to entry for quality hotels in the city centre are high	• Effectiveness of government limited due to questionable political stability • Room for improvements to the road infrastructure • Tourist segment is underdeveloped • Three-star hotel market nearly saturated • Limited buying power from the domestic market • Dearth of trained staff • High price for land
Opportunities	**Threats**
• Demand outlook positive in the medium term • Good outlook for tourism growth • EU accession will benefit commercial activity and therefore business travel • Introduction of the euro in the medium term • Privatisation, merger and acquisition activity and introduction of financial sectors should further attract foreign visitation • Continued flows of FDI primarily due to low labour costs • Low-cost carriers give opportunity to market city breaks • US military bases could further increase room demand	• Political instability could further delay EU accession • VAT increase could hamper earnings potential • Alleviation of corruption could take longer than expected

About the Authors

Jakob Forstnig is a Senior Associate with HVS International's London office. He joined HVS in 2004 after six years of operational and managerial hotel industry experience in Europe and the USA and two years of hotel consulting experience in Germany. Jakob holds a joint MBA from Cranfield University, the UK, and EM Lyon, France, and a Hotel School degree from Hotel & Tourism School Villach, Austria. Since joining HVS International he has advised on hotel investment projects, mixed-use developments and other hotel-related assignments in Europe, Middle East and Central Asia.

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