

The hospitality industry and economic fortunes in 2007

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Introduction

In 2006 most hospitality businesses experienced reasonably good sales growth, particularly in London but sales growth is one thing and real increases in profitability are another. Profitability is the key to further investment. If interest rates rise further, and there appears to be a possibility that this will indeed happen, and consumers react by cut their spending, then 2007 will be a more difficult year for the hospitality industry than currently predicted. But 2007 is only two months old and the evidence so far still suggests moderate hospitality industry growth but hospitality businesses will need to provide truly excellent quality services for increasingly discerning customers who will be feeling the pinch as real disposable incomes are squeezed by rising costs. 2007 is shaping up to be one of the most difficult years for quite a while.

The economy last year

Overall the UK economy was in reasonable shape in 2006. GDP grew by a respectable 2.6% following a disappointingly low growth rate of 1.9% in 2005 and real GDP growth had returned to its long-run average rate. Now economic forecasts are signalling a period of below-trend GDP growth until the first quarter of 2008 as growth slows quite markedly.

The labour market remained reasonably healthy during 2006 with employment continuing to rise strongly. It has been suggested that with rapid workforce growth, partly fuelled by migration from the emerging European economies and higher participation by older people, there is a certain slack in the labour market and the economy's capacity has been expanded. Productivity however, remains stubbornly as mediocre as ever by international standards and is lower than that of the other G7 countries taken as a whole. Public sector pay growth has fallen below that in the private sector and will continue to do so throughout 2007 but public sector employment growth has fallen below the private sector growth for the first time since 2000. Unemployment is likely to rise although in the latter half of 2006 the upward trend in the people claiming unemployment benefit has slowed.

Consumer spending remains fragile although in the second half of 2006 there was, in spite of the comments of doomster business analysts, reasonable growth and consumer disposable incomes have risen and continue to grow, albeit at a slower rate than experienced in recent years. The prime reason for consumer spending fragility is since August 2006 the three interest rate rises of 0.25% each time, and currently standing at 5.25%. Rises in interest rates in such quick succession clearly affects confidence and fuels wage demands. High levels of consumer debt could still leave the economy vulnerable to a forecasted downturn in the global economy, a sudden oil price shock or rise in global interest rates. The savings ratio remains at historically low levels.

Consumer price inflation has hovered at the top end of the Bank of England Monetary Policy Committee's target range, due in part to steeply rising energy prices but oil prices have fallen year-on-year for the first time since early 2004. The deterioration of public finances witnessed over recent years means that finances are very tight and we still have every reason to believe that overall taxes will rise. Meanwhile UK employment and unemployment have registered record rises over 2006, with employment boosted by migrant workers particularly from Eastern Europe. In the three months ending in November 2006 the UK unemployment rate was 5.5% (1.67 million people unemployed, and up 139,000 over the year). Unemployment is likely to increase further particularly in the second half of 2007 as economic growth slows down. Annual growth of average earnings excluding bonuses was 3.7% in the three months to November 2006 but is expected to move upwards towards 5%.

The hospitality industry in 2006

According to the International Passenger Survey UK residents continue, as they have done for years, to increase the number of their visits abroad from 66.4 million in 2005 to 68.4 million in 2006, although the rate of growth slowed during 2006 to around 3%. Spending by UK residents going abroad increased by 4% to £33.4 billion, which is a decrease on the 2005 growth rate. Overseas residents' visits to the UK increased again during 2006 from 30 million to 32.2 million although the growth rate slowed to 7% reflecting continuing increases in the costs of international travel. There was however a 7% increase in the number of visits from Western Europe to 20.6 million and visits from North America increased by 6% to 4.5 million. Earnings from overseas visitors increased by 8% to £15.4 billion, which is slightly down on the 10% rate of growth experienced in 2005. Overall there was a deficit on tourism trade of £18 billion, almost exactly the same as the £17.9 billion deficit in 2005.

