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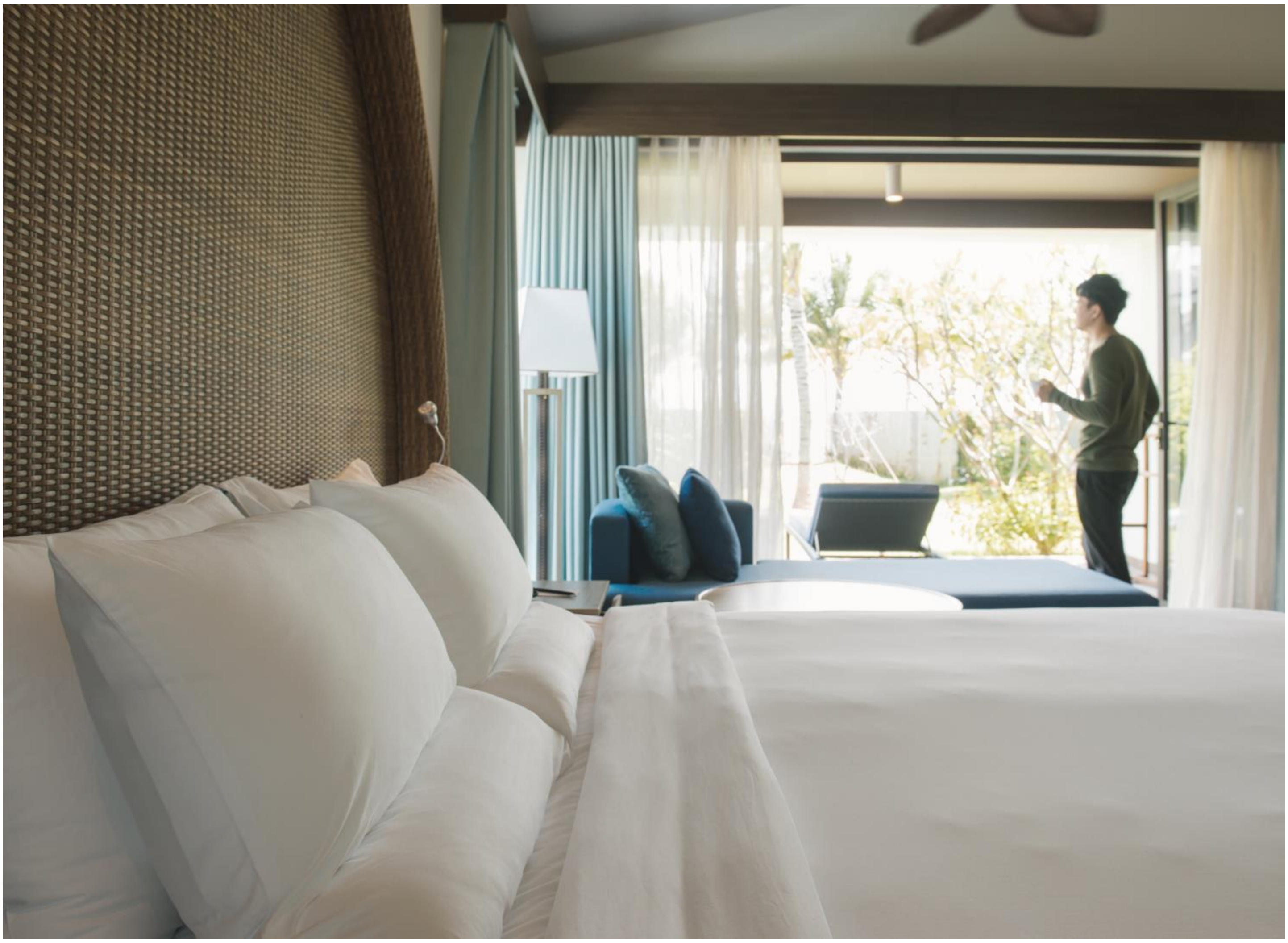
VIEWPOINT

Adaptive Spaces

Revival and Restructuring of the Baltic Hotel Market

CBRE BALTICS RESEARCH
JUNE 2023



Introduction

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The Baltic hospitality sector continues to undergo challenges following the post-pandemic vulnerability and regional tensions. However, alongside the economic uncertainty, an opportunity for restructuring arises. By embracing innovation, financial restructuring, and adopting sustainable practices, the hotel sector can not only regain its strength but also enter the blue ocean strategy. With shifting market forces, exploring unconventional niches can become a strength, as Baltic domestic tourism demand continues to bring in most of the revenues.

