ANALYSIS OF DEVELOPMENT TREND AND OPERATION MODELS FOR MIDSCALE HOTELS IN CHINA

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Introductory Heading

Against the backdrop of the declining profits of upscale and economy hotels, the midscale hotel market which has always been considered less important in China has begun to receive attention from many international and domestic hotel brands. Considering the large room for growth and development potential for midscale hotels in China, branded hotel groups are adopting different strategies to develop and seize China's midscale hotel market.

'Dumbbell' Development Pattern

There is currently still no unified definition on the standard for midscale hotels in the market. This concept can be defined in terms of star rate, development cost per square meter, customer profile and etc. In this article, we consider midscale hotels to be the category between economy hotels and upscale hotels, targeting midmarket and high-end consumers and business travellers.

China's hotel market is generally characterised by a 'dumbbell' development pattern of strong growth in upscale and economy hotels and weak growth in midscale hotels. Between 2000 and 2010, the star-rated hotel room inventory in China increased rapidly at a compound annual growth rate (CAGR) of 11%. Room supply growth was the strongest within the five-star segment, recording a CAGR of up to 18%. In addition, economy hotels have achieved rapid expansion by taking advantage of their low costs, chain management and easy attraction for investment. For instance, renowned economy hotel brands like 7 Days Inn, Jin Jiang Hotels and Home Inns have already reached or will reach the milestone of having 1,000 hotels. However, the new upscale hotel supply experienced significantly slower growth due to the impact of factors such as the macroeconomy and tightening policies on spending from 2011 to 2013. According to the latest Statistical Bulletin of National Star-rated Hotels in the Third Quarter of 2013, the five-star segment's CAGR decreased to 8%, with a total supply of 717. Meanwhile, new economy hotel supply continued to decline. Between 2011 and 2013, the one-star segment grew at a CAGR of only 1%, and the two-star segment was recorded at a CAGR of -2%.

In recent years, occupancy levels and profits of the upscale and economy hotel markets have decreased significantly with the expanding polarisation of the two markets. Due to the impact of factors such as the travel cost control and the implementation of the 'Eight Provisions' and 'Six Bans', average occupancy and ADR of the five-star segment recorded year-on-year decreases of 5.6% and 3.3%, respectively, which led to a sharp year-on-year decrease of 8.5% in terms of RevPAR, as shown in the latest data for the third quarter of 2013. Due to the central government's anti-corruption measures, a large number of upscale hotels, especially self-managed individual hotels, have had to launch online group buying services or make medium- and long-term promotional efforts to attract guests, and five-star hotels in some second-tier cities have carried out price-off promotions to compensate for their declining occupancy. Meanwhile, economy hotels have also experienced decreasing room rates and occupancy levels as a result of increasing rental and human costs, which has given rise to a fall in industrial profits. In 2012, the total net profit of Home Inns, 7 Days Inn and Jin Jiang Hotels dropped by 45.12%, as compared to the previous year. Against the backdrop of the declining profits of upscale and economy hotels, the midscale hotel market, which has always been considered less important, began to receive attention from many international and domestic hotel brands.

Budding Midscale Hotels

Midscale hotels in China possess large room for growth and excellent development potential. First of all, the midscale hotel market itself is large enough in scale, capturing a big market share. According to the latest data for the third quarter of 2013, the number of three-star hotels accounted for 48% of the total star-rated room inventory. Next, midscale Commercial and Leisure demand is large in third- and fourth-tier cities, and midscale hotels are just in line with the positioning of third- and fourth-tier cities, so they are expected to
hold great development potential in these cities. According to data provided by the China Tourism Academy, 40% of international overnight visitor arrivals and 25% of domestic overnight visitor arrivals prefer to choose midscale hotels as their lodging products, based on which the midscale hotel market size is expected to exceed 100 million consumers and continue to grow. Again, impacted by the travel cost control and guided by the national policy for the ‘three public consumptions (overseas travel, receptions and official cars), more guests are expected to be diverted from the upscale hotel market to the midscale hotel market, which will lay a market foundation for the development of midscale hotels. In addition to tighter spending by the government and corporate guests, leisure guests have gradually returned to being rational and experience consumption from a pure pursuit of luxurious consumption. Also, the increasing number of the middle class domestically is a large group of rational consumers, and midscale hotels with high value for money can typically better meet their demand, which is expected to promote the further development of midscale hotels. Additionally, the cost-effective return on investment (ROI) represents a favourable factor for the thriving development of midscale. In contrast to the high investment and long payback period of five-star hotels, as well as oversupply and low ROI of economy hotels, midscale hotels are characterised by moderate investment costs with a typical payback period of about three years and relatively high ROI. Comparatively, midscale hotels have better investment value and outlook.

