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Spanish Hotel Market Review and Assessment – Madrid

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AFTER THE BOOM YEARS BEFORE 2001, WHERE ARE SPAIN'S MAIN COMMERCIAL MARKETS STANDING?

As has been well documented already, Spain surpassed the USA as the second most important tourist destination in the world after France in 2001. The country has a greater variety of destinations, a more plentiful supply of hotels and a more expansive tourism infrastructure than competing destinations. Spain has adapted its marketing strategy and is now promoting itself as more than just a beach destination, with a new emphasis on quality. The Spanish hotel market has made the transition from being mainly leisure oriented to becoming more commercially oriented. The improving economy has significantly boosted demand for hotel accommodation in the country's major cities, demand driven mainly by the local commercial market and the increasing number of European weekend break visitors.

Since joining the European Union (EU), Spain has greatly invested the funds received from the EU in mayor infrastructure investments and projects. Tourism is the second most important industry, representing 10% of the national GDP in 2004 and employing 9% of the active population. The record 53.6 million tourists in 2004 (an increase of 3.4% on 2003), generated travel receipts of US$45.2 billion (€34 billion), 3.8% higher than 2003.

The quality of the city centre hotel stock in the major Spanish city markets has improved significantly following heavy investment from domestic hotel chains and construction companies. The hotel sector's more 'international' reputation makes it a more attractive target for international investors, developers and operators.

Cities such as Madrid and Barcelona brought themselves in line with other key European cities in recent years, achieving occupancy levels in excess of 70% and significant year-on-year growth in average room rates. The improvement in trading performance over recent years and the lack of liquidity in the investment markets have prompted investors to consider development as their only means of entering the market.

In a series of three related articles, HVS International will present its own analysis of the market trends of the main commercial Spanish markets and their outlook. The first of these articles follows this introduction, with the other two to be published at a later date.

Part 1: Madrid – The financial heart of Spain

Part 2: Barcelona – The art of reinventing a city

Part 3: Seville & Valencia – The balance between leisure and business tourism

Madrid – The Financial Heart of Spain

Economic Overview

- Real gross domestic product (GDP) growth in 2003 was 2.4%, and 2.7% in 2004. Although these are high rates of growth compared with other EU countries, the economy has been expanding more slowly than it did during the boom years of the late 1990s. In 2004, Spain witnessed a rebound, in line with a recovery in domestic demand and a stronger external environment. The Economist Intelligence Unit (EIU) estimates that, following a growth of 2.5% in 2005, a gradual slowdown in GDP growth is expected over the following four to five years;
- The primary problems for the government are the demand for housing, which is a wide component of general economic growth, and the supply of labour, which drives growth by boosting jobs rather than productivity. Spain made a start on 700,000 houses in 2004, four times as many as the UK. Even so, prices for new Spanish houses rose 18.5% and for existing ones 16.7%. The boom continues, fuelled partly by foreigners drawn to Spain by the thought of having a house in a sunny part of the Eurozone, and partly by share-shy Spaniards looking for an investment;
- The labour question is equally problematic. Though 3 to 4 million jobs were created under the Aznar government, Spain still has an unemployment rate of around 10%, one of the highest in the EU. Moreover, more than 30% of those in work are on short-term contracts, and many in the black economy have no contracts at all;
- Inflation, which averaged 3.0% in 2004, is expected to fall to around 2.3% by 2007, according to the EIU's forecasts;
- In terms of infrastructure, the redevelopment of Barajas International Airport includes two additional runways and a new terminal, plus a new satellite building and an extension to the control tower. The project is due for completion in early 2006. This redevelopment is expected to increase passenger capacity by approximately 5-6% annually, to a projected 70 million passengers by 2015, doubling the current capacity within the next 12 years.