Visits and Spending by overseas residents to the UK 2006

	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
2006				
January	2266	2610	957	1220
February	1794	2500	771	1160
March	2310	2690	1024	1290
April	2884	2790	1277	1360
May	2801	2670	1301	1290
June	2685	2560	1350	1260
July	3411	2680	1799	1410
August	3597	2700	1721	1220
September	2961	2890	1530	1350
October	2450	2500	1285	1280
November	2530	2810	1080	1250
December	2480	2780	1305	1310
Total for Year	3217	32170	15400	15400
% change 2005-2006	+7%	-	+8%	-

Source: The International Passenger Survey (IPS) 7 February 2007

Visits and Spending by UK residents abroad 2006

	UK residents going abroad all visits		UK residents going abroad Expenditure	
	(000) not seasonally adjusted	(000) seasonally adjusted	£ million, current prices not seasonally adjusted	£ million, current prices seasonally adjusted
2006				
January	4440	5670	2310	2790
February	4090	5690	1968	2730
March	4592	5640	2380	2810
April	6008	5780	2797	2840
May	5760	5930	2584	2800
June	6820	5650	3282	2790
July	6598	5610	3321	2810
August	8232	5640	4340	2800
September	7123	5590	3554	2690
October	6420	5650	2995	2690
November	4290	5630	2005	2790
December	4040	5930	1855	2860
Total for Year	68410	68410	33385	33390
% change 2005-2006	+3%	-	+4%	-

Source: The International Passenger Survey (IPS) 7 February 2007

During 2006 UK hotels, especially those in London, generally increased their average room rates and consequently revenues increased quite strongly but profitability improvement outside London and in the provinces was very weak, increasing by only 0.6%, from £11,912 per available room in 2005 to £11,979 in 2006. Revenue per available room in London was up 13.7%, from £74.08 to £84.22 and London hotel profitability per available room increased by 12.6%, from £18,083 to £20,363. In the provinces revenue per available room increased by only 3.9% and costs per available room increased significantly, especially energy costs which rose by over 25%, while wage costs increased by 3.3% during 2006. The following Table gives the latest detailed results for the full 12 months of 2006. At the time of writing no figures were yet available for the first two months of 2007 although the first quarter of the year is usually wet, grey and relatively cold which are all factors which tend to depress the tourist trade.

UK Hotels Performance, 2005-2006

	2005	2006	% change 2005-2006
Occupancy (%)			
UK hotels	73.5	75.1	+1.6 points
London	78.4	82.6	+4.2 points
Provinces	71.0	71.4	+0.4 points
Room rate (£)			
UK hotels	77.34	81.72	+5.7
London	94.50	101.90	+7.8
Provinces	67.71	70.02	+3.4
Revenue per available room (£)			
UK hotels	56.86	61.41	+8.0
London	74.08	84.22	+13.7
Provinces	48.10	49.98	+3.9

Total revenue per available room (£)			
UK hotels	36,826	39,109	+6.2
London	40,560	44,951	+10.8
Provinces	34,929	36,133	+3.4
Total profit per available room (£)			
UK hotels	13,991	14,809	+5.8
London	18,083	20,363	+12.6
Provinces	11,912	11,979	+0.6

Source: TRI Hospitality Consulting, HotStats December 2006, based on a sample of 474 hotels, mostly 3 and 4-star hotels, averaging 171 bedrooms

UK Economic Forecasts

2007 is likely to be a year of slower economic growth as a reaction to continued increases in interest rates sets in. As the hospitality industry mirrors to some extent overall UK economic growth we can reasonably forecast a respectable hospitality sector growth in London and to some extent in the provinces, provided interest rates do not rise yet again. The jury is out on further interest rises with economic commentators divided as to whether there will or will not be a further rise before June 2007. The last thing British hospitality businesses need at this time is another interest rate rise and most are pleading for a period of interest rate stability.

The following Table summarises the key economic indicators and forecasts. We use the British Chambers of Commerce (BCC) Quarterly UK Economic Forecast published in February 2007 and the Deloitte Economic Review, 2007.