Following the post-pandemic demand surge in the summer of 2022, hotel operators leveraged the opportunity by increasing average daily rates to boost revenue. However, this strategy negatively impacted already fragile customer demand. Since July-August 2022, hotel occupancy has been on a downward trend, reaching its lowest point of ca. 40% in January-February 2023. It is important to note that this downturn can be partially attributed to seasonality, with a potential recovery in summer. However, it is unlikely to surpass the 2019 occupancy levels of ca. 70% across the Baltics in 2023.

In 2023, the Baltic capital cities have nearly 200 operational 3*, 4*, and 5* hotels, providing over 19,000 rooms. However, there has been a decline in the number of hotels compared to 2019. Government incentives introduced to mitigate the impact of COVID-19 on the hospitality sector ended in 2022 in Latvia and Lithuania. In Estonia, there are plans to abolish the 9% VAT exception for the accommodation sector starting in 2025. Some hotels remain temporarily closed but may reopen in the coming year, while others have successfully transitioned into rental residential buildings. Additionally, certain hotels have permanently ceased operations.

ADR, Baltic Capital Cities & Average Bedroom Occupancy Rates, FY2022

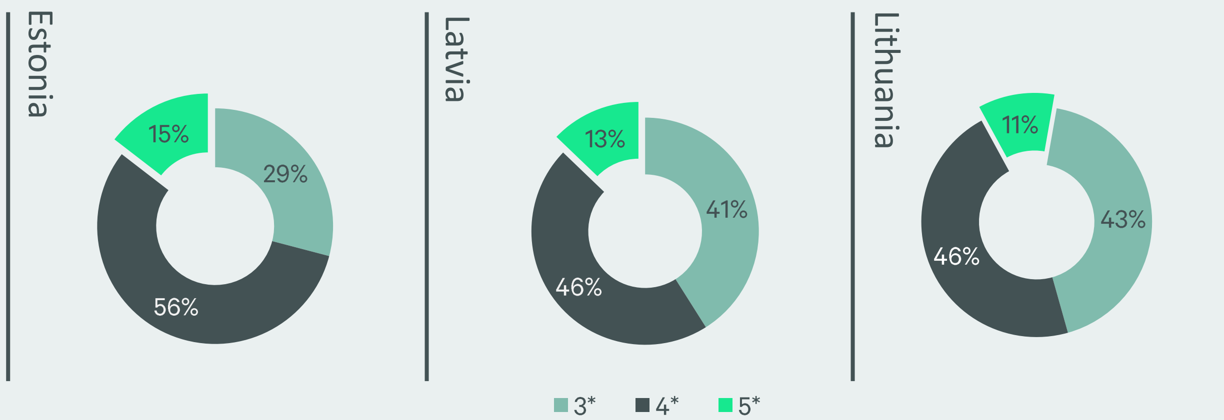
Tallinn, Estonia
73 EUR / 40%

Riga, Latvia
67 EUR / 36%

Vilnius, Lithuania
67 EUR / 42%

Source: STR, Eurostat, CBRE Baltics Research

Number of Operating Hotels in the Baltics, Segmented by Class, 2023



Source: CBRE Baltics Research

Three-Star (3*): ordinarily have some unique amenities and provide quality service.

Four-Star (4*): upscale quality, comfortable, and many amenities.

Five-Star (5*): flawless guest services in a state-of-the-art facility. As a five-star property, such as premium dining options and personalized services for its guests. With no detail being overlooked, these hotels commonly even provide guests with high-end, luxury toiletries.

Shifting Demand Patterns

Although total tourist arrivals at accommodation establishments are gradually returning to and surpassing 2019 levels, there have been notable shifts in demand patterns. Customers are now favoring regional and domestic travel routes, opting for land journeys over air travel. This trend has been accelerated by the increase in plane fuel prices, leading to higher ticket costs that impact hotel prices. Along with budget constraints, travelers are becoming more conscious of the carbon footprint and overall sustainability impact of their trips. Reduced affordability, coupled with changing consumer behavior, has driven domestic Baltic tourism.

