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Riga, Latvia: Are Too Many New Hotel Rooms Checking In?

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The number of new hotel projects recently announced in Riga is extensive: at least nine new hotel projects of 100 rooms or more, a total of approximately 1,800 new hotel rooms, have entered or are expected to enter the market over the next four years (from 2006 to 2009). This would result in an average annual increase in hotel supply of approximately 8% over the next four years. Even though tourism in Riga has grown strongly over the last few years, the questions are whether this level of supply growth can be sustained in the medium term and whether the existing average occupancy of 66% can be sustained. In this market snapshot we highlight the supply and demand fundamentals of this relatively new hotel market and analyse the supportable level of new supply in the three-star to five-star sector. Our article is divided into the following headings.

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

Overview of Latvia

With an area of 64,100 m² Latvia is the second-largest of the Baltic States ahead of Estonia and behind Lithuania. It has a coastline on the Baltic Sea and land borders with Estonia, to the north, and Lithuania, to the south. It also shares a border with Russia, to the east, and Belarus, to the southeast.

Latvia first gained independence in 1919. In 1940 it was occupied by the Soviet Union in accordance with the 1939 Molotov-Ribbentrop Pact with Nazi Germany. Shortly afterwards, large numbers of Latvians were deported to Siberia. Occupation of the country by German forces and the persecution of Latvian Jews followed from 1941 to 1944, when the Red Army drove back the German Army. Many Latvians left their country and headed for Germany or the USA to escape the Soviet regime. Society and industry were modelled along Soviet lines and absolute power rested with a Communist regime under Moscow's control.

The more tolerant political atmosphere in the Soviet Union under Gorbachev in the late 1980s allowed pro-independence and reform groups to come to power. Independence was declared and the Republic of Latvia was recognised by the European Community on 27 August 1991. In May 2004 Latvia joined the European Union (EU), further strengthening its economic and political ties with other EU countries. Latvia's entering the EU has had a remarkably positive impact on the growth in its tourism. For example, as a result of the country's joining the EU, Riga International Airport saw passenger numbers increase by approximately 49% in 2004 and a further 77% in 2005. The trend in airport passenger numbers will be explained in more detail later in the article.

Table 1 Map of the Baltic States, showing Riga

Source: Lonely Planet

Riga, the capital of Latvia, is not only the largest city in the Baltic States but also probably the most important commercial centre in the Baltic region. Given the size of the city and Latvia's strategic location – between Lithuania to the south and Estonia to the north – Riga is considered to be an ideal location for international companies doing business in the Baltic region. In 2004 the largest Estonian bank in the Baltic region, Hansabank, relocated its head office from Tallinn in Estonia to Riga. This trend is likely to be followed by other companies and institutions.

Political Environment

In June 1993 Latvia's first post-independence parliamentary elections resulted in the formation of a minority centre-right nationalist coalition government committed to free-market reform. Centre-right governments have been the norm since then. In 1998 Gustav Krasts replaced Andris Skele as Prime Minister. Mr Skele had been in office between 1995 and 1997. Soon afterwards, the right-wing nationalist government confirmed its commitment to economic reform and membership of the EU and NATO.

In October 2004 parliament rejected the draft national budget for 2005, and the cabinet resigned shortly afterwards. On 2 December 2004 parliament approved a new coalition under Prime Minister Aigars Kalvitis. The government consists of five parties and they command 70 of the 100 seats in parliament. The five parties are the People's Party, New Area, Latvia's First Party, the Greens and the Farmers' Union.

The make-up of the coalition and the ideological differences between the parties mean that there is a risk of delays in the implementation of structural reforms. Nevertheless, according to the Economist Intelligence Unit's country forecast, the political agenda will remain broadly unchanged, as a majority of parliamentarians are on the centre-right and ideologically focused on developing a free-market economy.

Economic Overview

In 2004 Latvia witnessed GDP growth of 8.5% on the previous year. The forecast of national GDP growth for Latvia is 6.0% in 2005 and 5.8% in 2006. Consumer price inflation was 6.2% in 2004 and is estimated to fall to 5.5% in 2005, 3.9% in 2006 and 3.0% thereafter.

The privatisation process in Latvia is almost complete. The remaining state-held or municipal assets that could be sold include a 53% stake in the carrier AirBaltic, a 51% stake in the fixed-line telephone operator Lattelekom, a 40% stake in the mobile phone operator LMT and a 39% stake in the oil transit operator Ventspils Nafta. Many smaller assets could also be sold.

