Hotel

Summary of the Operation Performance Evaluation Review

(January 2005)

THE PROJECT

In 1997, the company approached the Bank for a loan of US$ 8 million to refurbish the then-derelict hotel. The company wanted the Bank to be involved in order to mitigate the political risk in a country with a weak legal framework and limited access to medium-term credit. The hotel had closed in the early 1990s. It had an ideal location in the city centre next to major attractions and many government offices. In addition, the building was built to high seismic standards.

PROJECT RATIONALE

The company wanted to develop and operate this hotel. The project fitted well with its regional strategy; it had previously developed two highly successful operations in other countries. The Bank wanted to support the upgrading of tourism infrastructure in the country, given the sector's potential importance for the country's future economic development. The Bank considered that turning the derelict hotel into the city's first international class hotel would support foreign investment and private sector development. The country has dramatic mountain scenery and many attractions, including an interesting mix of cultures and a friendly population. The facilities for visitors are relatively old-fashioned (especially the spas/health clinics), due to slow privatisation. There is also limited promotion of the country internationally, and increased competition for tourism from other destinations.

ACHIEVEMENT OF OBJECTIVES

To develop a modern, four-star hotel offering an international standard of accommodation. This objective was achieved in full. Both the company and the Bank receive much local recognition for creating this state-of-the-art hotel and meeting venue. It has enabled the government to attract certain conferences to the city, and has also provided the business sector with a top end venue for meetings.

To transfer know-how and enhance local training. The company has encouraged the transfer of know-how and training for its staff while reducing the number of expatriate staff. The motivation, friendliness and language skills of the reception and restaurant staff are excellent.

To create a best practice model for financing other hotel developments and refurbishments in the region. The effects of a financial crisis in 1998 and the events of 11 September 2001 have had a negative impact on tourism in this region. This partly explains why no other large hotel projects have been started in this country. Also, the project has some unique characteristics that are not easily replicated by a smaller project. The demand for hotel rooms in this city is relatively limited in terms of business travel and does not presently justify another four-star hotel. Furthermore, the tourism season is traditionally extremely short (June – September) and it is therefore difficult to structure a project that generates attractive rates of return. This particular project is ambitious and it is unclear to what extent this model can be replicated.

Financial performance

The projections used for the project were relatively optimistic and the financial crisis in 1998, as well as the initial impact of September 11, resulted in some dips in demand. This was offset by the inflow of military personnel, which boosted the hotel's initial operation. Since then, the management has been able to steadily increase occupancy and average room rates. Due to very tight cost management, the hotel has been able to achieve reasonable results in an extremely difficult environment. In the first half of 2003, the results were higher than the fairly conservative internal budget.

OVERALL ASSESSMENT

Based on its independent review of the project, the Bank's Project Evaluation Department (PED) concluded that its overall performance could be rated *Successful.*[1] In spite of a disappointing financial performance so far, the positive transition impact and the excellent fulfilment of objectives justified the overall rating. The project's financial performance was rated *Marginal* at this early stage of operations, mainly due to the negative effect of the 1998 financial crisis and the events of September 11. The environmental performance was rated *Good* and the extent of environmental change was rated *Some.* The Bank's additionality was classified as *Verified in all respects.* Commercial banks would not have been able to extend long-term financing on a limited recourse basis to this project, given the country's risk rating. The operation team's handling of the project was rated *Good* and the Bank's investment performance was rated *Satisfactory.*

TRANSITION IMPACT AND THE BANK'S ADDITIONALITY

PED rated the overall transition impact as *Good*. New standards in room design and service levels have been introduced. There is increased management know-how, combined with new standards for business conduct in the fields of accounting, business codes and environmental practice. All these elements have a good effect on other companies in this sector. Both know-how transfer and the introduction of new standards were rated *Excellent.*

