Hospitality and Leisure

Hospitality Directions Europe

Hotels: managing in a downturn

November 2008 Issue 18

PricewaterhouseCoopers

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"In 2009 hotel revenues typically will drop 20 per cent, with the five-star market hardest hit, four star properties down by a quarter, three stars dropping 10-15 per cent, and budget hotels remaining static"

Niels Pedersen,
Managing Director
Supranational Hotels
6 November 2008

Introduction

Services industries in the UK, from banks to hotels, shrank by a record amount in September 2008.The Chartered Institute of Purchasing and Supply's (CIPS) services index which measures overall activity for the industry, was down from 49.2 in August to 46 in September.[1] CIPS has commented that hotels and restaurants were among those areas worst hit as customers reined in their spending.

No hotel business is likely to be immune to the effects of an economic recession and although this time it may be different in terms of the unprecedented circumstances that are driving the slowdown, businesses still need to ensure they address key fundamental priorities such as a hands on approach to cash management, taking stakeholders with them and managing the cost base.

In a second article from this edition of Hospitality Directions Europe, November 2008 we present the results of our experience and research during past recessions, what's different this time and what owners and operators can do to protect themselves in such a volatile and unpredictable market.

Global downturn starts impacting UK hotel performance

Hotels tend to be a late cycle industry, in terms of registering the impact of either positive or negative economic trends. This lag occurs because corporate clients review their own travel polices when they see business slowing but it takes time for these changes to filter through, and the effect is often delayed until the annual round of rate negotiations. Analysis of historic performance data indicates that as a general rule hotels take between 6 and 12 months to record a change in performance in line with the wider economy. See Chart 1.

Although year-to-date results remain in positive territory, recent months are starting to show decelerated growth as the financial crisis deepens and reduced consumer spending starts to take its toll. The economic downturn to date has affected hotels across provincial UK to a greater degree than in London and year-to-September 2008 results for hotels in the provinces show a marginal 0.6 per cent decline in RevPAR, driven by a 2.1 per cent drop in occupancy while average room rates continue to grow by 1.5 per cent. In the month of September 2008, average room rates grew 0.8 per cent over the same month in 2007 but occupancy showed accelerated declines.

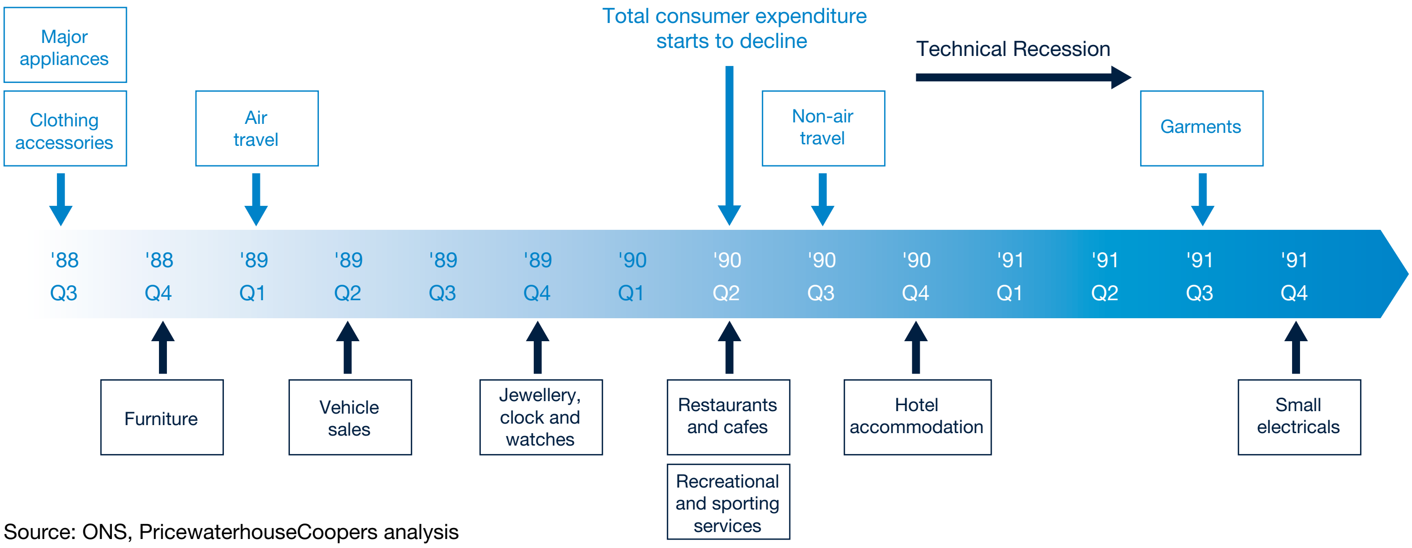
This trend reflects a classic hotel supply and demand pattern whereby historically a decline in the volume of rooms sold is followed by a reduction in average room rate as buyers flex their buying muscle and hoteliers use price as a tactic to try and attract greater volumes. Historically both strategies have ultimately led to lower profitability.

