

## **The hospitality industry and economic fortunes in 2008**

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### **Introduction**

In 2007 many hospitality businesses had good sales growth and reasonable profitability, particularly in London. Forecasting what is really going to happen in 2008 is unusually difficult this year. Many people believe that interest rates will continue to fall in 0.25% steps throughout the year but this is in fact unlikely because inflationary pressures are building up across the economy and the Bank of England will want to keep within the government's inflation target. Although there is now undoubtedly an economic slowdown the reaction of consumers so far is mixed; consumers continue to be spending on holidays and eating out but are likely to react to increased mortgage, food and energy costs by cutting their discretionary spending by the second half of 2008. If this happens then 2008 will be a more difficult year for the hospitality industry than currently predicted. But 2008 is only three months old and the evidence so far still suggests, perverse as it may seem, moderate hospitality industry growth but as always hospitality businesses will need to provide truly excellent quality services for increasingly discerning customers. 2008 is going to be a year when those hospitality businesses with a good value proposition will prosper seemingly against the odds but stand by for rising business failures as those businesses with poor products and service go to the wall.

### **The economy last year**

The economy certainly slowed down during the second half of 2007 as successive increases in interest rates had effect (with five rate increases in relatively quick succession after August 2006). UK GDP fell below trend in the last quarter of 2007 and will remain below trend during 2008, moving from 2.8% in 2006, 3.2% in 2007 to 2.0% in 2008. Interest rates peaked at 5.75% and at the time of writing in March 2008 are 5.25%. There is evidence that higher mortgage rates and average earnings growth below RPI inflation is beginning to squeeze personal disposable incomes and this will inevitably follow through to a more constrained household consumption.

The UK government budgetary position was very stretched during 2007, giving rise to serious concerns of government over-borrowing. Overall taxation continues to increase although rising in relatively small steps. These economic conditions were at the end of 2007 beginning to dampen business confidence but the biggest jolt to confidence came in September with the first run on a British bank for 166 years. The Northern Rock bank crisis revealed a bank which had engaged in questionable lending operations although the full effects are still not determined. Subsequently the British government, unable to secure a private sector buyer, took Northern Rock into public ownership. The combined effects of untold numbers of banks operating outside normally cautious operating norms, an international credit crunch the dimensions of which are still not known with certainty and slowdown in the US economy all combine to produce very uncertain economic and business conditions.

Inflationary pressures continued to build during the year and in March the Governor of the Bank of England had to explain by letter to The Treasury why inflation had reached 3.1% and thus breached the government's inflation target of 2.5%.

The manufacturing sector was in 2007 performing more strongly than the service sector, and indeed the service sector saw third and fourth quarter falls for both domestic and export sales and orders but cash flow was stronger. There is no doubt that small businesses are beginning to face more intractable problems and lower interest rates would undoubtedly help, as would easing of the business tax burdens and regulatory conditions.

In the October pre-budget report and three-year comprehensive spending review the Chancellor of the Exchequer Alistair Darling downgraded The Treasury forecast for economic growth next year. The economy is now forecast to grow at between 2 to 2.5% (compared with a previous forecast of 2.5 to 3%). Government borrowing will increase in 2007 to £38 billion (£4 billion more than predicted in the March Budget). Overall government spending is now set to rise from £345 billion to £397 billion over three years.

### **The hospitality industry in 2008**

According to the latest International Passenger Survey data published in February 2008 the total number of UK residents' visits overseas (not seasonally adjusted) increased by 1% from 69.5 million to 70.1 million in the 12 months ending in December 2007 compared with the 12 months ending in December 2006. This overall increase was because the number of visits to Europe was broadly static at 55.1 million, visits to North America decreased by 2% to 4.6 million, and not surprisingly visits to other parts of the world increased by 7% to 10.4 million.

The total number of overseas residents' visits to the UK (not seasonally adjusted) increased by 1% from 32.7 million to 32.9 million in the 12 months ending December 2007 compared with the 12 months ending December 2006. This small increase was as a result of the number of visits from Europe increasing by 2% to 23.8 million, visits from North America decreasing by 6% to 4.5 million (which given the changing economic circumstances is not surprising) while visits from other parts of the world remained broadly static at 4.6 million.

Earnings from overseas visitors increased during the year. During the 12 months ending December 2007 (not seasonally adjusted) overseas earnings increased by 2% to £16.3 billion and expenditure by UK residents increased by 4% to £35.7 billion compared with the previous year. This resulted in a deficit to the UK of £19.4 billion compared with £18.4 billion during the same period to December 2006.

