DLA PIPER

CONTROLLING THE DOMINO EFFECT

Russia & CIS Hotel Market 2015-2016
Survey Report

CONTENTS

Foreword 1

CIS Hotel Market Overview 2

Crisis in Russia 8

Models for Growth 11

Our Respondents 12

DLA Piper in Russia and the CIS 13

DLA Piper is a global law firm with a dedicated team of lawyers specialising in the hospitality and leisure sector.

As part of our commitment to the region, we have conducted research on the Russia & CIS Hotel Market in 2015-2016 and would value your thoughts and comments on this report.

Our survey was carried out in September/October 2015 and is based on data from over 100 online interviews with hotel industry professionals focused on the CIS and Russia market.

Any unattributed quotes which feature in this report were made by respondents to our survey.

FOREWORD

This is the first year we have run this survey for the Russia & CIS region and we have had a very good response rate from top leaders in the industry who shared their views of the current situation within the hotel market and future prospects. We had more than 100 participants and about 70 respondents made it through all of the questions. We would like to thank all those who contributed to this survey.

Russia still remains the leading CIS market for hotel development with Moscow and St Petersburg well ahead of others, both as destinations for new development and for hotel acquisitions. At the same time, we have seen a marked shift of interest to developments in Georgia and Kazakhstan, each having delivered a number of projects with more in the pipeline. Armenia and Belarus have also seen an increase of investor activity and interest from international brands. Ukraine, on the other hand, has seen a significant slowdown in hotel development for the past year and the pipeline appears equally weak.

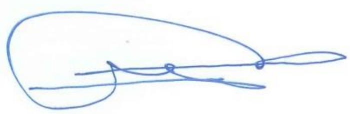
While Europe seems poised to enter into “a Golden Age of Hospitality”, the CIS region is generally experiencing difficult times. Low oil prices and economic and political turbulence has left Russia and Kazakhstan, the two largest economies in the region, struggling at present. After the introduction of free-floating exchange rates in October 2014 in Russia and in August 2015 in Kazakhstan, local currencies have rapidly devalued, causing instability and further erosion of investor interest.

The Russia-Ukraine crisis and related sanctions had a heavy, indirect impact on the region. The Russian hotel market significantly slowed down a year ago because of the sanctions regime and resulting lack of affordable debt financing. Almost 67% of respondents believe that sanctions have had a negative impact on the Russian economy, but 23% think that they have opened new opportunities. Only 7% of respondents think that sanctions have not substantially influenced the long term outlook. Currency losses and the increased price of hotel fit-out to meet brand standards are quoted most frequently as key pressures on the economic performance of the sector.

We are seeing more interest from Chinese and Korean investors with market players hopeful of alternative financing streams from the "East" to prop up new development in the sector. Preparation for the FIFA 2018 World Cup remains a key driver of hotel development in the regions, though it is becoming clear that not all of the projects from the initial pipeline are likely to be accomplished.

As a result of sanctions and the Rouble devaluation, the market has seen a boost of internal tourism, the leaders being Sochi and Crimea. Probably, the same reasons gave rise to a boost of travel from China. It seems that this time, recovery from the crisis for Russia will not be as fast as it was in 1998 and 2008. Almost 50% of our respondents believe that it will take between one and three years for the Russian economy to recover and almost 40% think it will take between three and five years.

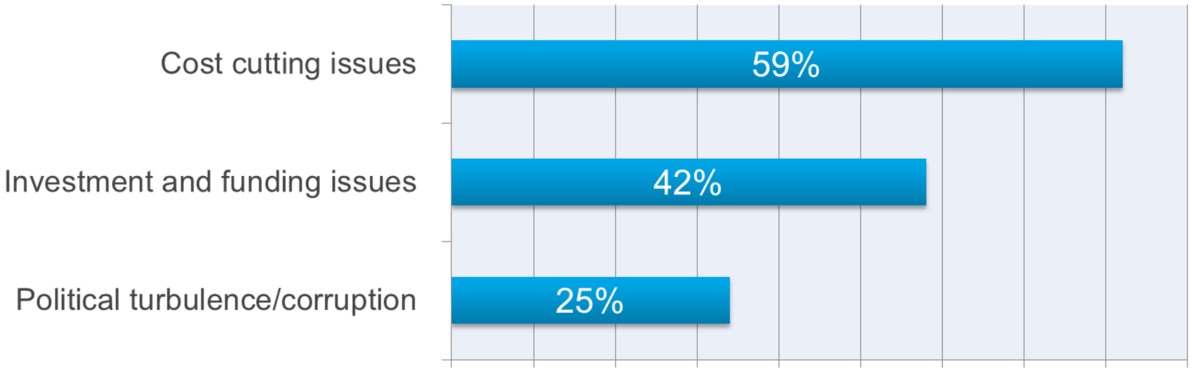
Through cost control measures and additional efforts to secure financing and minimise political turbulence/corruption risks, our respondents are trying to gain control over a domino effect of political and economic instability, which will help us all get through challenging times.