1 A reading below 50 signals industry contraction.

A closer look at the consumer spending downturn

Chart 1: Hotels are a late cycle industry and take 6 to 12 months to register a decline in the wider economy

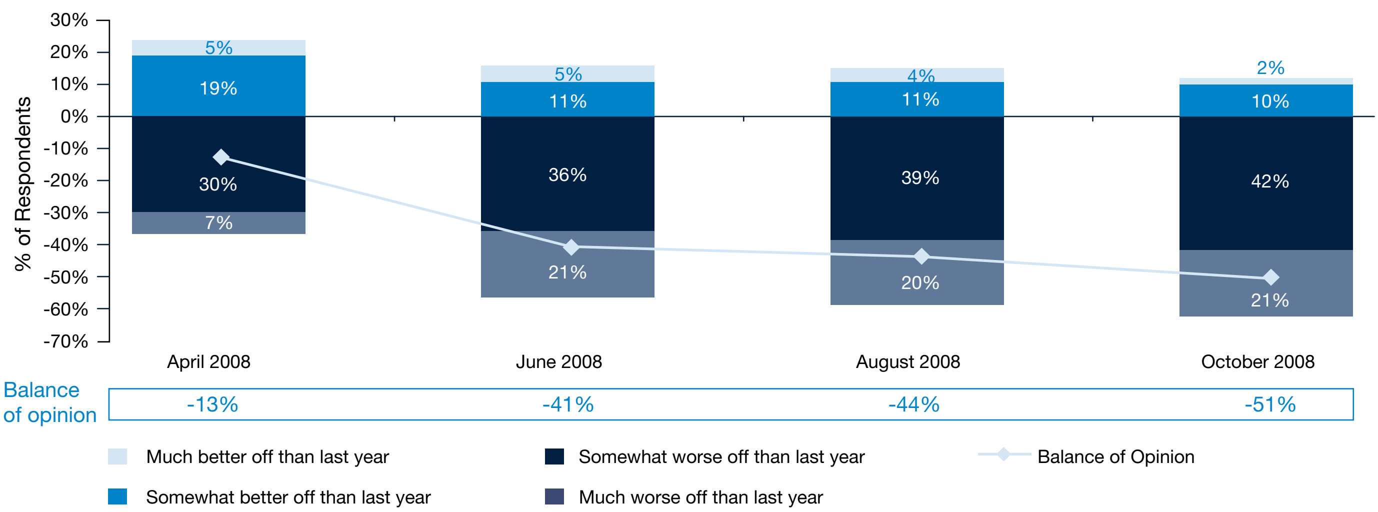
Timeline of when categories started to decline



Source: ONS, PricewaterhouseCoopers analysis

There has been a marked decline in consumer confidence between April and October 2008. See Chart 2. This is very much in line with what our hotel operator clients have reported in terms of when they started noticing the decline in demand. Consumer confidence fell further in October and is now approaching levels recorded back in the 1970s, according to GfK NOP. House prices also continue to fall and banks tighten their grip on credit. Even the recent larger than expected reduction in the interest rates and lower petrol prices are unlikely to have a significant effect on confidence in the upcoming months as consumers brace themselves for a prolonged and deeper recession than forecast earlier in the year.

Chart 2: Thinking about your disposable income (e.g. money remaining after household bills, credit cards etc), over the next 12 months do you expect that your household will be…?



Source: PricewaterhouseCoopers consumer survey, April, June, August and October 2008

What happened last time?

The headlines for the UK hotel industry from the 1990's recession include:

- Accommodation spend in the UK shifted from rapid pre-recessionary growth to a real decline of 3 per cent from Q4 1990 to Q2 1992
- Occupancy rates declined first followed by average room rates.
- RevPAR declined by 7.7 per cent between 1990 and 1992
- The recession widened the market opportunity for budget hotels resulting in continued growth in UK budget hotel turnover during the recession
- As demand fell, the number of hotels and bedspaces declined as many small independent hotels were forced out of the market. Registered hotel numbers reduced by 1,562 between 1990 and 1993
- The consumer started putting more pressure on room rates and started expecting more 'value for money' from the hotel industry.
- It took five years for average room rates to recover to pre-recession levels.