## Visits and Spending by overseas residents to the UK 2007

	Overseas visitors to UK all visits	Overseas visitors to UK all visits	Overseas visitors to UK Earnings	Overseas visitors to UK Earnings
	(000) not seasonally adjusted	(000) seasonally adjusted	£ million at current prices not seasonally adjusted	£ million at current prices seasonally adjusted
2007				
January	2,350	2,720	999	1,300
February	2,050	2,760	1,000	1,380
March	2,474	2,790	1,091	1,360
April	2,931	2,860	1,291	1,380
May	3,002	2,790	1,319	1,330
June	2,760	2,670	1,410	1,340
July	3,355	2,700	1,824	1,390
August	3,357	2,620	1,797	1,300
September	2,871	2,710	1,623	1,380
October	2,740	2,790	1,370	1,370
November	2,520	2,730	1,105	1,320
December	2,470	2,760	1,490	1,490
Total for Year	32,880	32,900	16,320	16,340
% change 2006-2007	+1%	-	+2%	-

Source: The International Passenger Survey (IPS) February 2008

## Visits and Spending by UK residents abroad 2007

	UK residents going abroad all visits	UK residents going abroad all visits	UK residents going abroad Expenditure	UK residents going abroad Expenditure
	(000) not seasonally adjusted	(000) seasonally adjusted	£ million, current prices not seasonally adjusted	£ million, current prices seasonally adjusted
2007				
January	4,626	5,810	2,203	2,800
February	4,233	5,810	2,316	3,160
March	5,082	5,920	2,665	3,080
April	5,959	5,860	2,877	2,940
May	5,529	5,760	2,737	2,960
June	6,747	5,710	3,407	2,950
July	6,839	5,880	3,558	2,960
August	8,673	6,000	4,607	2,970
September	7,540	5,950	3,929	2,920
October	6,540	5,810	3,220	2,980
November	4,230	5,700	2,100	2,860
December	4,150	5,950	2,055	3,100
Total for Year	70,148	70,160	35,674	35,680
% change 2006-2007	+1%	-	+4%	-

Source: The International Passenger Survey (IPS) February 2008

According to the latest TRI Hospitality HotStats survey - during the eleven months ending November 2007, and in comparison with the same period ending in 2006, UK hotels, especially those in London, had virtually static occupancy levels. Average room rates however, increased by a healthy 10.2% in London from £102.25 to £112.73 and a reasonable 4.2% in the provinces, from £69.56 to £72.47. Overall across the entire UK average room rates increased from £82.29 to £88.21, which was an increase of 7.2%. Rev PAR increased by similar percentages. Total revenue per available room increased by a very healthy 10.9%

in London from £41,136 to £45,622, and across the UK increased by 8.4% from £35,565 to £38,534. Average income per available room before fixed charges increased in London by a very satisfactory 13.2% from £56.85 to £64.33 while in the provinces the increase was markedly less at 2.6% with income rising from £32.34 to £33.16. Overall these figures underline the good year that London hotels and many UK hotels actually enjoyed in 2007.

### UK Hotels Performance, 2006-2007, eleven months to November

	2006	2007	% change 2006-2007
<b>Occupancy (%)</b> <sup>1</sup>			
UK hotels	76.4	76.2	-0.1 points
London	83.5	83.4	-0.1 points
Provinces	72.4	72.2	-0.2 points
<b>Room rate (£)</b> <sup>2</sup>			
UK hotels	82.29	88.21	+7.2
London	102.25	112.73	+10.2
Provinces	69.56	72.47	+4.2
<b>Revenue per available room</b> <sup>3</sup> (£)			
UK hotels	62.84	67.24	+7.0
London	85.38	94.02	+10.1
Provinces	50.37	52.34	+3.9
<b>Total revenue per available room</b> <sup>4</sup> (£)			
UK hotels	35,565	38,534	+8.4
London	41,136	45,622	+10.9
Provinces	32,494	34,550	+6.3
<b>Average Income per available room before fixed charges</b> <sup>5</sup> (£)			
UK hotels	41.07	44.30	+7.9
London	56.85	64.33	+13.2
Provinces	32.34	33.16	+2.6

Source: TRI Hospitality Consulting, HotStats November 2007, based on a sample of 462 hotels, mostly 3 and 4-star hotels, averaging 175 bedrooms.

Notes:

1. Occupancy is that proportion of bedrooms available during the period which are occupied during the period
2. Room rate is the total bedroom revenue for the period divided by the total bedrooms occupied during the period
3. Room RevPAR is the total bedroom revenue for the period divided by the total available rooms during the period
4. Total RevPAR is the combined total of all hotel revenues divided by the total fixed bedroom stock
5. Income before fixed charges for the period divided by the total available rooms during the period.