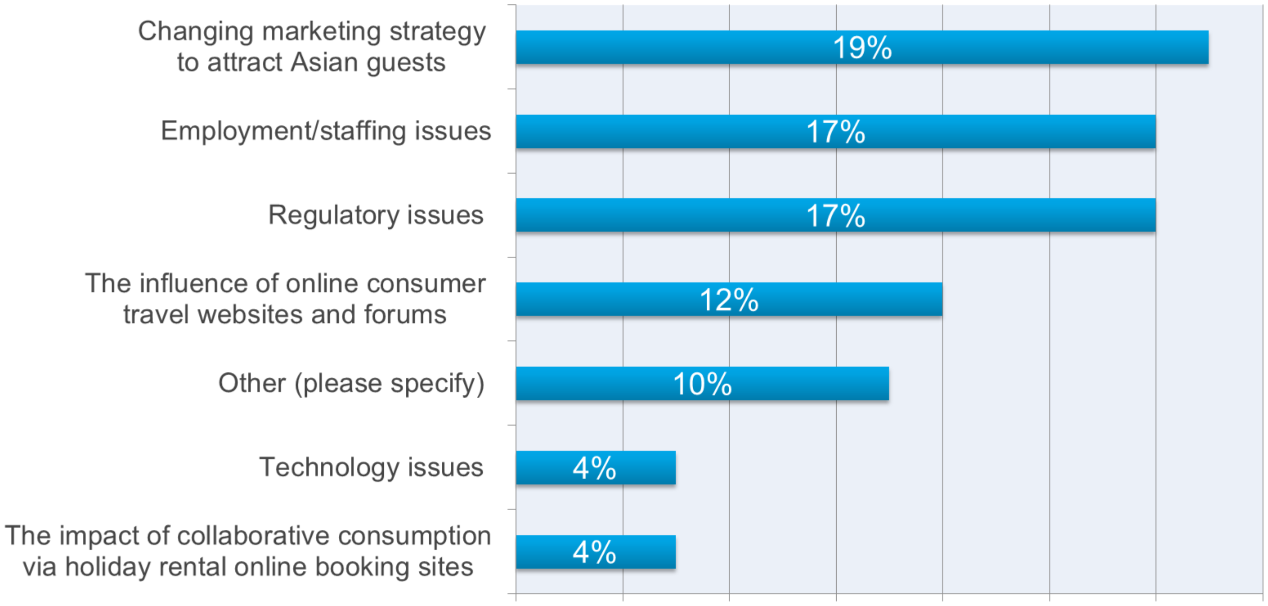
Pavel Elnikov
Senior Associate, Hospitality & Leisure Group
pavel.elnikov@dlapiper.com

CIS HOTEL MARKET OVERVIEW

Our respondents faced the following key issues in their business in 2015*:



Less frequent issues have been*:



* multiple answers were provided by some of the respondents

Additionally, our respondents indicated:

- Changes from traditional to digital sales
- Increase of prices
- Adjustments of yield strategy to fluctuating currencies

“ The market has sufficient qualified human resources, enough competitors and modern hotels concentrated in every great city of Russia. It needs the government to participate, to value every political decision because each time it influences the tourism industry and investors. ”

Attractiveness of the hotel development business

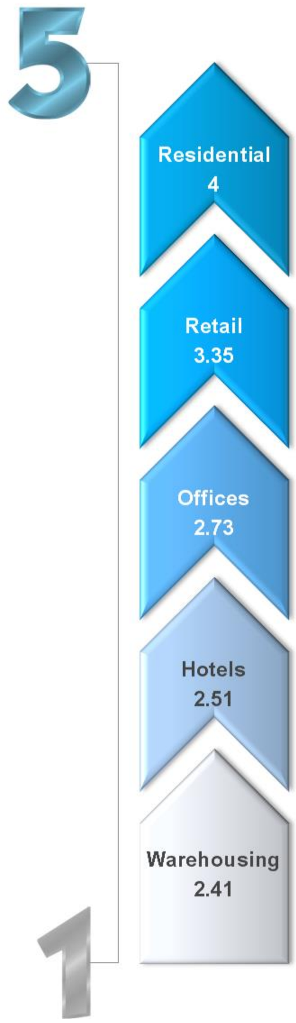
While hotels are not rated very highly among other real estate assets in terms of investment return (see the picture on the right),

73% of our respondents agreed that in the last five years there had been more traditional real estate investors exploring **diversification of their asset portfolio** with hotel projects. The key reasons for this are:

- diversification itself (43%);
- the declining attractiveness of traditional real estate (30%);
- less risks when investing in hotels (18%).

The remaining 9% mentioned other reasons for this trend, including:

- "multiple reasons ranging from the country’s major projects such as the 2014 Sochi Olympics and the 2018 FIFA World Cup to regional tourism development programmes"
- "obligation from local authorities"
- "promotion of sub-brands of chains at the budget to upper mid segment"



