Why has the German hotel business

Introduction

Germany is the largest economy in Europe, but this is not reflected in its hotel business. Germany has been problematic for hotel investors for years. Invariably, the level of demand has disappointed, yet this has hardly deterred developers. Hotel chain supply has continued to grow with some strength in spite of the so-so demand performance and projections. In this note we examine why this pattern has emerged and consider some of the options for the future.

The German Economy

Since 1990 Germany has been faced with two major challenges in its economy, the integration of the East and the maturing of its manufacturing industry. Progress is being made in overcoming these challenges, but they remain the core issues. GDP CAGR between 2000 and 2004 of 0.7% illustrates very low cyclical growth. This has been paralleled by the highest levels of unemployment since World War II, which, over the past five years, has stayed above 10% and at times exceeded 12%. Unemployment has been worst among manufacturing workers, since manufacturers have sought to reduce costs and increase productivity by further mechanisation. Germany also operates a highly rigid and national set of labour laws and provides high levels of unemployment benefit. In terms of productivity and unemployment there are major differences between the West and the East that have their roots in the communist era of the East. Productivity in the East is around 30% lower than in the West and unemployment in the East is regularly double that in the West. More than 4% of GDP of the West, around $65 billion, is transferred annually to the East in an attempt to redress this balance with an estimated total of ?1.5 trillion invested since reunification, but it has still not equalised the economic structure or performance of the two regions.

Agriculture contribution to GDP in Germany, 1.1%, has already been reduced to levels equivalent to the US and the UK. Between 2000 and 2004, agricultural GDP CAGR fell by 2.9%, the biggest segment faller in Germany. This has had very little impact on hotel demand since agriculture provides little business demand into hotels.

Germany is the largest manufacturer in Europe and the World's leading exporter of manufactured goods. The value of German manufacturing is 40% more than the UK's and 80% more than France's, respectively the second and third largest manufactures in Europe. However, between 2000 and 2004 manufacturing contribution to GDP fell marginally, but this does not reveal that German manufacturing is under pressure from lower cost producers in Asia and Eastern Europe. We subscribe to the plateau theory. German manufacturers have achieved a competitive equilibrium with lower manpower cost producers in Asia and Eastern Europe, but it is short-term. The problem is that another dose of price reductions by the lower cost producers or a higher level of taxes or wages in Germany and the equilibrium will be disturbed. At best, unemployment will rise again as more manufacturing manpower is laid off and at worst, German manufacturing will experience the traumas that the UK endured during the 1970's.

Germany operates a social welfare system, with 57% of Government spending going to social welfare. Per capita healthcare spending is the highest in the OECD. Social security and healthcare costs account for 42% of the wage bill. A central economic and political issue for Germany is that the size and growth of the citizen services segment of the economy are struggling to be funded by the remainder of the economy, which is dominated by manufacturing.

The solution to the German economic challenges is not to build more factories or to provide more citizen services, but to stimulate the development of the market services and experience segments of the economy.

Market services, including retailing, financial services, communications and professional services, account for only 16% of GDP compared with 22% in the UK or on a per capita basis about 30% less than in the UK. Germany still has a long way to go to create the conditions for a much more significant market services segment. It was less than five years ago that retailers were permitted to open after 2.30pm on Saturdays. There is a very low level of credit card usage and acceptance, and insufficient ownership of appreciating assets such as homes.

been a disappointment?

Similarly the experience segment, including hotels, restaurants, bars, gaming, nightclubs, theatres, cinemas and travel, is under-developed. Experience services account for around only 9% of GDP compared with 16% in the UK. Inbound tourism is still low at around 18.5 million per year compared with almost 30 million in the UK and 75 million in France. The domestic economy is insufficiently tuned to the experience segment, except for outbound tourism where spending is almost three times as much as the spending of inbound tourists.

The structure of the German economy is a key determinant of hotel demand. A massive 75% of the economy is focussed on the agriculture, industry and citizen services segments that yield low levels of domestic business demand into hotels. The low levels of ownership of appreciating assets, the double-digit unemployment and the low use of credit cards are key factors that limit the level of domestic leisure demand into hotels. Add to this the low levels of inbound tourism and the high levels of outbound tourism and the sluggishness of hotel demand is clear.

The question is what has to be done. The Merkel administration is running out of options. The palpable logic is that the solution is in the provision of fiscal stimulus to the development of the market service and experience segments of the economy. They are the only segments that have the capacity to grow at superior rates, to soak-up the high volumes of unemployed and to accelerate the domestic economy. The longer it takes, the worst it will be for the rest of us. We are encouraged by the initiatives of the German banks to promote the use and acceptance of credit cards and by the growth in the transfer of rental agreements to home ownership. Although it is still too slow, we are also encouraged by the early signs of growth in demand for out of home leisure in Germany. These are all necessary precursors to the secular shift in the growth rates of the market service and experience segments and central to the development of the hotel business.