### UK Economic Forecasts

We now know for sure that 2008 will certainly be a year of slower UK economic growth as the continuing effects of the international credit crunch, persistent uncertainties in just what exposure UK banks have to bad debts, higher energy, food and financing costs, and housing market slowdowns hit UK consumers and businesses. The hospitality industry mirrors to some extent overall UK economic growth (sometimes with time lags) but in spite of

worsening UK economic indicators we can forecast moderate hospitality sector growth in London albeit at a slowing rate but a very mixed picture in the provinces. The assumption being made is that interest rates will be reduced by a further 0.25% in 2008 to 5.0% and severe slowdown or recession in the US will have an impact on UK economic fortunes. We need however to caution against talk of a UK recession – there is a slowdown but this is not the same as a recession and we need to keep that in mind.

The following Table summarises the key economic indicators and forecasts. We use the Deloitte Economic Review, first quarter 2008.

### UK Economy Key forecasts - % change over previous year

	2005	2006	2007	2008 forecast	2009 forecast
<b>GDP and demand</b>					
GDP	1.8	2.8	3.2	2.0	1.7
Consumer spending	1.5	2.0	3.2	2.0	1.5
Government consumption	2.7	1.9	1.7	2.0	2.0
Investment	1.5	7.9	6.3	4.0	3.5
Exports	8.2	10.3	-4.6	2.0	2.0
Imports	7.1	9.8	-2.4	3.0	2.5
<b>Output</b>					
Manufacturing	-1.2	1.5	0.7	-1.0	0.5
Services	3.0	3.6	3.7	2.7	2.0
<b>Retail Prices</b>					
CPI Retail Price Index	2.0	2.3	2.3	2.4	1.5
RPIX Retail Prices	2.2	3.0	3.2	3.1	2.1
RPI	2.8	3.2	4.3	3.4	2.3
<b>Labour market</b>					
Unemployment rate (%)	2.9	2.9	2.7	2.7	3.0
Average earnings	4.0	4.1	3.9	4.0	4.2
<b>Other indicators</b>					
Balance of Payments Current Account £billion	-31.0	-50.2	-70.0	-75.0	-60.0
Public sector net borrowing £billion*	37.5	30.7	45.0	45.0	42.0
Stockbuilding (% of GDP)	0.3	0.1	0.4	0.3	0.2
Company profits**	1.7	3.7	12.5	-3.0	-1.5
Real disposable income	2.9	0.9	1.4	1.8	2.8
Savings ratio	5.5	4.8	3.3	4.5	5.3

\* A positive PSNB figure indicates a budgetary deficit, negative PSNB indicates a surplus

\*\* Nominal gross trading profits of non-financial companies

Source: Deloitte Economic Review, First Quarter, 2008.

The forecasters are predicting a marked slowdown in GDP growth after relatively strong growth in recent years. In 2008 Deloitte believes growth will weaken to 2.0% and in 2009 to 1.7%, the weakest performance for 15 years. In addition Deloitte forecasts that interest rates could fall to 4.5% by the end of 2008 and to 4% in 2009 although some commentators believe

that interest rates are unlikely to go much lower because of increasing inflationary pressures. The slowdown is, it is believed, likely to be “rather more serious and longer-lasting than that seen back in 2005”. Time will of course tell but there is a real danger of talking ourselves into difficulties and we must remember that economic forecasting is an art and not a precise science.

Three main reasons are advanced for a slowdown. First, the global economy is weakening as the US economy weakens, with a 50:50 chance of a US recession, and UK exports to the US could fall or at best stagnate in 2008-2009. Second, there is a continuing crisis in the financial markets and monetary conditions are tightening in response. Third, the UK housing market could go into “significant downturn” but this is not certain as yet although house prices could fall on average by 5% in 2008 and a further 8% in 2009; consequently housing effects on the UK economy are still uncertain.

Inflation will continue to be above the government’s 2% target but a slowdown will ensure that it falls back on target by 2009. Although the sterling exchange rate may fall sharply nevertheless real household disposable income is surprisingly set to grow by more than 1% in 2008 and 2009. According to Deloitte, consumer spending will rise by 2% in 2008 but fall back to 1.5% in 2009. At the moment consumers expect, not unreasonably, prices to rise sharply, which may feed through to increased pay demands but high street retailers will probably absorb a large proportion of increased supply prices. Exports to the USA will stagnate over 2008 or may fall sharply but the largest export market – the euro-zone- will, with Asia, ensure stronger export activity. A weaker UK economy will however produce a slowdown in imports growth.

The UK labour market is in good shape but as the economy slows unemployment is expected to increase by 400,000 to over 2 million by the end of 2009. In the financial sector (which is particularly important for hospitality businesses) a hiring freeze is expected.