To further strengthen its economic stability, in January 2005 Latvia repegged its currency to the euro. Latvia is hoping to join the European Monetary Union as soon as the Maastricht criteria are fulfilled; this is expected to happen some time in 2008.

The EU is Latvia's main trading partner. Trade with EU member states has been expanding constantly since Latvia regained independence. In 2003, 80% of Latvia's trade was linked with EU countries. Germany (16%), Lithuania (9%), Sweden (8%), Russia (8%) and the UK (7%) accounted for the biggest share of foreign trade turnover in Latvia.

Riga's airport has plans for extensive expansion. By the end of 2013 the airport aims to be ready to cater for 5 million passengers per annum, double the existing capacity.

Latvia has seen strong growth in foreign direct investment (FDI) over the last five years. The compound annual growth rate for FDI between 2001 and 2005 is estimated by the Latvian Commercial Bank to have been approximately 28%. The 2006 FDI estimate shows an increase of approximately 5.5% on 2005.

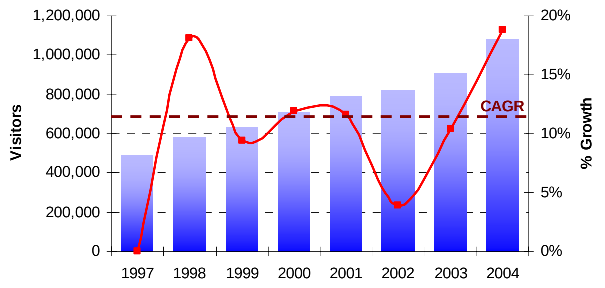
Investors in and developers of real estate play key roles in the development of Riga, as the city's growth dynamics and its attractiveness depend largely on the supply of new projects. According to Colliers International, the total supply of office space increased by 25,200 m² in 2004, which is an increase of nearly 30% in A and B class office buildings in Riga. With several projects having already been delivered, the 2005 forecast for the amount of additional B class office space is approximately 20,200 m². The peak increase in the supply of office space is forecast to be in 2006-07.

Tourist Arrivals and Demand

Over the last eight years visitation to Riga has increased by approximately 12% annually. The growth in international visitation has been particularly rapid since 2003, increasing by 19% in 2004 compared to the previous year. The above-average growth in visitor numbers can be explained largely by Latvia's accession to the EU in May 2004. Due to the rising popularity of the destination, low-cost airlines like Ryanair and easyJet started operating flights to Riga in 2004. It is worth mentioning that Riga's airport was the first in Europe to be served by both Ryanair and easyJet, a clear indication of the attractiveness of Riga as a tourist destination via low-cost carriers.

Graph 1 shows that the average compound annual increase in visitation to Riga, in terms of room nights, between 1997 and 2004 was approximately 12%. The highest rate of growth, of approximately 19%, occurred between 2003 and 2004.

Graph 1 International Visitation to Riga 1997-04



Source: Central Statistics Bureau of Latvia, 2005

Riga gained considerable positive publicity by staging the Eurovision Song Contest in May 2003. Furthermore, in 2006 Riga will host the Ice Hockey World Championships, an event which is likely to benefit tourism beyond the event itself.

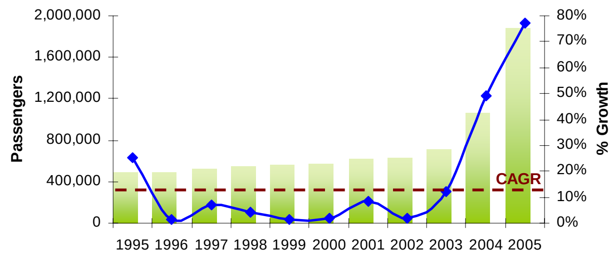
The increasing popularity of the city as a weekend break destination raises the following questions. What is it that makes Riga an attractive tourist destination? And is the current level of demand sustainable over the medium to long term?

Certainly, everybody has their own motivation for travelling, but if we were to generalise then the main five reasons for travelling to Riga would be as follows.