UK Economy Key forecasts - % change over previous year

	2004	2005	2006	2007 forecast	2008 forecast
GDP and main demand					
GDP	3.3	1.9	2.7	2.6	2.3
Household consumption	3.5	1.3	1.9	2.3	2.1
General Government	3.2	3.1	2.4	4.0	4.1
Investment	6.0	3.4	5.7	4.4	3.5
Exports	4.9	7.9	10.8	-2.8	3.8
Imports	6.6	7.0	10.9	-1.7	4.9
Output					
Manufacturing	2.0	-1.1	1.3	1.5	1.2
Services	3.9	2.9	3.7	3.3	2.8
Construction	4.0	1.5	1.1	2.9	2.8
Retail Prices					
CPI Retail Price Index	1.3	2.0	2.3	2.5	2.1
RPIX Retail Prices	2.2	2.3	3.0	3.2	2.6
All items RPI	3.0	2.8	3.2	3.6	3.1
Labour market					
Unemployment rate (%)	2.6	2.9	3.0	3.0	3.1
Average earnings	4.4	4.0	4.2	4.4	4.4

Other indicators					
Balance of Payments Current Account £billion	-19.3	-29.5	-37.0	-41.0	-39.0
Public sector net borrowing £billion*	39.1	36.9	36.8	33.9	33.3
Stockbuilding (% of GDP)	0.4	0.3	0.5	0.3	0.2
Company profits**	8.5	3.3	1.5	1.5	3.5
Real disposable income	1.7	2.1	1.3	2.9	2.7
Savings ratio	3.7	4.8	5.3	5.6	5.8

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

** Nominal gross trading profits of non-financial companies

Source: The British Chambers of Commerce Quarterly UK Economic Forecast February 2007 and Deloitte Economic Review, 2007.

The forecasters are predicting a marked slowdown in GDP growth after relatively strong growth in recent years. In 2008 growth is expected to pick up. If interest rates go up to 5.5% then GDP growth is likely to be weaker at 2.5% during 2007 and 2.1% in 2008. As disposable incomes are squeezed, the global economy slows down (particularly in the USA and Eurozone) and interest rates go possibly higher. In such a scenario growth will inevitably slow down. Annual RPI inflation rose from 3.6% in September 2006 to 4.4% in December 2006 and this may have a significant effect on the next pay round. RPI inflation is forecast to average 3.6% in 2007 and 3.1% in 2008 in comparison with 3.2% in 2006. If consumers expect interest rates to go higher this would have damaging effects on the economy but so far into 2007 there is no firm evidence that UK wage settlements are above the headline inflation rate. Unemployment is however, expected to increase in 2007 and is sadly at the highest level for six years.

The service sector remains the main driver of the economy and services output is forecast to grow 3.3% in 2007 and 2.8% in 2008, somewhat lower than the 3.7% growth in 2006 but rather higher than the expected GDP growth. Manufacturing output is forecast to grow at a disappointing 1.5% in 2007 and a poor 1.2% in 2008. Manufacturing is gradually recovering although manufacturing output remains weak by historical standards. Investment growth is expected to drop from 4.4% in 2006 to 3.5% in 2007 and 2008.

The external trade balance continues to be disappointing and this position will continue into 2008. UK exports are expected to continue losing market share in world markets and exports are forecast to decrease by nearly 3% in 2007 but grow by nearly 4% in 2008, but these figures need to be placed in comparison with an exports growth of 18% in 2006.

Overall public finances are going to continue being restricted. Many commentators are of the view that the UK budgetary position is constrained and undeniable concerns over future tax increases are having a major impact on hospitality business confidence. The UK medium-term budgetary outlook has clearly deteriorated and this is almost certainly due to structural problems rather than underlying cyclical factors. The government's books will need to be balanced at some point and unless public expenditure is severely curtailed or cut back then tax increases are inevitable.

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 2007 and 2008:

UK Hotel Forecasts 2007-2008

	2004	% change 2003- 2004	2005	% change 2004- 2005	2006*	% change 2005- 2006	2007*	% change 2006- 2007	2008*	% change 2007- 2008
Average Room Rate (£)										
UK	71.82	+4.4	74.12	+3.2	76.48	+3.2	79.76	+4.3	83.27	+4.4
London	102.91	+7.0	106.99	+4.0	112.04	+4.7	117.36	+4.8	123.43	+5.2
Provinces	60.57	+2.9	62.55	+3.3	63.83	+2.0	65.32	+2.3	66.96	+2.5
Occupancy (%)										
UK	72.10	+2.9	71.82	-0.4	73.45	+2.3	73.58	+0.2	73.90	+0.4
London	77.28	+5.5	75.93	-1.7	81.85	+7.8	82.23	+0.5	82.58	+0.4
Provinces	70.47	+2.1	70.55	+0.1	71.22	+1.0	71.62	+0.6	72.05	+0.6
Revenue per available room (£)										
UK	51.78	+7.4	53.24	+2.8	56.18	+5.5	58.69	+4.5	61.53	+4.9
London	79.53	+12.9	81.24	+2.1	91.70	+12.9	96.51	+5.2	101.93	+5.6
Provinces	42.68	+5.1	44.13	+3.4	45.46	+3.0	46.78	+2.9	48.24	+3.1