The pattern of hotel chain development in Germany over the past five years has been as follows:

Market level	Rooms 2000	Market share 2000	Rooms 2005	Market share 2005	Growth	CAGR
Deluxe	3 k	2%	4 k	3%	2 k	9%
Up-market	39 k	30%	63 k	35%	23 k	10%
Mid-market	73 k	55%	87 k	49%	14 k	4%
Economy	12 k	9%	18 k	10%	6 k	8%
Budget	5 k	4%	7 k	4%	2 k	5%
Total	**133 k**		**179 k**		**46 k**	**6%**

Source: Otus & Co

At the end of 2005 hotel concentration in Germany reached 25%, up from 19% in 2000. A reason for the low level of concentration is the operation of German banks. It has been common practice in German banking that lending decisions are devolved to regions, to cities and even to branches depending on the size of loan. One consequence of this is that most hotel lending has been handled further down rather than further up the bank organisation structure. Thus, traditionally, the loan books of German banks have been polluted with lending to unaffiliated hoteliers and one-off developments of hotels that have then been leased to hotel chains. Slowly, the banks are beginning to realise that their organisation and lending practices to the hotel business have added too much to risk, but there is no quick fix. Of bankers in the major economies, German bankers as a group have less of an understanding of the size, structure and dynamics of the hotel business and this is at the root of the poor investment record in German hotels. This is fed by the lack of transparency of performance of hotel companies in Germany. There are no publicly quoted German hotel chains publishing annual, interim or quarterly performance data and the international quoted chains provide no systematic details on their German operations. The RevPAR disseminators provide limited and sketchy details and all of this makes the German hotel business too much of a lottery.

The portfolio growth of hotel chains in Germany has underperformed Europe as a whole with only 6% CAGR against 9% for the region as a whole. This has reduced Germany's share of affiliated rooms in Europe from 14% in 2000 to 12% in 2005. Over the period, hotel chains in Germany added an average of 9,200 rooms per year, materially more than in France where the average annual addition was only 7,600, but significantly less than in the UK where the average was 16,000 rooms. Germany is under-represented by hotel chains having double the number of citizens per chain room than the UK. Germany also suffers from the peculiarity of the West/East history over the past half century. The presence of hotel chains in the former East Germany is significantly lower than in the West. The former East accounts for only 18% of the affiliated rooms stock of Germany as a whole, which is a function of the political system under which the East operated until 1990 and its less developed economic structure.

Why has the German hotel business been a disappointment? continued

The market level profile of affiliated rooms in Germany is also changing. Notably over the past five years half of the room stock added to chains has been at the up-market level and most of these have been in the West. Up market rooms in Germany account for 35% of chain room stock against only 27% in Europe as a whole. Up market chain rooms in Germany grew at a CAGR of 10% against only 6% for Europe as a whole.

Domestic German chains account for only 25% of chain exposure to Germany, which is very low for a major economy. The global companies: Accor, Cendant, Choice, Hilton, Hyatt, Intercontinental, Marriott, Rezidor SAS and Starwood account for 31,000 up market rooms in Germany, half of all chain up market rooms. They account for 60% of mid-market rooms, 73% of the economy rooms and 98% of the budget rooms. Only Maritim and Steigenberger, among the domestic chains have a nationwide portfolio and we expect the long-term trend of increasing domination by foreign chains to continue.

Locations

A characteristic feature of Germany is the concentration of chain hotels in relatively few locations. At the end of 2005 hotel chains were represented in only 300 conurbations, an average of about 600 rooms per conurbation against almost 700 conurbations in the UK and nearly 600 in France.

In Germany there are no major hotel cities (those with more than 30,000 chain rooms). However, there are six primary cities with more than 6,000 rooms – Berlin, Cologne, Dusseldorf, Frankfurt, Hamburg and Munich, all of which are in the West. Together these cities account for 72k rooms, 40% of all chain rooms in Germany, but their room stock is skewed to the up market level, which account for 29k rooms, 42% of the primary city room stock. This is an exceptionally high level in comparison with other primary cities in Europe.

Conclusions

The German hotel business will not stop being a problem until the Government makes bold decisions about the structure of the economy. When that begins to happen we expect a rapid transformation. Capital providers will become more rational and business demand will rise sharply as the market service and experience segments, the prime drivers of business demand in to hotels, grow in both size and scope. We also see that, as these processes develop, domestic hotel chains will continue to underperform foreign chains in Germany. The one issue that remains to be tackled is the increase in inbound tourists. We cannot see any sea change in this until the structure of the economy changes and there are more exciting leisure activities in the country. Factory watching provides little or no appeal to tourists!

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