Madrid

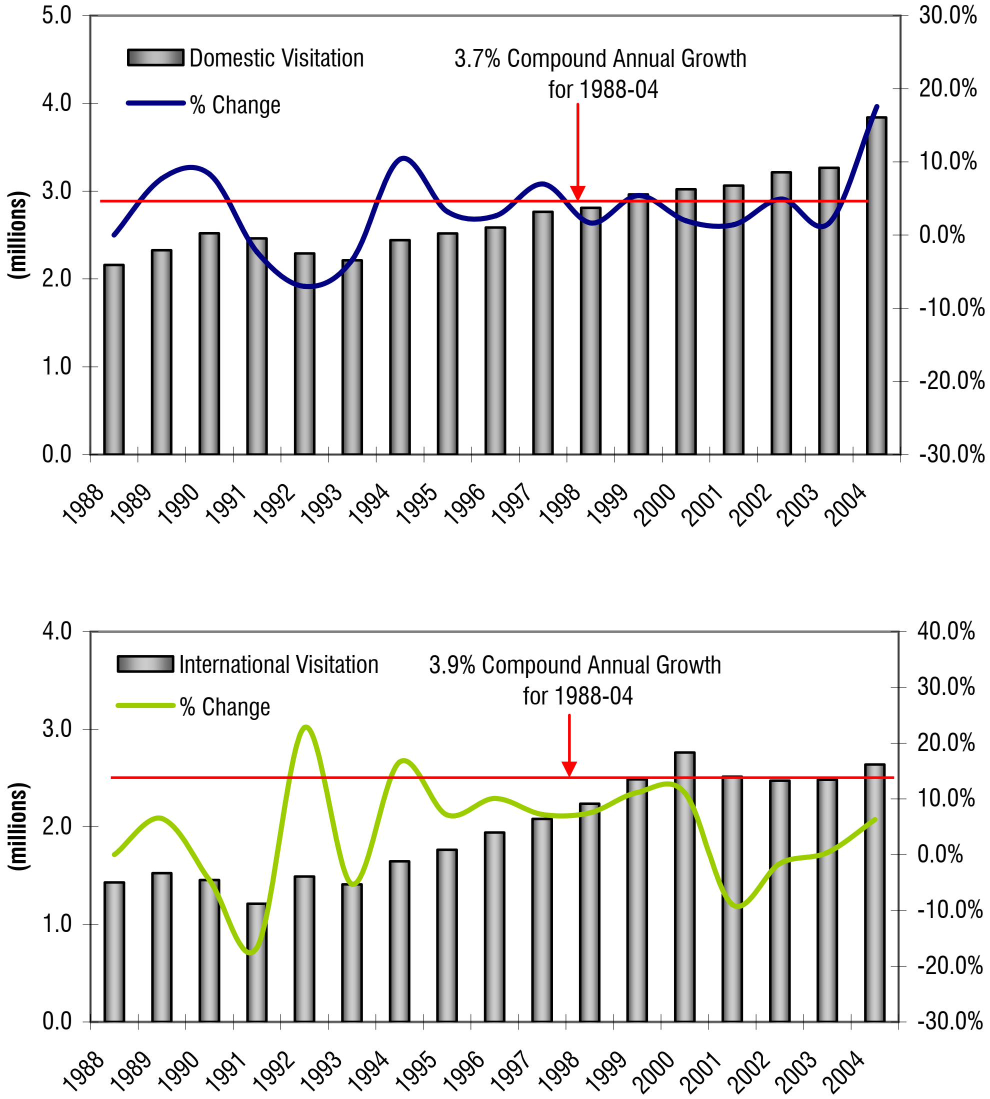
Madrid is the political and financial capital of Spain, as well as the principal transportation hub. The city has a population of approximately 3 million in the city. The city has historically been a predominantly business destination. The capital of Spain is characterised by the role it plays as the main centre of technological education, training and development, the main financial market, the leader in industrial production, the most important transport hub within the region and the country, and as a cultural and business centre.

Additionally, Madrid has positioned itself as one of the most important venues in recent years for international conferences, ranking 15th in terms of the number of meetings held by over 100 cities worldwide in 2004, according to the International Congress and Convention Association. However, the local authorities are currently working on positioning the city as a more attractive leisure and cultural destination and the city is becoming increasingly known for its nightlife, historic sites and museums.