During the 1990's recession there was considerable variability in hotel sector company performance. The leading hotel groups increased their advertising spend as more importance was given to branding and product differentiation to gain market share. The use of short lead in tactical discounted advertising campaigns in national newspapers blossomed for the first time. Offers were aimed at both the corporate and leisure markets. But the public soon wised up to this strategy and, rather than booking in advance, were prepared to trade certainty for price and waited until the lowest rate offers appeared.

Some measures taken in 1992-1993

Blanket naked discounting was also used as a tactic to drive up demand in periods of lower seasonal demand:

"Hilton Hotels and Holiday Inns, the world's biggest hotels chains, are discounting European room rates by up to 50 per cent for July and August."

The Evening Standard, June,1993

To counter the reduction in revenues and maintain margins, tight cost control measures were adopted across most hotel businesses. Forte Hotels for example implemented tight cost control measures in addition to intensified brand segmentation:

"Higher profits were more the result of intensified marketing and tight cost controls than any real improvement in the industry."

Forte Hotels, The Wall Street Journal, October 1993

Others were forced to adopt more drastic measures as pressure on cash flows worsened:

"Head office staff was cut by a third, developments put on ice, a disposal plan launched and the chief executive forced to stand down."

Stakis Group, Management Today, July 1992

Even the UK's finest hotels were not immune from recession, and suffered the ignominy of publicly offering discounts in an attempt to increase volume:

"You know that times are tough for the hotel trade and good for customers when the Savoy Group offers 'summer sale rates' for the first time."

The Evening Standard, June 1993

Unfortunately segmented industry benchmarking was not in widespread use in the UK hotel market in the 1990s. However data from the downturn between 2000 and 2002 indicates that only budget hotels experienced occupancy growth and luxury and first class fared worst.

What's different this time around?

We have identified the following areas of difference for the UK hotel sector between the early 1990s and today that are likely to have an impact on trading performance in a recession, with many of the changes driven by the development of the internet:

- Within the hotel sector, there has been considerable structural change and industry rationalisation. There are more brands in fewer hands.
- Corporate hotel level ownership and business models have seen a huge shift away from property ownership towards brand management.
- The supply of budget hotel rooms has increased from less than 10,000 in the early 1990s to more than 86,000 in 2008. There were no branded budget rooms in London in 1990.
- The development of multi-channel web-based distribution systems, accessible distribution channels and the use of sophisticated yield management systems.
- Consumers are taking shorter, more frequent holidays and booking more holidays independently and through the internet.
- There has been an increase in the usage and demand for hotels. Room occupancy in 2006 was the highest ever recorded in the UK.
- Management teams have become more astute and adept and are now able to react much faster in response to declining revenues. Performance benchmarking is widespread.
- The current crisis is more global in nature than the 1990's recession. Therefore for London, in particular, more incoming tourist source markets will be negatively impacted.

"The broad-based deployment of yield management systems has enabled RevPAR to outperform the competitive set (by 2.5 points in France for the first eight months of 2008, for example)."

20 October 2008, Accor Investor Presentation "A Campaign in Transformation".

Since the last recession there has been an increase in the usage and sophistication of rate and yield management systems allowing management to be more responsive to patterns of demand. In addition, the advent of multi-channel distribution networks has provided hotels with a far wider and more cost effective method of reaching different markets. These systems are becoming ever more sophisticated but will not, of course, create demand where it does not exist.

Responding to the challenge

When a downturn threatens, hotel businesses need to take decisive steps to understand the situation and what it means for their future survival. Planning for a downturn maximises the opportunities available, enabling the best prepared businesses to come through the bad times re-energised and fit for the future. We believe that hotel businesses that will emerge from the downturn agile and fit will be those that focus on PwC's "10 fundamental priorities".

10 fundamental priorities

A guide to managing in a downturn

1 Take a closer look

The goal posts are moving; understand the true picture not what you'd like to believe. Get to the bottom of what's driving the business; what you do best and why. Understand how the business is being impacted by the downturn.