- Riga is a strategic location for companies doing business in the Baltic region;
- Art Nouveau. No other city in the world has preserved so many fine examples of buildings in this style;
- The greatest concentration of wooden buildings of any European capital;
- The Riga Opera is ranked among Europe's top opera houses. The National Opera in Riga is home to both the Riga Ballet and the Riga Opera and it was one of the first buildings to be renovated when Latvia gained independence;
- Prices are still relatively low compared to those in Western and Northern European countries.

To further illustrate the tourism potential for the city, Graph 2 shows the evolution of passenger movements at Riga's airport.

Graph 2 Passenger Movements – Riga Airport 1995-05

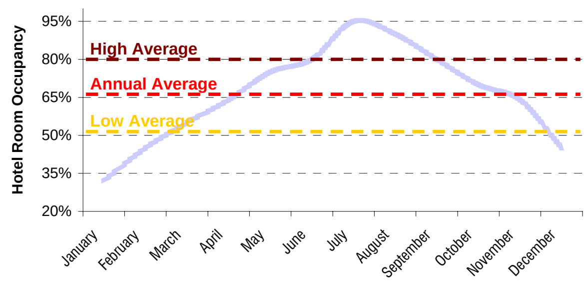


Source: Airports Council International

Graph 2 shows that there was a 50% increase in passenger movements between 2003 and 2004; the increase between 2002 and 2003 was approximately 13%. Furthermore, 2005 has been exceptionally successful with nearly 1.9 million passengers travelling through Riga's airport, an increase in passenger numbers on 2004 of 77%.

Despite the strong increase in the number of visitors to Riga the market remains highly seasonal. The high season for Riga's hotel market runs from May to October, when the average room occupancy ranges between 75% and 95%. During the low season occupancy can be as low as 30%. Graph 3 shows the approximate average monthly occupancy for three-star to four-star international-standard hotels in the Riga hotel market.

Graph 3 Seasonality in the Riga Hotel Market (all three- to four-star hotels)



Source: HVS International Research

With the aim of raising the attractiveness of Riga as an international conference destination a number of local hoteliers and the City of Riga have recently launched a Convention Bureau. Attracting conference business to Riga is especially important as it can be particularly beneficial during the shoulder season when the supply of rooms far exceeds demand.

Taking into consideration the trends in airline passenger arrivals, total tourist arrivals, the country's GDP forecast and several other quantitative and qualitative data, we have estimated the future room night growth for the Riga hotel market over the short to medium term. By combining the forecast new hotel room supply entering the market in the short to medium term with the forecast demand we show in Graph 4 the number of supportable rooms in the Riga hotel market in order to maintain an average marketwide occupancy of 66%.

Hotel Market Analysis and Estimated Supportable Demand

During his meeting with the Mayor of Moscow Yuri Luzhkov on 28 May 2005 the Latvian Minister of Transport Ainars Slesers commented that about 50 new hotels would have to be built in Riga to catch up with the rapid tourism development in the city. That was a very bold statement, and one that leaves plenty of room for interpretation. Without a thorough study of supply and demand any statement about how many hotels or hotel room nights are 'needed' in a market is a sweeping generalisation. Riga is still a very seasonal market, with hotel occupancy ranging from approximately 30% in the low season to 95% at the peak of the high season. If one focuses solely on the peak period then one ignores the remaining six months of the year when the marketwide average hotel occupancy for international-quality hotels is approximately 45-50%.

Despite the generalised statement from Mr Slesers, Riga's hotel market *does* offer strong potential for hotel development.

The real question is how much additional hotel room night supply the market can support in the short to medium term so that the average marketwide hotel occupancy remains at its current average of 66%. We combined the estimated amount of hotel supply likely to enter the market in the short to medium term with the projections for room night demand growth over the same period in order to forecast the supportable level of room supply in the market. The results are set out in Table 2.