Tourist Arrivals and Demand

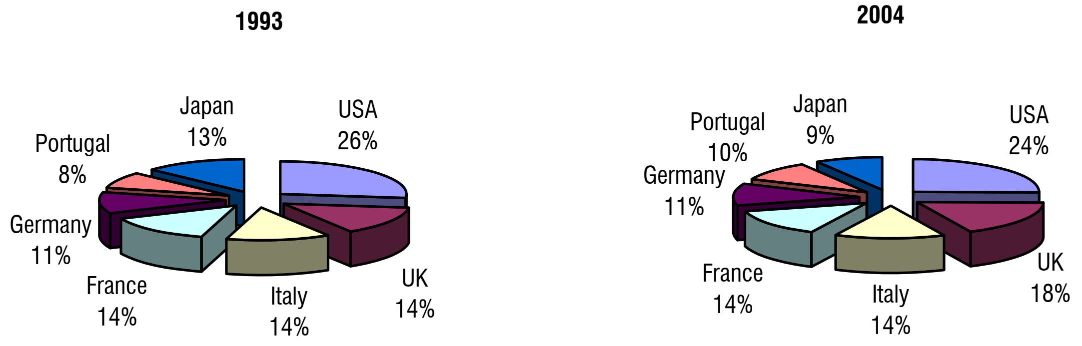
- As illustrated in Figure 1, visitation to Madrid from 1988 to 2004 increased by approximately 80%, representing a 3.8% compound annual growth. High growth has been noticeable since 1994, especially in international visitation, which experienced 4.8% compound annual growth from 1994 to 2004;
- Due to less favourable economic global conditions, the effect of the terrorist attacks in the USA and the global economic slowdown, international visitation fell in 2001 and 2002 by 8.9% and 1.6%, respectively;
- However, the practically stagnant number of visitors in 2003 was compensated by a strong pick up in 2004, with a total increase of 12.7%, despite the terrorist attacks in March of that year. This was mainly driven by domestic visitation, which increased by 17.6% on 2003, and was a result of the market recovery and a strong and stable domestic market;
- The number of visitors up until October 2005 was 11% higher than the same period in 2004, indicating that the year-end performance in 2005 will be significantly higher than the previous year;
- As illustrated in Figure 2, the USA remains the main feeder market, although its market share amongst the principal feeder markets has decreased from 26% in 1993 to 24% in 2004. It is followed by the UK, which on the contrary has significantly increased its market share from 14% in 1993 to 18% in 2004. Japan has also lost market share (from 13% to 9%) in this period. In general, there have been no other sizeable changes in the market mix of the feeder countries over the period under review;
- The year-on-year increase in domestic visitation in 2004, at 17.6%, is indeed the highest registered in the years under review since 1988. On the other hand, international visitation is just recovering to the levels it achieved in 2000.

Figure 1 Domestic and International Tourist Arrivals – Madrid (Millions)



Source: Patronato Municipal de Turismo de Madrid

Figure 2 Market Mix of the Main International Feeder Countries – Madrid 1993 versus 2004