2 Act decisively

With increased uncertainty and volatility it is important to take tough decisions early. Focus relentlessly on the key drivers of value and the key risks across the business. Don't sit back and wait; the winners will be those who position themselves to take advantage of the upturn.

3 Remember "cash is king"

Ensure that your finances and working capital are in good order; protect your liquidity; re-examine your treasury, financing, funding and pension exposures. Monitor your performance against financial and non-financial covenants. Adopt a hands on approach to cash management.

4 Focus on what really matters

Evaluate which products, customers and channels create or destroy value. Revisit your existing investment programmes – what initiatives could you stop or defer?

5 Manage your cost base

Focus on enhancing operational performance; go for targeted rather than across the board cuts; extract better value; reduce unnecessary complexity; look at whether your business model needs to change.

Standing shoulder to shoulder with our clients

6 Reliable management information is key

Now more than ever you need the right management information; clearly defined KPIs are essential. Decision making needs to be based upon facts; speed of decision making needs to improve.

7 Plan for different scenarios

Winners demonstrate agility and flexibility; model a range of financial, operational and workforce scenarios that reflect the impact of the downturn on your business; adapt quickly; explore your strategic options.

8 Recognise the value of your people

Regular and clear communication with employees is key to their engagement.Identify key talent and develop appropriate incentives for them – retaining and motivating the best people is critical to your future.

9 Take your stakeholders with you

Evaluate the likely impact of the downturn on your stakeholders; make sure you understand their agendas. Perception is often reality so maintaining regular and open dialogue is essential.

10 Take advantage of the opportunities

Don't stop innovating or investing in those areas of growth you will need for the future; don't forget your brand. Have an eye for the future; think beyond the next quarter.

Source: PricewaterhouseCoopers 2008

What does this mean in practical terms for hoteliers?

It's easy to jump to conclusions when under pressure to protect profits during a downturn. Many hotel businesses will be tempted to freeze infrastructure investments, mothball new growth hotel projects and defer integrating the latest acquisition. Advertising and recruiting investments are easily cut, as are loyalty programmes for customers and staff. However, some hotel businesses will take a different approach and selectively invest where others are cutting back. These are the businesses that will benefit.

Businesses that understand the situation can navigate a downturn in a way that makes the most of the opportunities arising. Those who don't know enough about themselves or the external market will be inclined to take the path of least resistance, leading to defensive and piecemeal actions which result in reduced service levels and disgruntled clients. Most damaging of all, these businesses risk losing out to their competitors.

In the practical examples below we have identified some of the key areas that we believe should be priorities for hotel businesses, large and small. Of course these are provided as examples only and taken in isolation will not necessarily ensure survival.

Remember "cash is king"

A hotel business's life support system is its ability to generate cash but in a downturn, even more emphasis should be placed on the following:

- reviewing the adequacy of banking and other financing arrangements;
- assessing whether financing arrangements are appropriate in light of changing circumstances;
- monitoring performance against financial and non-financial covenants;
- communicating openly and frequently with key stakeholders to enhance transparency and avoid surprises;
- adopting a more proactive hands-on approach to cash management, e.g. short-term cash flow reporting and forecasting, immediate investigation of variances;
- aggressive working capital management, i.e. ensuring customers pay to term, securing best possible payment terms from suppliers, assessing adequacy and quality of stock levels;
- review of discretionary and non-discretionary expenditure and assessment of what the business really needs; and
- enhancing controls over purchasing and order processes (core and non-core) by lowering authorisation limits and introducing greater senior management accountability.

Shareholders should also be invited to agree to a dividend distribution policy, or indeed cash injection policy, in this new environment.

"Furthermore, we continue to develop new sales promotions with a focus on leisure and group business opportunities to increase property-level revenue, rather than simply discounting room rates."

Marriott management discussion and analysis period ending 9 May 2008

Manage your cost base

Hotels carry a large proportion of fixed or semi-fixed costs so a small shortfall in revenue can have a disproportionately negative impact on profitability.

The economic downturn has forced companies to re-evaluate their relationship between cost and profits. In recent years inefficiencies may have been tolerated and unnecessary complexities been built into the way organisations conduct business. For some, the competitive landscape has changed so fundamentally through, perhaps, the expansion of budget hotels, that the previous business model will no longer be appropriate and significant change is required.

In the economic downturn the emphasis must be on:

- enhancing operational performance and driving profits through eliminating unnecessary cost;
- challenging yourself and your team to stop doing things that just don't add value to the customer;
- improving efficiency – outsourcing those things that others can provide at a lower cost;
- stemming value leakage;
- simplifying and improving end to end business processes; and
- improving the overall cost control environment and creating a cost culture.