Table 2 Supportable Number of Hotel Rooms in Riga 2005-11 (000's)

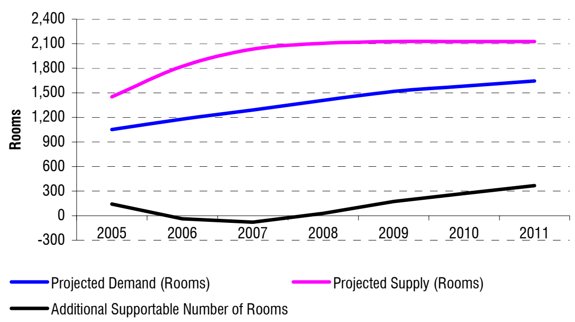
	2005	2006	2007	2008	2009	2010	2011
Projected Room Night Demand	384	430	471	514	553	577	600
Supportable Supply (Room Nights)	581	651	714	778	839	875	909
Assumed Occupancy	66%	66%	66%	66%	66%	66%	66%
Actual Supply (Room Nights)	530	665	742	768	776	776	776
Additional Room Nights Supportable	52	(14)	(29)	10	63	99	134
Supportable Number of Rooms (no scale)	**142**	**(38)**	**(78)**	**28**	**173**	**272**	**366**

Source: HVS International Research

Over the next six years it is estimated that the demand for three-star to five-star hotels in Riga is likely to increase, on average, by 5% per annum compared to an annual increase in hotel room supply of, on average, 4%. In 2005 the market would have supported an additional 140-room hotel. If all the projects that we have been made aware of are realised, see Table 3, then there would appear to be no room for additional supply between 2006 and 2008. Nevertheless, from 2009 onwards we estimate that the market will be ready to accommodate approximately 200 additional hotel rooms without this having an impact on overall marketwide occupancy. By 2010 and 2011 the potentially acceptable amount of new supply is even greater: a shortfall of approximately 300 to 350 rooms, respectively.

A graphical illustration of the supportable number of rooms on the basis of the total number of rooms per day is shown in Graph 4.

Graph 4 Supportable Number of Rooms 2005-11



Source: HVS International Research

Some of the new hotel developments already open or due to enter the market over the short to medium term are shown in Table 3.

Table 3 New Hotel Supply in Riga 2005-08

	Star Rating	No. of Rooms	Estimated Opening Date
Domina Inn	4	110	Apr-05
Hotel Albert	2-3	246	Nov-05
Europa Royale	4	60	Mar-06
Jekaba Street Hotel	4	170	Jun-06
Europa City	3	147	Jun-06
Elisabetes Street Site	2-3	230	Jun-07
Stockman Department Store Site	4	113	Jun-07
Elisabetes Railway Station Site	2-3	250	Jun-07
Ice Hockey Hall Site	3	200	Jun-08
Redevelopment of Riga Hotel	5	234	Jun-08
Total		**1,760**	

Source: HVS International Research

We note that in this analysis we are considering only the three-star to five-star hotel market in Riga and are making no discrimination between the different hotel categories. A single new three-star hotel development is unlikely to have a major effect on a five-star hotel; however, it would have a certain degree of competitiveness, depending on location, visibility, size, facilities, branding and general market orientation. To estimate the supportable number of rooms in a specific hotel category, it would be necessary to estimate demand growth for this specific segment and go through the same process, considering the competitiveness of existing and future hotel supply.

Conclusions

Riga, which is geographically at the centre of the three Baltic States and a city that enjoys close proximity to Russia, to the east, and Scandinavia to the north, is likely to offer good potential for hotel development in the medium term. Despite the strong growth in demand, there is a slight risk of temporary oversupply between 2006 and 2008 at the current estimated levels of supply growth based on current projects.

Seasonality in the Riga hotel market limits the growth potential. This issue is likely to be addressed by local hoteliers with sales and marketing measures especially in conjunction with the low-cost airlines. Hotel products addressing this issue with attractive offers, potentially for corporate clients in the low season such as conferences and meetings, are likely to reduce operating risk significantly.

New developments should be geared to enter the market at the ‘right’ time and should offer specialised positioning to ensure a fair market penetration.

Riga is a fairly ‘new’ hotel market and specialised products such as extended stay, lifestyle or branded budget hotels have not yet been launched. Their potential is certain to grow.

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 United States and two years of hotel consulting experience in Germany. Jakob holds a joint MBA from Cranfield University, 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 and Central Asia.

Lasse Ristolainen is a Consultant and Valuation Analyst with HVS International's London office. He joined the company in mid 2005 after completing MBA studies at IMHI (Essec Business School, France and Cornell University, USA). Prior to his two-year MBA studies he worked for five years at the largest hotel management company in the Baltic countries, Reval Hotel Group. His latest position was as a general manager at the 166-room Reval ExpressHotel, Tallinn, Estonia. Since joining HVS International, Lasse has conducted numerous valuations and feasibility studies in Europe.

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