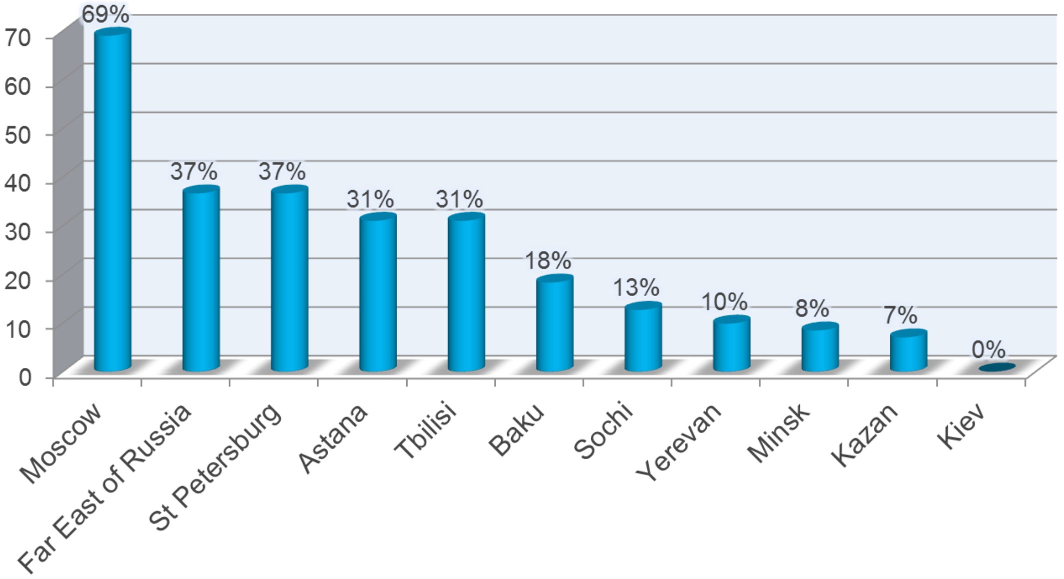
"Today there is a shortage of good hotel supply for transactions which result in premiums being paid, particularly in gateway cities. Also, as is always the case, hotels are a more sexy asset class than other investments."

Scott Antel, Partner, BLP

A midmarket hotel project in the CIS pays off in:

- Up to 7 years – 17%
- 7-11 years – 56%
- 11-15 years – 24%
- More than 15 years 3%

CIS regions with the best opportunity for hotel development*:



Additionally, our respondents indicated:

- Novorossiysk
- Petropavlovsk
- Odessa (sea-city)
- Krasnodar Territory
- Crimea (in few years)
- Yekaterinburg
- Yekaterinburg Region
- Batumi
- Bishkek
- Central Asian capitals

One of our respondents believes that the best opportunities for hotel development are in "*all regional cities with no international hotels*".

"Traditionally, the most attractive investment destinations are the cities with the most sustainable demand. For the Russia &CIS region sustainability of demand comes from solid corporate travel and MICE/leisure guests. Following this logic, capital or key regional cities are the most attractive for either acquisition or development. The list of such cities is longer than the obvious Moscow and St Petersburg and should include capital CIS cities and key business hubs in the region."

Ivan Kiseev, Director, Development for Russia & CIS, Marriott

"This fairly reflects our views, we still see great development opportunities in the region, of course driven by Moscow but certainly the Far East is seeing more activity and we are very positive on Georgia now."

David Jenkins, VP Development, The Rezidor Hotel Group

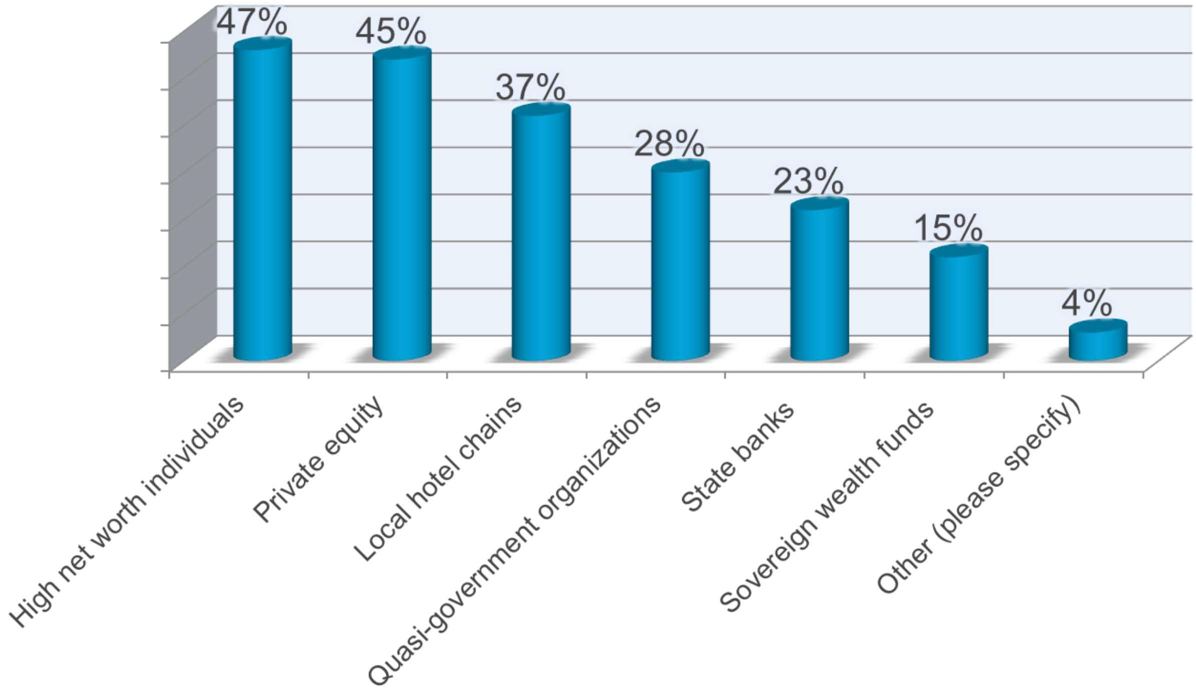
The CIS asset acquisition market

18% believe that there is **no established acquisition market** in the region. One of the comments in this regard is: "*Seller expectations are based on invested equity and buyers on cash flow and the difference is usually too great to make a deal happen.*" We asked our respondents to name three cities which are good for asset acquisition. They responded as follows:

63% see an asset acquisition market in **Moscow**, and 37% in **St Petersburg**, 20% in **Astana**, 15% in **Baku**, 15% in **Tbilisi** and 13% in **Sochi**, 8% in Kazan, 4% in Kiev, 4% in Minsk and 6% in Yerevan. Our respondents also specifically identified Nizhny Novgorod, Vladivostok and Samara as asset acquisition markets, while one of our respondents believes that such market exists in "a lot of regional cities (*millionniki*)".

Who will invest in hotels in 2016?

The following equity investors will be the most active in the CIS hotel market in 2016*:

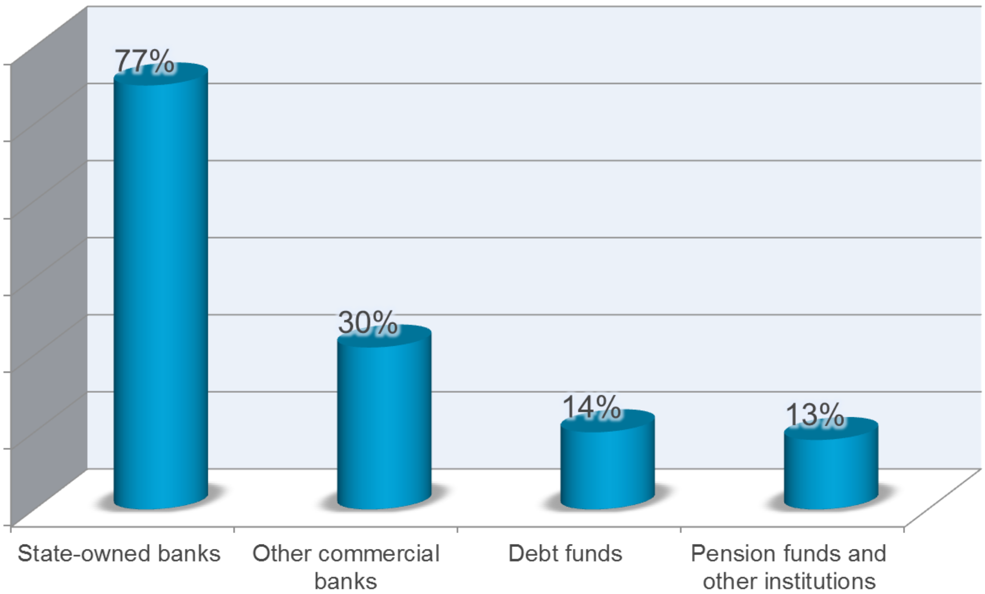


Additionally, our respondents indicated:

- Big companies
- Local developers
- International Investors - PE Funds

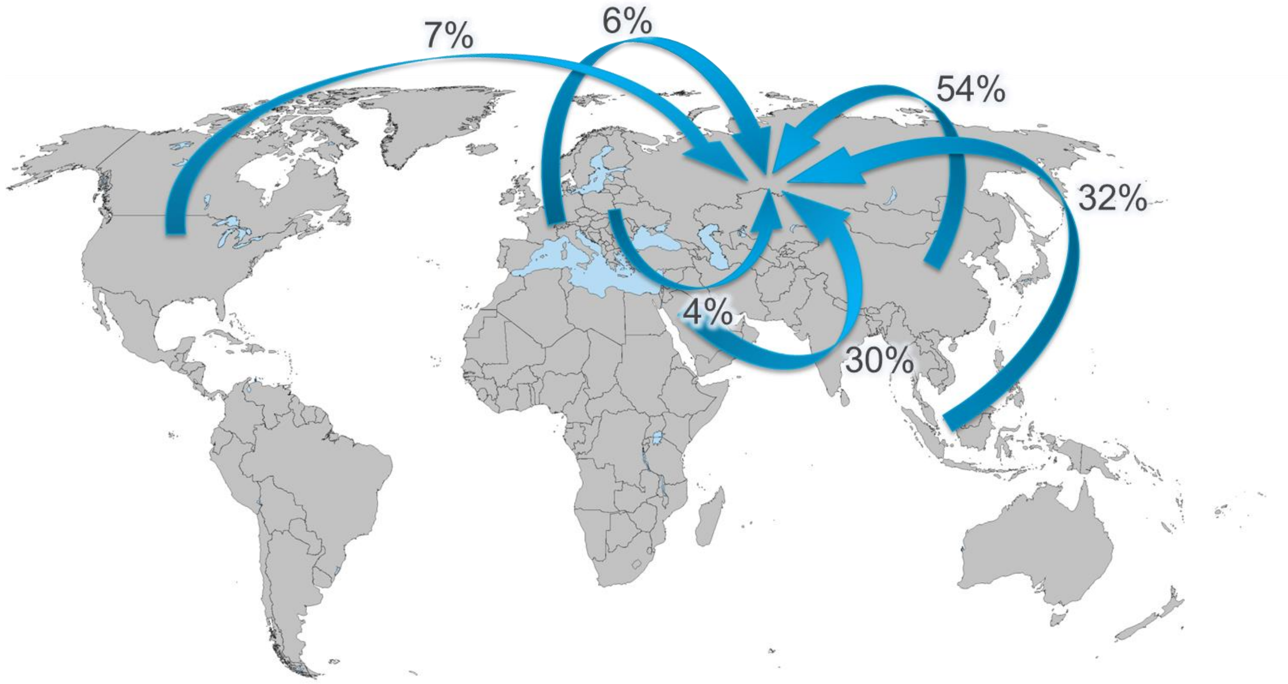
> "I hope all kinds of financial sources will be available and active. As for us we also are looking for opportunities to collaborate and be a partners will all kind of financial "resource" organisations that can be either domestic or foreign."