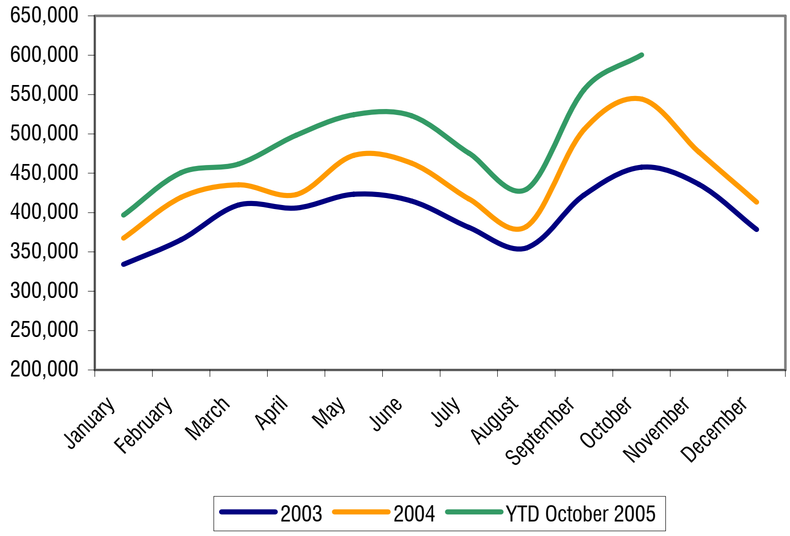


HOTEL MARKET PERFORMANCE AND CHARACTERISTICS

The improving economy of Spain has allowed for the development of commercial accommodation in line with the increase in demand in the major Spanish cities. This has created more of a balance in the type of hotel on offer amongst resorts and commercial destinations. Spanish commercial markets have shown strong domestic demand and proved to be relatively resilient to international demand. If the ten most important cities in Spain are considered, a compound annual growth of 5.0% in room night demand has been experienced in the period from 1999 to 2004. Approximately 85% of the room night demand is concentrated on the four main markets of Madrid (with 39% of the total for the ten major cities in 2004), Barcelona (29%), Seville (9%) and Valencia (7%).

Madrid experienced the typical commercial destination seasonality, as shown in the following graph, with the strongest demand occurring during the months of May and June, and September through November. Both 2003 and 2004 show very similar seasonality patterns, with lower occupancies during the months of January, February and December; hence, there is the potential for higher marketwide hotel occupancy. Again, the number of arrivals until October 2005 indicates stronger visitation that in the previous two years.

Figure 3 Seasonality of Arrivals in Madrid



Source: Instituto Nacional de Estadística (INE)

Although Madrid has historically been a predominantly business destination, a concerted effort is being made by the local authorities to reposition the city as a leisure destination, both through its renowned nightlife and the cultural appeal of its historic sites and museums. Despite the high summer temperatures, an increase in visitation during July and August would broaden seasonality, allowing for higher year-end occupancies.

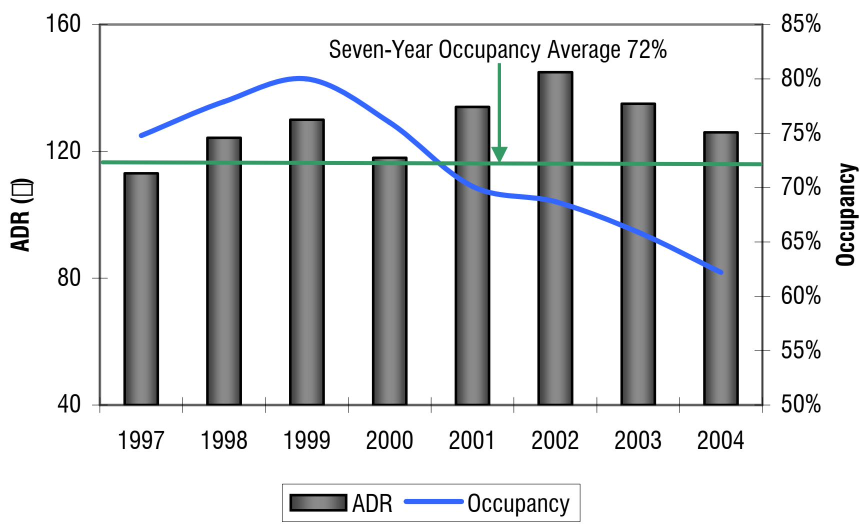
Occupancy and Rate Performance

- Quality hotels in Madrid have achieved occupancies of between 62% and 80% in the period since 1997. After a significant peak in occupancy in 1999, marketwide average occupancy started suffering a steady decline, until reaching occupancies of 62% in 2004. This can be attributed largely to the impressive increase in supply over this period, as well as to other negative factors at an international level. An improvement in the 2005 performance is expected, as year-to-September showed signs of improvement, with an increase in occupancy to 66.9%, compared to 62.6% for the same period in 2004. This would indicate a possible recovery of the occupancy to approximately 66% by the year's end. It is worth noting that these performances are well under the seven-year average occupancy of 72% for Madrid from 1997 to 2004;
- Contrary to the occupancy, average daily rate (ADR) kept increasing until 2002, reaching levels of €145 (€156 in 2005 prices), and has since experienced a compound annual decline of 7% until the end of 2004. Marketwide ADR has not shown signs of improvement in the year-to-

September 2005 figures, decreasing by 4.5%, to €106, compared to the same period in 2004;

- Revenue per available room (RevPAR) experienced a peak in 1999, and has since steadily decreased (except for moderate recoveries in 2001 and 2002), culminating in an almost stagnant compound annual growth rate of 1% since 1997. The year-to-September 2005 performance saw an increase of 2% compared with the same period in 2004, possibly indicating a very moderate recovery by the year's end.