* forecast

Source: PricewaterhouseCoopers Forecasting Model, 2006. Hotel Benchmark TM Survey Deloitte 2006 and 2007

The continuation of strong corporate travel demand and strong volumes of leisure are important elements in the PricewaterhouseCoopers forecasts for 2007, especially for London. PricewaterhouseCoopers says that despite these strong industry indicators the hospitality sector is very vulnerable to external shocks and must prepare for an “uncertain future” where terrorist attacks, Middle East conflicts, health scares and periodic economic downturns can seriously and quickly affect tourist and business traveller confidence. It is persuasively argued that hotels that can differentiate themselves through “brand, product and guest experience as well as location will benefit most from anticipated rate growth.” Continued and unresolved fears of a government-imposed bed tax continue to cast a shadow over these forecasts.

UK hotel occupancy levels grew by 2.3% to 73.4% in 2006 but occupancy growth rates are forecast to drop sharply to 0.2% in 2007 (giving a UK occupancy level of 73.5%) and to 0.4% in 2008 (UK occupancy of 73.9%). The UK average room rate grew by 3.2% to £76.48 in 2006 and is forecast to grow strongly by 4.3% to £79.76 in 2007 and 4.4% to £83.27 in 2008. If this growth does materialise, rates in 2007 will be greater than their previous peak in 2000. Growth of RevPAR (revenue per available room) is forecast to slow down in 2007 and 2008, dropping back from a very healthy 5.5% in 2006 (£56.18) to 4.5% in 2007 (£58.69) and 4.9% in 2008 (£61.53).

In London the hotel market has somewhat different characteristics to other UK cities and the provinces. London is in competition with other world cities and needs innovation and new hospitality concepts in order to maintain market share. Hotels companies have however wisely invested in infrastructure and new brands such as Silken and Yotel. Consequently

occupancy is forecast to grow to 81.8% (2006), 82.2% (2007) and virtually standstill in 2008 (82.58%) as London hotels come close to capacity. The forecast occupancy in 2008 is close to the record 84% achieved in 1997. London hotels will see average room rates rise by 4.7% to £112.04 in 2006, with further growth of 4.8% in 2007 (£117.36) and 5.2% in 2008 when average room rates are expected to be £123.43. With strong average room rate growth, RevPAR growth in 2006 will be a very high 12.9% (to £91.70) but growth for 2007 and 2008 will be more modest at 5.2% (to £96.51) and 5.6% (to £101.93) respectively as slower economic growth takes effect. Taking out inflation gives a real RevPAR growth rate which is far less impressive and gives rise to investment concerns. London RevPAR growth is clearly variable according to the type of hotel – for luxury hotels over 18% growth for 2006 is expected but for budget hotels only a low 3.3% growth is forecast. Rising energy and other costs have threatened profit margins during 2006 but energy costs are expected to fall by the second half of 2007 (although for how long is anyone's guess).

Outside London and in the provinces, business has been very mixed, giving a moderate occupancy growth to 71.2% in 2006 but a poor and virtually a static occupancy growth is forecast for 2007 (to 71.6%) and 72.9% in 2008. Average room rate which grew by just 2% to £63.83 in 2006 is expected to grow by 2.3% in 2007 to £65.32, and by 2.5% in 2008 to £66.96. RevPAR grew by 3% in 2006 to £45.46 and is forecast to grow by 2.9% in 2007 to £46.78 and by 3.1% in 2008 to £48.24.

Conclusions

2007 is likely 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. The big fly in the ointment is whether interest rates will continue to rise to 5.5% and beyond and in so doing have a corrosive effect on consumer confidence although Deloitte are predicting an interest rate of 4.5% by the end of 2008. Finally we are beginning to see a fall in gas and electricity prices which should help to contribute to a fall in the inflation rate in the latter half of 2007.