The impact on the sector and competition was only rated *Good*; the luxury hotel market is still very small and the second hotel in the local market charges room rates that are approximately half those of the new hotel. The project was rated as having a *Good* effect on the frameworks for markets, as its general manager actively contributes to the dialogue with the government on sector issues. International banks were, and are, unwilling to assume medium to long-term limited recourse project risks in the country. This is particularly true for a project that does not produce exports that can be taken as additional collateral. The Bank was therefore clearly additional in this operation. Additionality was rated *Verified in all respects.*

BANK HANDLING

The Bank's performance was rated *Good* due to the following factors:

- the initial structuring did not include some elements which had the potential for a wider transition impact on the entire sector
- the operation team pushed for a certain mix of hotel rooms as well as office space/apartments for longer-term stay. However, this mix did not achieve the initial revenue targets due to a vast number of alternative accommodation offers emerging in various parts of town
- the control of the outside legal costs of the Bank's lawyers was not tight enough in the eyes of the client, and several factors led to a substantial increase in the initial legal cost estimate.

The sponsor felt that the banking team did not show much flexibility when reviewing documents prior to authorising disbursements, even when some flexibility could have made the process more efficient. The sponsor also felt that there was only the minimum involvement of the EBRD Resident Office, and all relevant issues had to be discussed directly with the EBRD's banking

[1] *Ratings: Highly Successful, Successful, Partly Successful, Unsuccessful*

team in London. Overall, the company believed that the Bank's role as a mitigator of political risk was a positive one, especially in a country with such a weak legal framework.

MAIN ISSUES AND LESSONS LEARNED

Capital costs must be evaluated and there must be confidence in the ability of the contractor to deliver. In reconstruction projects it is particularly important to ensure that adequate contingency levels for capital costs are maintained, and that contractors have experience of similar types of projects. Even in cases where a sponsor provides full guarantees and the Bank loan is not at risk, lower capital costs mean the project is more profitable which then cushions the impact of a market downturn.

The lender's supervisor must be in control. The Bank needs a skilled supervisor to track funds used for large plant and equipment investments, as well as hotel and real estate projects. In these cases, it is not always possible to obtain a lump sum turnkey contract from an acceptable party. Therefore, the Bank needs to be professionally represented throughout the construction period.

Backward and forward links should be enhanced. As hotel projects procure a variety of services locally, the transition impact could be enhanced through a related small and medium-sized enterprises (SME) component focusing on such links (for example, garden maintenance, supply of foodstuffs, and so on). Such links could also include the promotion of local tour operators that organise tailor-made trekking, extreme sports and community-based tourism. At the time of project structuring, such links should be identified and adequately supported either through technical cooperation (TC), SME or other programmes.

Training and the skills transfer effect should be promoted. The project itself has benefited greatly from the EBRD's approach, know-how and internal training channels, combined with the appointment of experienced expatriate staff in key positions. However, the transfer of this skill set via attrition and staff rotation to the rest of the tourism sector is limited, given that this hotel is the best employer in the sector. Projects of this kind could incorporate a training programme for hotel trainers to enhance the transfer of skills. There could also be TC measures that review and update the teaching curricula at school and university levels to make these courses more practical. This would equip more graduates with the skills and education that private employers in the sector are looking for.

Sector reform may be needed to enhance the transition impact on the tourism sector. A private sector hotel project in a low transition country may need to be coupled with specific elements of sector reform in order to achieve a larger impact. Reforms could include a memorandum of understanding with the government, outlining steps towards creating a forum for private and state sector operators, together with the creation of a privately organised tourism promotion company. Progress on such reforms may be a condition that has to be met before there is further Bank involvement in the sector/country.

Cost control must be introduced when contracting outside legal counsel. The selection of outside counsel may need to be subject to caps and lump sum contracts (a general practice in the Bank since July 2001), in order to avoid increases that can strain the relationship with a client. Since July 2001, the Bank's legal department has insisted on a detailed description of legal work to be performed under a contract, in order to reduce the risk of price increases. Due to limited local law experience and the limited availability of law firms with a strong local practice, ongoing cost control is particularly important in early transition countries.