**STAR-RATED HOTEL SUPPLY MIX, 2013 Q3**

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<tr>
<th>Star Rating</th>
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<td>One-Star</td>
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<td>Two-Star</td>
<td>26%</td>
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<td>Three-Star</td>
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<td>Four-Star</td>
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<td>Five-Star</td>
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'Downward Positioning' Strategy

Due to its huge development potential, the midscale hotel market has become a 'profit cake' which international and domestic hotel brands are competing for, and is anticipated to represent the main competing battlefield for all brands. In recent years, a large number of internationally branded hotel groups have invariably shifted their business priorities towards the development and expansion of midscale brands. Hilton Worldwide announced that it would introduce Hilton Garden Inn, a midscale brand under its portfolio, for the first time in China in 2014. Positioned as a midscale brand, Hilton Garden Inn highlights its orientation towards business travellers and excludes unnecessary tedious facilities such as food and beverage outlets and grand ballrooms, with room rates set between that of upscale and economy hotels. Compared with Hilton Worldwide, InterContinental Hotels and Resorts realised the development of midscale hotels earlier, and it has opened dozens of midscale Holiday Inn Express hotels in China. Accor Group has also strengthened its investment in the midscale hotel market. In June 2013, Mercure Chengdu North was opened in Chengdu, marking the debut of Mercure, a midscale brand under Accor, in China. The development of Wyndham Hotel Group in China has always been focused on Ramada, a midscale brand under its portfolio, including a total of 55 hotels distributed in first-tier cities such as Beijing, Shanghai and Guangzhou, and most second- and third-tier cities across the country. In 2013, Wyndham Hotel Group announced its opening of eight new Ramada hotels in China, making Ramada its second largest brand in China (trailing only after Super 8).

'Upward Positioning' Strategy

International hotel groups, which have always focused on the development of upscale luxury hotels, have begun to adopt a ‘downward positioning’ strategy. In contrast, domestic economy hotel chains positioned at fair room rates have also competed to introduce their midscale brands by adopting an ‘upward positioning’ strategy. In 2009, Home Inns announced the opening of Yitel Taiyuan, a hotel under its midscale brand, and its plan to expand to 50 properties in the next five years. In 2012, Haning Inns was renamed Huzhu Hotels Group Ltd and acquired Starway, a midscale brand under Ctrip; coupled with Ji Hotel, its own midscale brand, Haning Inns managed over 130 midscale hotels, which accounted for 10% of the group’s total hotel supply. In addition to stabilising its development in Beijing, Shanghai and Guangzhou,
Starway Hotel Group will make greater efforts to develop the markets in second- and third-tier cities for their increasing business travellers, as well as tourist cities which are preferred by white-collar visitors, in the next three years. Meanwhile, Hanting Inns has also opened properties under the Ji Hotel brand in ten major business cities such as Hangzhou, Dalian and Wuhan, in addition to Beijing, Shanghai and Guangzhou, with the total number of Ji Hotel properties amounting to 23. In late March 2013, Jin Jiang Hotels introduced its Metropolo brand for the midscale hotel market, which is expected to witness the outbreak period. In the same year, with the complete privatisation of 7 Days Inn, its founder introduced strategic investment to establish Plateno Hotels Group and launched three midscale brands: Lavande Hotel, James Joyce Coffetel and ZMAX. Over 40 franchise contracts were signed in less than five months after the launch of these three new brands.