The following debt providers will be the most active in the CIS hotel market in 2016*:



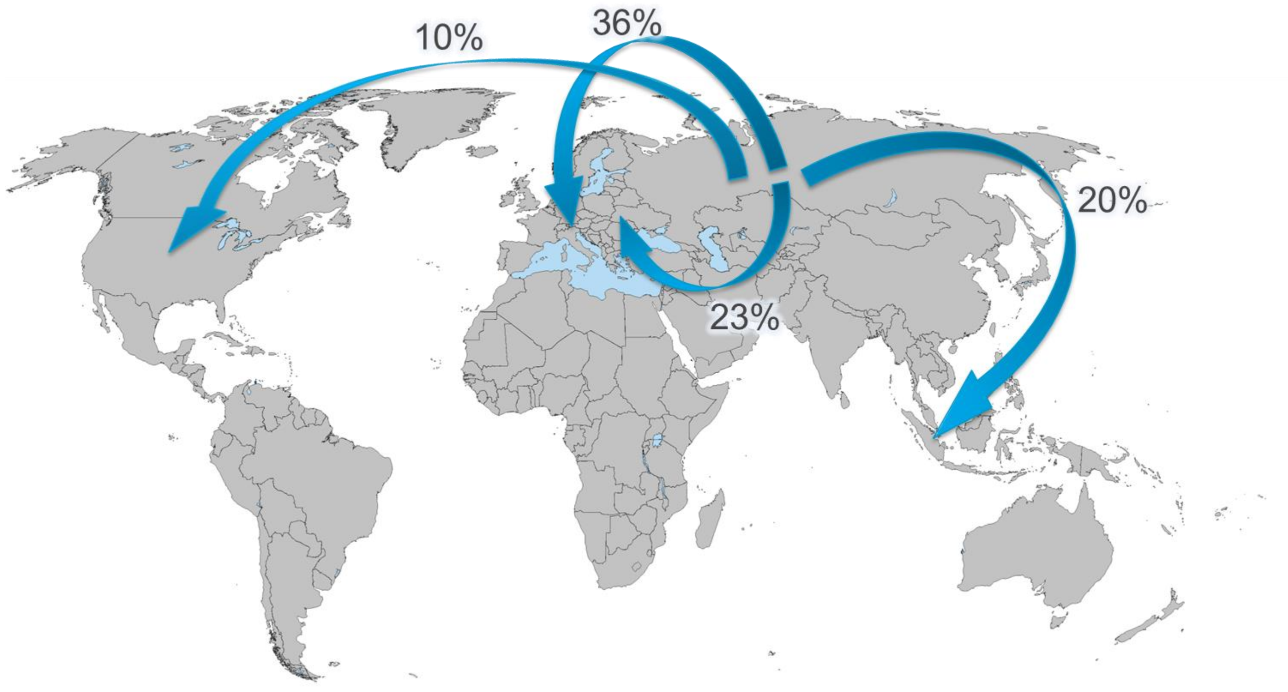
* multiple answers were provided by some respondents

Who will invest in the CIS hotel market in 2016?



58% believe that investments in the CIS region will come from the CIS.

The majority of CIS investment will be focused in the following regions during 2016:



CRISIS IN RUSSIA

Impact of the Rouble devaluation and sanctions/political crisis:

Rouble devaluation		Sanctions/political crisis
49%	Has impacted the Russian hotel market negatively	67%
33%	Has opened new opportunities for the Russian hotel market	23%
9%	Has not substantially influenced the long term outlook	7%
1%	Has not had a substantial impact	2%
8%	Other (please specify)	1%

The flow of Russian clients is decreasing due to the decrease of rouble cash and economic operations in different sectors. But the flow of foreign guests increases as the weak rouble and high currency level of the dollar and euro has opened Russian gates with 50% currency rates. The final revenue is going down because: 1) the Russian guests flow has a great share in the total scale; 2) the negative media coverage of Russia stops foreign guests from visiting Russia, and there is no information available for foreigners with no special knowledge of economics about the opportunity to take advantage of the tourism situation in Russia where everything is half-price. In two years the currency level will go back and such opportunity will end for foreigners.