Figure 4 Hotel Performance in Madrid 1997-04

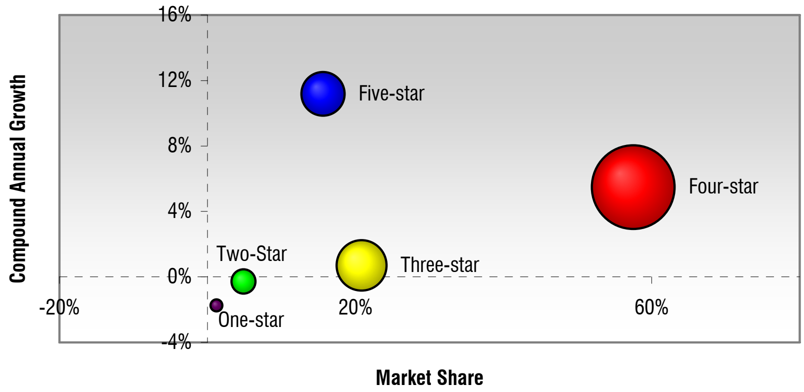


Source: Deloitte & Touche

New Supply

The largest market share by category of hotel in Madrid is the four-star segment, as shown in Figure 5. It is nevertheless five-star hotels which have shown the most important compound annual growth in the number of available rooms over the last six years. On the contrary, we could deduce from the available data that one-star and two-star hotels have both lost market share and decreased their real number of available rooms over this period.

Figure 5 Market Share and Compound Annual Growth by Category of Hotel – Madrid



Source: Patronato de Turismo de Madrid

The increase in hotel room supply in the city of Madrid has been very high over the last few years. Although a change in the statistical method to account for hotel room numbers since 2005 makes it difficult to establish a reliable trend, we can see that there has been a 5% compound annual growth in the number of rooms from 1999 to July 2005. This growth is higher than the increase in demand from 1999 to 2004, at a compound annual growth of 3.5%, and thus reflects the imbalance between supply and demand. As at December 2005, it was expected that some 50 new hotels totalling approximately 6,100 rooms would enter the city centre market in the next few years, although a number of these projects are still at a speculative stage.

Table 6 Estimated New Supply –Madrid

Estimated Opening	Star Category	Number of Hotels	Number of Rooms
2005-06	Five-Star	3	376
	Four-Star	21	2,034
	Three-Star	3	385
	Two-Star	3	397
	One-Star	1	20
	Subtotal	**31**	**3,212**
2007	Five-Star	2	290
	Four-Star	9	1,079
	Three-Star	—	—
	Two-Star	—	—
	One-Star	—	—
	Subtotal	**11**	**1,369**
2008	Five-Star	1	500
	Four-Star	4	690
	Three-Star	—	—
	Two-Star	—	—
	One-Star	—	—
	Subtotal	**5**	**1,190**
Later Date	Five-Star	—	—
	Four-Star	1	40
	Three-Star	—	—
	Two-Star	—	—
	One-Star	—	—
	Not Yet Determined	2	320
	Subtotal	**3**	**360**
Total New Projects		**50**	**6,131**

Source: HVS International

This new supply would represent an increase of approximately 22% on the existing room supply, and it is therefore likely to continue to have a short- to medium-term impact on marketwide operating performance. We nevertheless expect that the market will successfully absorb such a growth in supply, albeit some hotels (notably the independent hotels, which lack the financial support and know-how of a chain) might need to be converted into other uses.

CONCLUSIONS AND OUTLOOK

General Outlook

- Spain's economy remains very dependent on the construction sector, and on the government's ability to further decrease unemployment. However, Spain has been growing at levels above the EU average, and the current and intermediate outlook for the economy is very positive;

- In terms of tourism, Spain can no longer compete in terms of pricing with emerging destinations such as Morocco and Croatia. The country continues to reposition itself as an upscale destination, away from the mass tourism it was traditionally geared towards, as it benefits from its strategic location in Europe with easy access from strong European source markets. Given the superiority of its tourism and transport infrastructure, we consider that Spain needs now to capitalise on higher-spending visitors to stimulate additional growth;
- The recent terrorist attacks in Madrid on 11 March 2004 have demonstrated the resilience of this market, as these events have not triggered a significant decrease in visitation and had only a minor impact on the country's tourism industry.