In Q1 2023, the share of domestic tourists accommodated in hotels and similar establishments reached 55% in Estonia, 47% in Latvia, and 66% in Lithuania. This represents a change of +19 p.p., +8 p.p., and -16 p.p., respectively, compared to 2022, and an increase of 8 p.p., 14 p.p., and 9 p.p., respectively, compared to the same period in 2019.

Depending on the country, the proportion of foreign tourists accommodated from other Baltic states ranged between 15%-31% of the total foreign arrivals in Q1 2023, demonstrating the interconnectedness of the region and the potential for collaboration. Overall, these demand tendencies turning to more local markets provide an opportunity to reassess the target clientele and their specific needs.

Share of Accommodated Tourists with Domestic Origin & Share of Foreign Origin Tourists from other Baltic States in Q1 2023

Estonia

55% / 20%

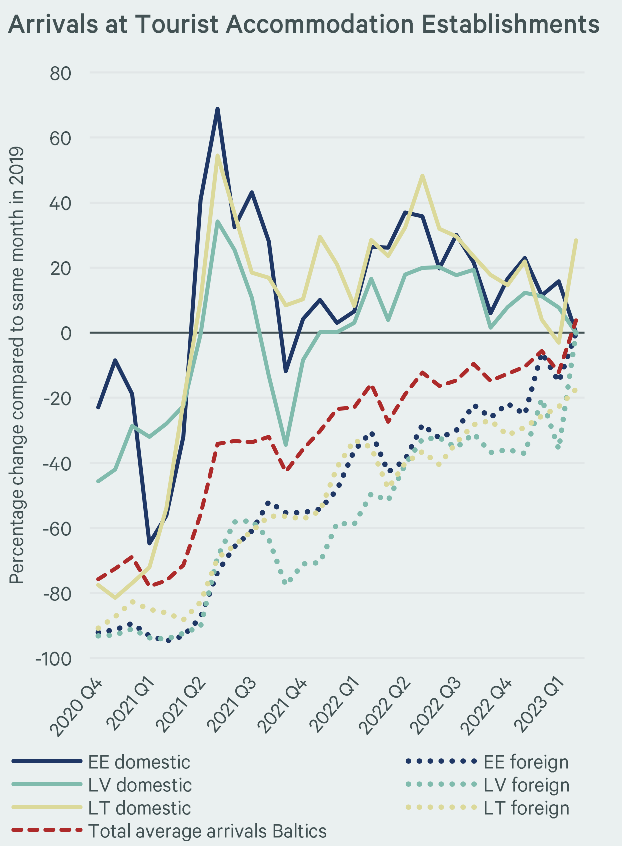
Latvia

47% / 31%

Lithuania

66% / 15%

Source: Statistics Estonia, Statistics Latvia, Statistics Lithuania, CBRE Baltics Research



Source: Eurostat, CBRE Baltics Research

Hotel Investment Market

The investor appetite for hotel assets in the Baltics remains uncertain due to regional geopolitical tensions. While Covid-19 is no longer a major concern, the conflict near the Eastern border of the Baltics continues to influence investor perception. Investors are primarily interested in above-average and below-premium segment hotels, particularly 4-star properties. Recent transactions, such as the sale of two 4-star hotels (L'Embitu and L'Ermitage) in Tallinn and the transactions in Riga involving Ibis Riga Centre and Pullman Riga Old Town Hotel, all these under Accor Hotels' agreement, demonstrate strong investor interest and expansion plans in the Baltics.

Given the current market circumstances, the attractiveness of investment deals depends on buyers' goals, interests, and risk tolerance. Real estate investors favor strong international brands, and foreign players compare potential yields to those in their home markets, which may outperform the Baltics. Prime hotel leased yields range from 4.6% in the Nordics to 7.5% in some SEE countries, with the Baltics falling towards the higher end. Hotels under management agreements imply slightly higher risk (c.a. 100-200 bp). Hotel operators prioritize financial stability and clear force majeure definitions in contracts with building owners to withstand economic downturns.

> Pricing expectation gap between buyers and sellers is evident, with significant differences observed in targeted asking prices versus factual transaction values.

Looking ahead, the outlook for the investment market is influenced by factors such as landlords' ability to service existing loans and the challenges buyers face in securing loans for potential acquisitions. The tightening financial conditions and persistently low transaction activity in the market have led to an increase in hotel yields by approximately 25-50 basis points across most EU markets since May 2022. In the meantime, we anticipate investors adopting a cautious approach until financing costs become more sustainable.