[The Rouble devaluation] killed development and investments with Forex debt. Hopefully higher inflation will generate better Rouble on Rouble returns and limit future supply in the mid-term.

Due to [the Rouble devaluation] on the one hand, we have new opportunities; on the other hand, the market value per room in USD (for foreign investors) was halved (based on cash flows which are in RUB).

[The Rouble devaluation] has negatively impacted the development of new projects, not the financial results of hotels in Roubles.

How much time will it take for the Russian economy to recover?

Up to 1 year	1-3 years	3-5 years	More than 5 years
3%	47%	40%	10%

Short-term, operational results are suffering in USD terms. Long-term, this will make a hole in new openings 3-5 years down the road. Foreign investors that can see beyond the sanctions, find Russian Hotel real estate a very good deal right now.

[Due to sanctions] the market will become more inverted. Which is not bad, given the opportunity domestic tourism has in the country. Less foreign investors are interested.

[The Rouble devaluation] has reduced outbound travel and increased inbound travel which has affected the business negatively or positively based on the location of business.

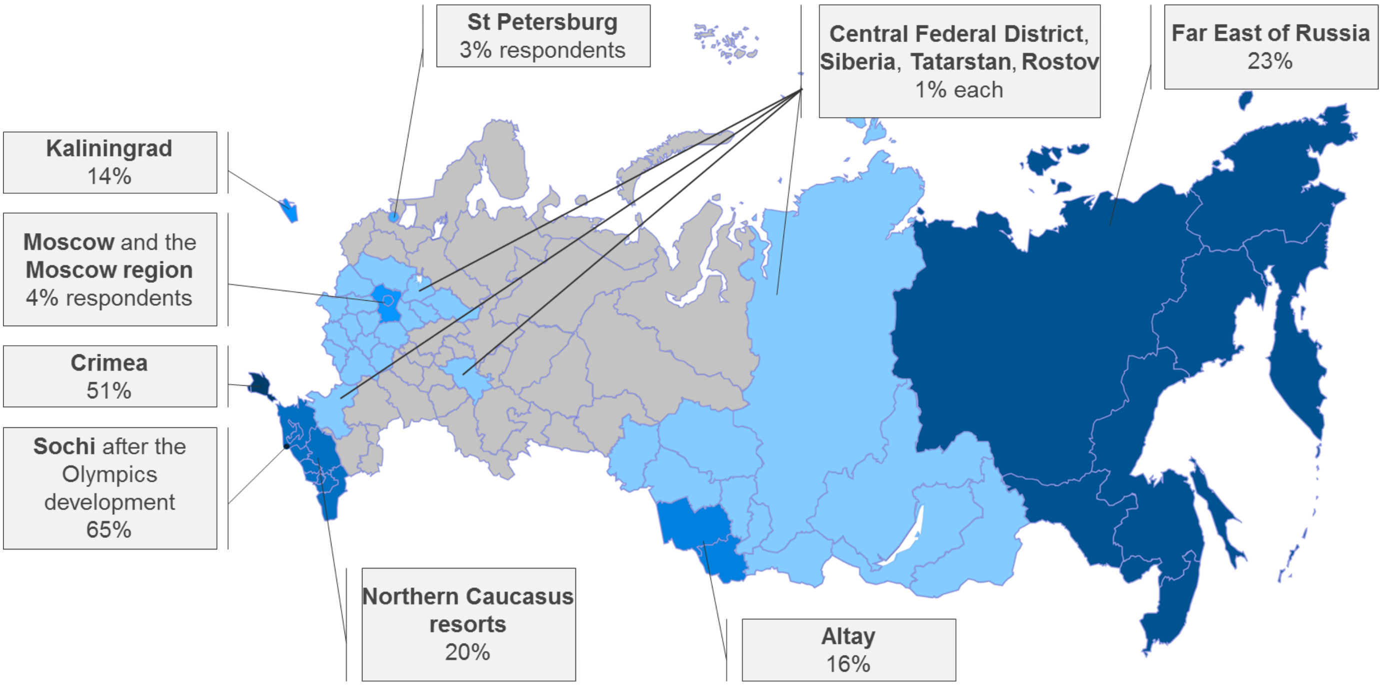
[The Rouble devaluation] has impacted the Russian regional hotel market negatively.

Domestic tourism

86% see a **growth** in levels of domestic tourism,

69% believe that the growth is **sustainable**.

The key new developing markets are*:



* multiple answers were provided by some respondents

75% consider 2015 a **successful year for Sochi** as a destination.

71% have witnessed an inflow of **tourists from China** in 2014-2015, which includes 43% who described this inflow as **substantial**.

60% think that the Moscow Government's decision to allow construction of apartments with a hotel (hostel) component will boost development of mixed-use hotel projects.

"Russian law aimed at the regulation of residential real estate and **"quasi" real estate such as apartments is still not developed enough** *[despite the Moscow Government's decision]* to allow the combination of apartments for sale and a hotel component in one development without a threat of damaging hotel quality standards. There is no enforceable option to oblige future/existing owners of the apartments to follow common rules of such mixed-use project, thus usage and proper maintenance of the joint public areas will most likely become a challenge, and it would be quite hard to keep facade of the building and adjacent territory in a proper state."