The challenge is to drive profits through the targeted reduction of costs without damaging the long-term health of the business.

Focus on what really matters

As demand start to reduce, there tends to be an automatic response to reduce prices to try to continue to maintain volume. This can be a mistake.

What's really important is to identify those channels and those segments in which demand is dropping, as well as those channels and segments where price resistance is being experienced.

As demand in one segment reduces, it's important to replace this business from segments that are not declining and from those segments that are even growing. Managing hotels in a downturn will require a shift from managing demand to creating demand.

Take advantage of the opportunities

A downturn can present businesses with opportunities, as well as challenges, and strong businesses often capitalise on their position to establish an even greater advantage during these conditions. Businesses that are in good shape to ride the downturn, have greater flexibility to invest, strengthening their position while competitors are hamstrung.

Hotel companies should not automatically halt all investment programmes, sacrificing future growth because of current difficulties. Businesses need to have a clear idea of investment opportunities, best rates of return and risk levels. Generally investment levels are likely to be lower in a downturn due to reduced asset prices and competition for assets.

In fact, structural change in an industry can be accelerated by a slowdown, as the most progressive players implement strategies that made sense all along, but may have been difficult to push through in the good times because the 'burning platform' wasn't there.

A downturn can be the making of the best hotel businesses with the strongest brands, as the changes implemented at this time can make businesses much stronger in the long term.

If you are an independent, it may also be the time to consider employing a professional management company to enhance profitability in your current operation. It may also be the right time to consider the strength of or even the need for hotel branding and whether this can give you access to enhanced distribution channels.

All of this requires your executive team, hotel management and staff to innovate and work hard to reshape and reposition the business for the immediate future whilst not forgetting that the good times will return in a few years.

Who will ride out the storm best this time – winners and losers

You would expect us to say that the clear winners will be those that understand and implement actions in line with our 10 fundamental priorities outlined above and the losers will be those that adopt a more ostrich like stance. And we believe that at a macro level this will be absolutely true.

However it also seems likely that those businesses with a strong brand and sound operating model, and a strong driven management team, particularly those that have been able to reduce debt via property disposals, and will be best placed to survive and thrive in this recession. Conversely this probably means that it will be harder, but not impossible, for the smaller unbranded (or weaker branded) hotel businesses with high levels of debt and lower levels of management experience and expertise. In the table below we outline just some of the key attributes we would associate with potential winners and losers.

Key attributes

Winners	Losers
• Strong cash management focus	• Upscale full service operators
• Well defined and differentiated brand and proposition	• Poorly targeted undifferentiated brand proposition
• Value for money offering – budget hotels	• Price premium for no tangible quality benefit
• Sophisticated rate and yield management	• Untargeted blanket discounting
• Focused targeted tactical discounting	• Overcapacity necessitating discounting
• Exposure to more resilient segments and consumer trends	• Inflexible operational structure/higher cost ratios
• Well maintained and quality site portfolio	• Inability to respond to changes in demand
• Flexible operational structure	• Corporate/conference reliance combined with upscale offering
• Timely response to changing demand patterns	• Highly geared businesses
• Appropriate and innovative distribution channel strategy	

PwC's 10 fundamental priorities are about focusing on what really matters and you can read more about the detailed suggestions for strategies and actions for all 10 fundamental priorities at www.managinginadownturn.com

What does the future hold?

When the economy recovers it is worth considering whether things could be a bit different. Consumer behaviour may well be moulded differently. If consumers and businesses find attractive value for money propositions adopted during the recession acceptable, they may well 'stick' with them – for example, the 'smarter buying' behaviour that Alan Parker, Chief Executive of Whitbread, wrote about recently in relation to more corporates choosing the branded budget product, Premier Inn.

If oil prices remain high, travellers may travel shorter distances, and their holiday and short break behaviour could change significantly as well. Business travel could also be impacted by high energy costs, especially as the technology of video conferencing improves.

Consumers will also not be in a position for some time to derive wealth by taking equity out of their homes. History tells us that the housing market will probably take far longer to recover than the overall economy. In addition, credit conditions may remain weak for some time and consumer spending will be constrained as a result.

This means that hotel companies might want to plan for a slower and more modest recovery rather than a strong consumer rebound.

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Design: hb03648