Hotel Market

- The position of Madrid as Spain's key commercial and financial hub is undisputed, and thanks to the efforts from the authorities to increase its appeal as a leisure destination, as well as the continued improvement of its transport infrastructure (for example, the expansion of the airport), and the further development of the meeting, incentive, conference and events segment, demand for hotel accommodation in the market area is likely to be positively impacted;
- Despite the strong demand increases in 2004 and 2005, both occupancy and ADR have continued their downward trend. The significant increases of supply are to blame for the poor performance of hotels, and we expect no significant improvement in the short term as more rooms continue to enter the market;
- Madrid is nevertheless a key market, and we are confident that in the medium term this market will regain 'key city' occupancy levels similar to the ones it achieved in the past, at around 70%. Although ADR is likely to continue underperforming as new supply entering the market puts downward pressure on prices, stabilised occupancy levels will bring along an upward adjustment on the ADR, more in line with key cities.

Hotel Investment Opportunities

- Over the last few years, Spain has been one of the most resilient markets in Continental Europe, mainly due to international travellers and as a result of sizeable new hotel supply in recent years. Both Madrid and Barcelona continue to be considered as key investment markets with a strong interest from international investors;
- According to available market data, significant investment activity has occurred since 1999, and it is predicted to continue over the next few

years, with Spain becoming one of the most liquid countries in Continental Europe;

- As a consequence of the difficulty in penetrating this market, and the Spanish market in general, international operators have had to become more flexible in recent years, accepting agreements with guarantee elements and even lease contracts – typically structured with a fixed and variable component. However, enthusiasm for hotels with management contracts is stronger than it was a few years ago because management companies are doing better on the whole and investors have a better understanding of the sector, so the comfort level has increased;
- Although Madrid has experienced strong increases in demand over the last two years, the short-term sentiment remains somewhat negative due to the major increases in supply. We nevertheless consider Madrid to be a promising combination in terms of risk and return, growth and income, and pricing and liquidity;
- Given the somewhat difficult outlook for the hotel market performance in downtown Madrid, we foresee many hotels going on sale over the next three to five years;
- We consider that hotel investment opportunities will arise in the short term in Madrid, as well as in several other cities/regions in Spain. Although the market is still dominated by domestic operators, there are many foreign investors, banks and international operators looking to expand their representation in this gateway city, and we consider that there are considerable development opportunities, especially for the following products:
  - Internationally branded hotels. There are currently few such products in Madrid, especially at the higher end of the spectrum. International brands would induce higher rated demand through their reservations channels;
  - Further development of alternative options such as boutique hotels and extended stay products, underdeveloped at the moment in Madrid.

Note: *No investment decision in this market should be based on this article. For further information or advice, please contact the authors.*

About the Authors

Sophie Perret is a Senior Associate with HVS International's Madrid Office. She joined HVS International in 2003 and has ten years' operational experience in the hospitality industry in South America and Europe. Originally from Buenos Aires, Argentina, Sophie speaks English, Spanish and French. She holds a Bachelor degree in Hotel Management from Ateneo de Estudios Terciarios, and an MBA from IMHI (Essec Business School – France and Cornell University – USA). Since joining HVS International, she has advised on a number of hotel investment projects and related assignments in Spain, Portugal and other European countries.

Philippe Bijaoui is the Managing Director of HVS International's Madrid Office. He joined HVS International in 2005, after being in charge of the development of the Radisson SAS, Regent and Park Inn brands in Southern Europe and Benelux with Rezidor SAS Hospitality for the previous four years. He had been previously eight years working on hotel and mixed-use real estate developments for hotel investment companies. He was Director of Acquisitions for City Hotels (listed on the Brussels stock exchange) and he was Managing Director of Credicom Exploitation, the asset management subsidiary of Groupe SIH. He holds a Bachelor of Arts degree in Sociology and Anthropology from Tel Aviv University, and a Master of Business Administration from IMHI, a joint programme of Cornell School of Hotel Administration and ESSEC Business School.

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