**Issues and Challenges**

Despite its huge potential, the midscale hotel market has faced many issues to be resolved, from the perspective of the current development status. China’s midscale hotel market is mainly comprised by a large number of traditional individual three-star and four-star hotels; most of them are full service hotels, characterised by over-sized restaurants, fitness and entertainment facilities, higher employee per room, highly complex management and high daily maintenance costs, which have diluted their profits and affected performance growth. Meanwhile, currently, the vast majority of midscale hotels have not formed a chained development as with economy hotels, which implies that many midscale hotels do not have a scale advantage in terms of marketing, booking, cost sharing, and so forth. Due to the lack of strong brands and marketing capabilities, the vast majority of individual midscale hotels have survived at the breakeven point or even operated at a loss, beleaguered by upscale and economy hotel groups in recent years.

According to the latest data issued for the third quarter of 2013, the three-star segment, which represented 48% of the total star-rated hotel supply, accounted for only 29% of the marketwide operating revenue, with negative growths in operating profit and gross profit. As a result, the overall three-star segment was in red. In 2012, only the three-star segment went into deficit among all star-rated segments; therefore, the ability to establish appropriate operation and profit models in the potential midscale market represents the key for hotel brands to triumph over the competition in the future.

**An Insight into Operation and Profit Models of Midscale Hotels**

**An Asset-Light Path through Mergers and Acquisitions/Franchise Chains**

Although competition within the midscale hotel market has just begun, some of the industry experts have already pointed out that, similar to the development of economy hotels over the past few years, the number of individual hotel establishments in the midscale hotel market will be greatly reduced, either being eliminated or joining existing hotel chain brands. It is expected that within the next five to ten years, a number of large-scale midscale hotel chains will be available throughout the country. Taking Huazhu Hotels Group as an example, the group’s franchised hotels and directly-owned hotels currently accounted for 45% and 55%, respectively, of its total number of establishments, and Huazhu aims to revise this proportion ratio to 70% and 30%, respectively, over the next five years. Having maintained healthy RevPAR performance for six consecutive years,
Huazhu’s employee per room ratio at 1: 0.2 has enabled its human resource cost, one of the important factors that affect profits, to be kept at 16% thus ensuring the operating profit margin of 15% (exclusive of start-up costs). In addition, Huazhu Hotels Group has also further established its ‘property management franchise’ model to enhance quality supervision on its franchised properties. Meanwhile, in line with the increasing number of Huazhu’s brands opened to franchise, the group will work with financial institutions to create an internal financing platform to resolve the issues of inadequate short-term capital for its franchisees, to attract more franchise businesses. Vienna Hotels is currently planning for listing, while Yitel, Starway, Holiday Inn and Quanji are also planning for nationwide expansion. Over the next few years, opportunities for mergers and acquisitions of midscale hotels will be arising. In the next decade, the decentralised pattern of the midscale hotel market with individual hotels as the absolute main component is expected to experience significant change, where there will be four types of development outcomes for existing individual midscale hotels in the next ten years – continue operation for those which maintain the status quo or profits; exit the market for those which continue to suffer losses; redevelopment for those which join franchise brands; major revamp for those which are acquired by hotel groups. In addition, in view of the constant demand for venture capital investment, listing financing, mergers and acquisitions will become the main vehicles for midscale hotels’ capital operation. For instance, Pod Inn hotel chain obtained a joint investment of US$50 million in 2012 by Fidelity Investment, Legend Capital and so forth; Orange Hotel received capital injection from The Carlyle Group; the upsurge in financing is envisaged to further surge investment and financing activities in the midscale hotel market.

**Unique Brand Identity for Target Clientele**

Homogenisation is common among midscale hotels, hence, the ability to seize market share in a highly competitive market and to create an innovative brand that matches the demands of target clientele represent the top priorities for midscale hotels. Midscale hotels should determine their clientele positioning through targeted product offerings, which does not necessitate a revolutionary breakthrough or change, but an appropriate and evident product innovation that caters to the demand of guests for a better customer experience. It does not solely depend on high input costs. The most important aspect is to focus on the core requirements of users in terms of product and service provisions so as to provide services with high added value.