Public borrowing is set to grow to £50 billion or higher unless taxes rise significantly and this is greater than the government’s current projections. In addition the UK external position continues to get worse and the current account deficit is at a record. As the global economy weakens the deficit is expected to grow to £75 billion

Taking all available evidence PriceWaterhouseCoopers forecast the following average room rates, occupancy levels and revenue per available room for the UK, London and Provinces in 2008 and 2009:

### UK Hotel Forecasts 2008-2009

	2005	% <i>change</i> 2004- 2005	2006	% <i>change</i> 2005- 2006	2007	% <i>change</i> 2006- 2007	2008*	% <i>change</i> 2007- 2008	2009*	% <i>change</i> 2008- 2009
<b>Average Room Rate (£)</b>										
UK	79.23	+3.1	82.92	+4.7	88.52	+6.8	91.85	+3.8	95.31	+3.8
London	102.08	+0.7	108.28	+6.1	120.38	+11.2	127.02	+5.5	133.42	+5.0
Provinces	64.72	+6.0	66.73	+3.1	69.65	+4.4	71.62	+2.8	73.82	+3.1
<b>Occupancy (%)</b>										

UK	72.30	-1.0	74.70	+3.3	74.60	-0.2	74.90	+0.4	74.80	-0.1
London	74.78	-1.9	81.15	+8.5	81.09	-0.1	81.43	+0.4	80.92	-0.6
Provinces	70.86	-0.5	71.15	+0.4	70.97	-0.3	71.21	+0.3	71.29	+0.1
<b>Revenue per available room (£)</b>										
UK	57.31	+2.0	61.98	+8.1	66.04	+6.5	68.77	+4.1	71.26	+3.6
London	76.33	-1.1	87.87	+15.1	97.62	+11.1	103.43	+6.0	107.97	+4.4
Provinces	45.87	+5.5	47.48	+3.5	49.43	+4.1	50.99	+3.2	52.63	+3.2

\* forecast

Source: PricewaterhouseCoopers Forecasting Model, February 2008.

The UK hospitality industry and hotels in particular have been used to strong trading for several years now. PricewaterhouseCoopers says in its latest forecasts that economic slowdown means a weaker hospitality demand growth in the second half of 2008. A lack of confidence will affect corporate travel budgets and consumers alike. This forecasted weaker demand will mean a “decelerating room rate growth, lower revenues and, as a consequence, reduced operating income”. This will clearly affect profits but PricewaterhouseCoopers say “there is no reason to expect a meltdown in the UK hotel sector”. The reasons for this optimism (if optimism is the right word) are that the hospitality industry is in good shape with plenty of opportunities to grow revenues in strong locations and a good use of revenue management systems. London is still considered to be under-supplied with hotels and it is only four years to the London Olympics. London is certainly seeing some strong hotel developments and according to VisitLondon some 2,000 new rooms opened in 2007. Travelodge alone opened 892 rooms in 2007 and expects to open a further 22,000 rooms in London by 2020. In London hoteliers rightly remain reasonably optimistic as do many hoteliers around the UK.

UK RevPAR (revenue per available room) has grown every year since 2002 and PricewaterhouseCoopers forecast 4.1% growth in 2008 and 3.6% in 2009. In London RevPAR is expected to grow by 6% and 4.4% respectively, although RevPAR growth was over 11% in 2007 but not as high as the 15.1% growth in 2006.

UK average room rate growth is expected to fall from a healthy 6.8% in 2007 to 3.8% in both 2008 and 2009. In London six years of good growth could be followed by a slowing growth rate of 5.5% in 2008 and 5% in 2009 but again this must be compared with a 11.2% average room rate growth in 2007. In the provinces average room rate could grow by 2.8% in 2008 and 3.1% in 2009.

Occupancy levels are forecast to be mainly static and may even decrease somewhat in 2009 but 2009 is, in these difficult forecasting conditions, really light years away and no real confidence can be placed in any forecasts over 6 months into the future. Generally with the hospitality industry in good shape even though credit may be more difficult to obtain, many hotel groups will continue to expand their portfolios. New brands have been created in recent years including Yotel, Nitenite and easyhotel. Virgin is developing a new hotel brand for the UK and Europe and details should be clearer by the summer, while Holiday Inns has started a three year revamp of its Holiday Inn and Holiday Inn Express hotels. Such developments are but representative of a thriving hotel sector.

## **Conclusions**

2008 is likely, despite a general economic slowdown, to be a year of reasonable but not spectacular growth for the hospitality industry, especially in London markets, but it could turn out to be a difficult year particularly if numbers of US visitors to the UK decrease as seems likely. It may also, as so often in the past, turn out to be a year of two halves with a marked slowdown in the second half. The reaction of consumers is going to be critical – if energy, food and housing expenses continue to rise strongly then consumers may rein-in their spending in the second half of 2008 but at the moment there are still signs that consumers will take holidays, they will continue to frequent pubs and they will continue to consume meals out. The reason for this relatively upbeat forecast is that when times get tougher people do not automatically cut their expenditure on eating and drinking whether out of the home or in the home – there is a somewhat reverse “hang the consequences” effect, which can lead to increased expenditure on these items. So our advice is to take no notice of the doomsters and concentrate on providing value for money hospitality services for increasingly discerning customers.