10Y Average Share of Hotel Investments

6%

Hotel Investment Volume in the Baltics, FY2022, EUR

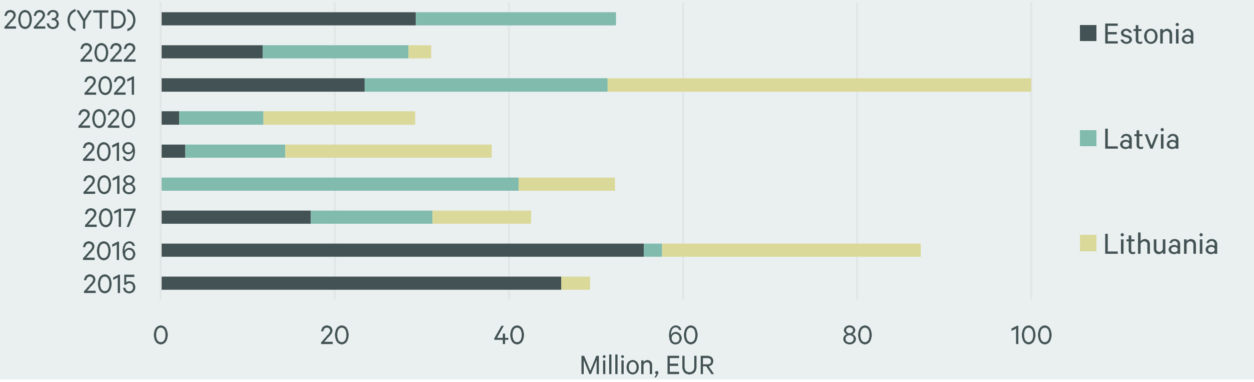
31M

Cumulative Hotel Investment Value in the Baltics, 2020 – 2023YTD, EUR

305M

Source: CBRE Baltics Research

Baltic Hotel investment Volume, 2015-2023 YTD, Mln EUR

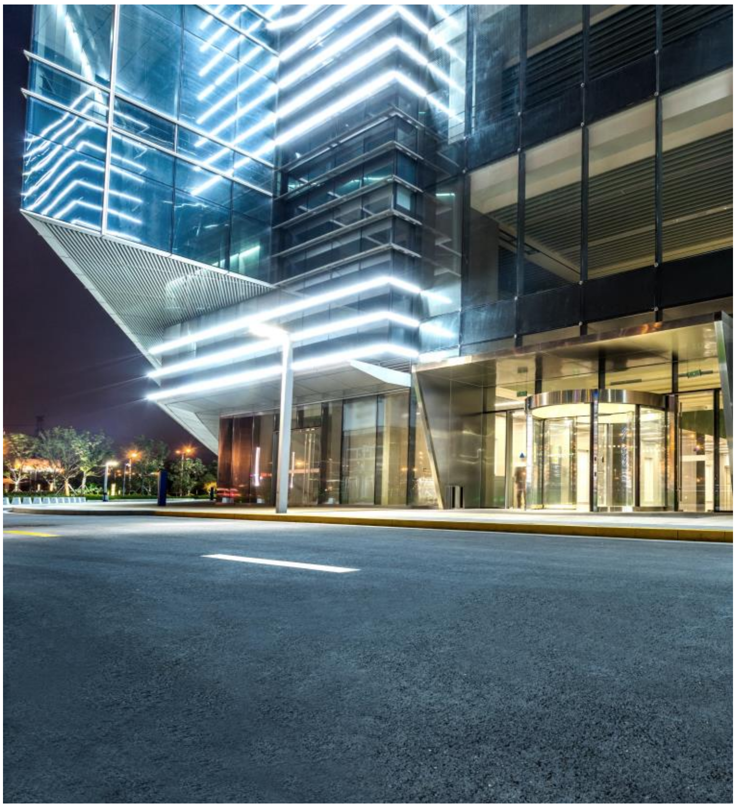


Source: CBRE Baltics Research

Vilnius

In Vilnius, the hotel segment has recently undergone significant restructuring changes. While some local hotel owners have chosen to rebrand their operations, others have halted plans for further expansion. The ongoing uncertainty has led to the repurposing of centrally-located developments for alternative uses, such as office, residential, and educational properties. For example, Lords LB Asset management announced that the St. Jacobs project, originally planned as the Clarion Hotel, is now leased to the Royal Russell School. Despite the presence of successful international operators in the market, there have been few new entrants in recent times. Currently, there are no ongoing construction projects, and the pipeline of over 700 rooms lacks a confirmed timeline.