The guestroom products of Narada Boutique Hotel, for example, are a main reflection of guest value, hence, the hotel focuses on the positioning of its guestroom products to shed the stereotype of traditional guestrooms, with enhanced sleep and bath experiences, and a decent functional meeting area or private business reading space. Two other case studies are James Joyce Coffetel and ZMAX Hotels, the two midscale brands under Plateno Hotels Group. The target guests of James Joyce Coffetel are fashionable white-collar workers who have an appetite for high-technology and a quick and easy lifestyle. From the aspects of product design, in order to cater to the demand of its target guests, the hotel has shortened the booking and registration times; guestrooms have been designed with separated dishwashing sink, toilet and wash basin to maximise space; unlimited WiFi and intelligent systems in guestrooms have allowed guests to stream movies from their computers on the large 42-inch television screen, play music in their mobile phones through the audio and video system, and charge their mobile phones, all via the multi-functional port. At the same time, the brand’s uniqueness is embodied in the coffee culture which is blended in every detail of the hotel. Each room is equipped with an intelligent coffee corner which provides coffee ground from authentic coffee beans, and a mini library, enabling guests to enjoy reading over a coffee. Another brand, namely ZMAX, targets mainly business elites, self-drive travellers and fashionable city dwellers between the ages of 25 and 40, and its guestrooms are priced at the range of RMB300 to RMB600. In order to fulfill the need for social interaction of such guests, ZMAX Hotels has designed an innovative lobby – ZOLO, which integrates the four functions of reception, business meetings, leisure and entertainment and social bar. A 60-inch interactive digital screen is available in the lobby to facilitate self check-in, organisation of parties, excursion invitations and photo uploads. Meanwhile, the social bar also includes billiards, darts, games, music, and so forth to provide a powerful interactive space for its guests.
Appropriate Design – the Addition and Subtraction Rules for Midscale Hotels

The development of midscale hotels are characterised by two distinct development patterns. Midscale hotels should be designed reasonably by applying an 'addition rule' on the core demand of guests, such as increasing investment in guestrooms, with a focus on enhancing the comfort of beds and sanitary equipments to match the standards of high-end hotels. In terms of food and beverage, particular focus should be given to the quality of breakfast by providing affordable Chinese-style breakfast suited to the taste buds of target guests. At the same time, the 'subtraction rule' should be applied to the superfluous gym, entertainment and spa facilities to reduce hard costs. In addition, appropriate 'subtraction' should also be made on the employee per room ratio to reduce labour costs.

It is important to note that both development patterns carry certain risks. Using the 'addition' approach practised by the economy hotels to operate midscale hotels have enhanced the décor and entertainment function of midscale hotels, however, the core requirements of guests have not been fulfilled. Some of the midscale hotels have also tried the 'subtraction rule' of upscale hotels, however, food and beverage facilities and additional products have eventually reverted back to their original conditions, while the operating and labour costs could not be maintained in a simplified manner. Therefore, this has led to excessive investment with low output and prolonged payback period, which has considerably limited the growth pace of these hotels.

Vienna Hotels is among the midscale hotels which have excelled in adopting the 'addition and subtraction rules' in terms of hotel design. The hotel focuses on the investment in its guestroom facilities, with an average investment of around RMB100,000 per room (in comparison to RMB50,000 to RMB80,000 per room for economy hotels). Meanwhile, the employee per room ratio of the hotel is maintained at around 1:0.3, much lower than the average mid-market level of 1:0.7, which have significantly reduced labour costs. According to Mr Huang Deman, the founder of Vienna Hotels, by leveraging the profit model contributed mainly by guestrooms, food and beverage and meetings, the overall occupancy rate can be maintained at more than 90% per year, with an annual revenue of RMB1.2 billion to RMB1.3 billion and profits of up to RMB100 million for its directly-owned hotels.
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