Tatyana Makarenko, Director, Corporate Counsel, IHG

MODELS FOR GROWTH

The following models will be important to the growth of hotel brands in 2016*:

Franchising	74%
Management agreements	64%
Hostels	26%
Asset ownership	23%
Joint ventures	22%
Fractional ownership	14%
Leasing	6%

* multiple answers were provided by some respondents

Additionally, our respondents specify **third party managers with franchise**.

72% think there is a demand for the development of **hostels** in the major cities of CIS. One respondent believes that this model is hot only for Moscow.

60% think **it is not a good time for fractional ownership and timeshare models** to be introduced in Russia contrary to 28% who believe that the model can be accepted by the market.

"The poll results are not surprising. This is mostly because the fractional model is not well known in Russia / not properly introduced to Russian investor-developers and clients. The situation (political, economic, financial) in Russia has changed substantially over the last year. And the Russians are changing too! Look around and you will see how people have changed their way to holidaying, shopping, wining & dining, and last but not least their way of possessing real estate . This has become much more European. The truth is that the time could not be better for starting to think and act differently!"

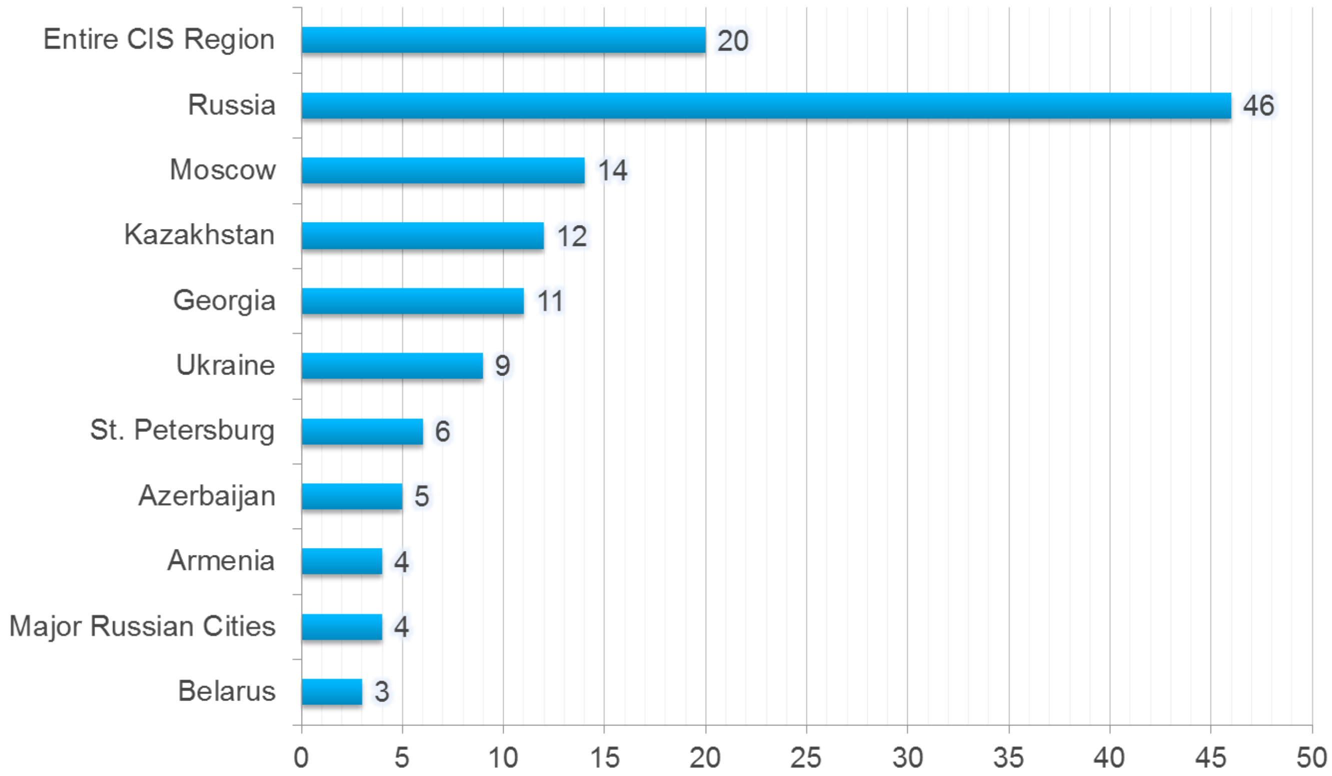
Evgeny Bezel, Managing Partner, Urbane Group

Our respondents on fractional ownership:

- "It'll work in the Black Sea resorts."
- "Maybe but not sure that Russian's would like to share ownership in a flat / vacation property with a group of people they don't know. Airbnb has this issue now to some extent."
- "In the short run, there will be a demand but a difficult model to sustain product and service quality."
- "This model is unlikely to work well in Russia."
- "Bad experience with the timeshare product in the 1990s in Russia. Poor perception of the best way idea."
- "The market is not ready for this model."