Tallinn



During the pandemic, while hotels were forced to close, many existing hotels took the opportunity to undergo refurbishments and renovations, offering a fresh start. Some international brands have decided to strengthen their presence in the market. Notably, Accor has announced the openings of three other 4-star hotels in Tallinn, bringing the total number of Accor-branded hotels to 6 in Tallinn and 17 in the Baltics.

Also, Hampton by Hilton (3-star) is scheduled to open in 2024, and Hyatt Place will become the first lodging establishment in the Baltics to meet the Hyatt chain's standards, with its opening set for 2025.

To the dismay of the sector, the authorities of Estonia have decided to raise the VAT for the sector from 9% to 13% starting in 2025. This will result in the highest VAT rate compared to neighboring countries and may negatively affect the industry.

Riga

In Riga, the hotel segment is changing and facing challenges. Recent hotel transactions in the city have shifted from a franchise model to a management agreement. However, various hotels face obstacles, such as technical and other difficulties, which hinder their development and potential transactions. Consequently, several hotels in Riga remain closed. However, this situation has created an opportunity for rental residential investors who recognize the potential of acquiring these hotels. An example of a successful conversion is the exCity Hotel Theater on Bruninieku Street. Furthermore, the opening of the ASTON hotel on Brivibas Street, a new non-branded and locally-owned establishment, further contributes to the dynamic activity in the Riga hotel sector.

Outlook

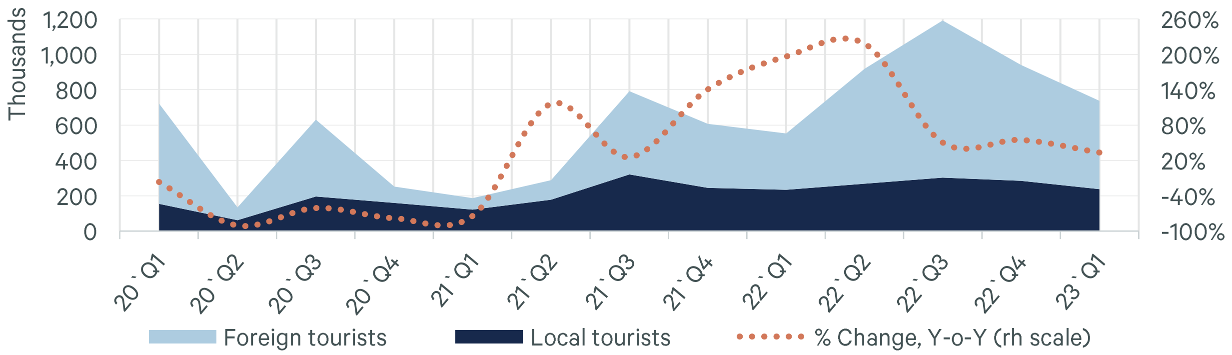
The hospitality sector is witnessing shifting trends that bring both opportunities and challenges. Hoteliers must be agile and responsive to navigate this changing landscape successfully.

Globally, people are prioritizing travel spending, allowing prices to rise for both hotels and means of travel. Leisure travel has returned to 2019 levels, while business travel still lags. Additionally, rising travel costs and budget constraints remain concerns for European tourists. Climate change is also impacting the tourism industry, with Europe experiencing its second warmest year in 2022, resulting in disruptive summer travel conditions. Cooler destinations are now leveraging this advantage as rising temperatures reduce the appeal of southern European-Mediterranean regions, causing tourism to shift towards the Baltics and Nordics as more attractive destinations.

The combination of elevated regional tensions and changing demand patterns pose a threat to the already fragile foreign investor and guest demand in the Baltics. While the Baltic States are attracting interest from new entrants and potential expansions by existing hotel chains, the scarcity of available pre-built structures for their operations is evident, and investors remain cautious about starting new construction projects in the current market environment.

In the short term, domestic and regional tourism will significantly benefit the economy, generating revenue and boosting the performance of the hospitality sector. Sustainability, wellness, and personalized experiences will be key drivers of conscious consumer demand. Travelers will seek experiences that align with their values, emphasizing the importance of sustainability and well-being.

Total Accommodated Tourists by Origin, Baltics, 2020 Q1 – 2023 Q1



Source: National Statistics, CBRE Baltics Research

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