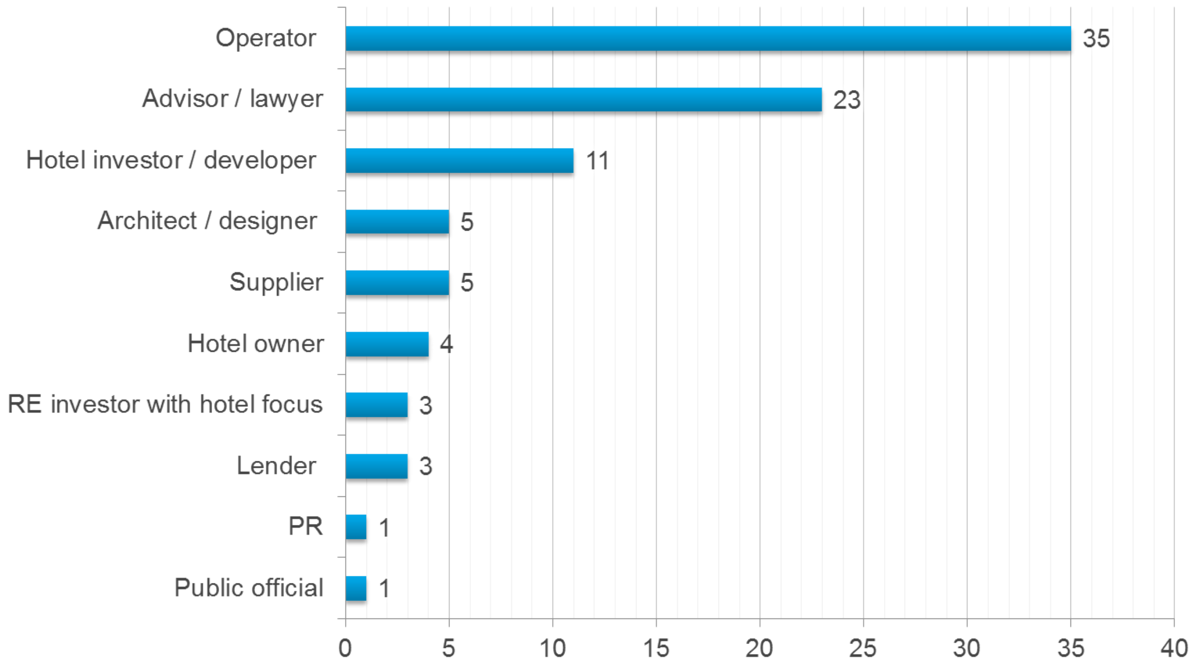
OUR RESPONDENTS

Our respondents are focusing on the following CIS regions*:



* multiple answers were provided by some respondents

and have the following roles:



DLA PIPER IN RUSSIA AND THE CIS

DLA Piper is a global law firm with lawyers located in more than 30 countries throughout the Americas, Asia Pacific, Europe, Africa and the Middle East, positioning us to help companies with their legal needs anywhere in the world.

DLA Piper's Hospitality team in Russia and the CIS represents the interests of owners of hotels and many international operators. Support with regard to management and franchising agreements as well as transaction work and operational advice is the core of our practice. Over the past five years we have represented the interests of clients on more than 100 such projects. Working with both owners and operators, we know the key commercial points of concern for the parties as well as the accepted market parameters for negotiation. We can save your time and money and also help to build a good working relationship between the parties by identifying and focusing on the key elements in negotiations.

In addition to advising on legal aspects of hotel management, our team is also active in such areas of hospitality and leisure as advising on legal aspects of the design and management of golf courses, ski resorts, spas, restaurants and large-scale event contracts.

Combining sector experience and knowledge of the Russian market "street" realities, we offer pragmatic solutions to our clients. We offer the locally based skills, knowledge and resources you need, when and where you need them.

Areas of expertise

- Management and franchising agreements
- Acquisitions and disposals of hotel/leisure companies and assets
- Corporate and commercial
- Employment
- Financing and funds
- Health, safety and environment
- Intellectual property and technology
- Data protection
- Licensing
- Litigation and regulatory
- Operational legal matters
- Legal issues of loyalty programmes
- Planning and construction
- Public affairs and lobbying
- Real estate (including development)
- Sponsorship arrangements for events
- Tax structuring and litigation

DLA PIPER'S GLOBAL HOSPITALITY AND LEISURE SECTOR GROUP

With more than 200 lawyers across our practice groups, DLA Piper's Global Hospitality and Leisure Sector Group advises owners, managers, franchisors, developers and lenders in respect of hotels and other hospitality and leisure businesses around the world.

Our sector group covers the following businesses:

- Hotels, including condominium hotels, apartment hotels and fractional and shared ownership schemes
- Resorts, including mixed use, leisure, timeshare, interval ownership, private residence clubs and country clubs
- Serviced apartments
- Leisure operations including golf courses, theme and amusement parks, health and fitness facilities, spas, gyms, leisure complexes, cinemas, marinas, pubs, nightclubs, casinos and gambling establishments
- Hospitality and catering operations such as restaurants and conference facilities

CONTACTS IN RUSSIA & CIS

Constantine Lusignan-Rizhinashvili
Managing Partner, Russia & CIS

T +7 495 221 4444
E constantine.lusignan-rizhinashvili@dlapiper.com

Pavel Elnikov
Senior Associate

T +7 495 221 4410
E pavel.elnikov@dlapiper.com

www.dlapiper.com