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The hospitality industry and economic fortunes in 2009

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Introduction

2008 was such a roller coaster of a year that most economic commentators have approached 2009 with a growing sense of impending doom; the reality should be a little better than that. We now know that the UK economy entered recession during the second half of 2008, and while inflation appears to have peaked in October 2008, we are now fearful of the UK entering a period of prolonged deflation, where prices fall and wages are at first frozen, and then fall. Falling retail prices spurred on by falling house, commodity and energy prices, coupled with falling mortgage costs might boost real disposable incomes but unemployment is forecast to rise to more than 3 million by 2010. If consumer real disposable incomes and household assets fall in value along with corporate profits, then we are in for a very dangerous time as public confidence reaches rock bottom.

Government policies appear, as far as we can tell, to be designed to stimulate consumer spending by reducing interest rates to nearly zero and increasing the amount of money in the economy but the biggest single problem appears to be the banks who, despite governments across the world continuing to bail them out with truly staggering amounts of money, remain reluctant to increase much-needed loans to businesses, especially small and medium sized enterprises. Yet they remain obstinately reticent about the true extent of bad debts. Little wonder then that both government and the banks are held in pretty low esteem. The view is still taken that most of the banks will still at some point need to be fully nationalised in order to save the global economic systems.

For the hospitality industry these economic conditions are the worst in post-war history and may even yet be the worst in living memory. Will people take holidays and eat and drink away from the home? Our belief is that while economic conditions are undoubtedly bad nevertheless, many people will be persuaded to take holidays at home and those restaurants and pubs prepared to be imaginative and bold in serving value for money products will survive and prosper.

The economy last year

We now know that the UK economy slowed down markedly during the first half of 2008 and then went into recession in the second half of 2008 (defined as two consecutive quarters when output has fallen). It is believed that perhaps the economy slid into recession by April 2008 but the final official figures are not available to confirm this. Overall the economy grew by 0.8% for the whole of 2008. Meanwhile Treasury estimates of economic growth have been perennially optimistic for the past two years, and while this is not by any means a discredited source, nevertheless, economic commentators are calling for more realistic forecasts from government sources.

2008 witnessed significant falls in house prices and at the same time rising inflation, which peaked in September. Unemployment continues to rise and many people experienced a distinct slowdown in real incomes. The result has been a sharp slowdown in domestic demand. Since September the extraordinary global financial turmoil has wrecked havoc – no longer do we have complete faith that the banks have declared all bad debts and despite government bank bailouts involving truly staggering sums of money, the banks continue to be reluctant to increase lending to companies and individuals, in part because they are unsure whether other banks have honestly declared all bad debts and in part because they are attempting to repair their balance sheets.

The Bank of England has reduced interest rates from 5% in October 2008, to 3% in November to 0.5% in March 2009 but there is a growing worry that not only has the Bank of England exhausted whatever economic weapons it has at its command in order to stimulate the economy, but that it has little idea of how to proceed from here. Consequently we are seeing the Bank embark on a policy of "quantitative easing" which means pumping money into the economy, primarily through the buying of corporate and government bonds. Such a move, dubbed by some as a "Zimbabwean solution", runs the high risk of stimulating rampant inflation. No one needs reminding of how increasing the money supply in the inter-war Weimer Republic in Germany led to rampant hyper-inflation. It is a measure of how extraordinary the current times are that very few people have raised any coherent arguments about quantitative easing. Reducing interest rates has shown to have no immediate effect (but then such a policy usually takes months to take effect). The cost of borrowing may be somewhat lower but the problem is not the cost of borrowing per se but the availability of loans particularly for businesses. Businesses, particularly small and medium sized businesses, are finding it extraordinarily difficult to finance day-to-day operations let alone any future investment plans.

Meanwhile the UK government seems to be in some form of denial and curiously ill at ease. The Chancellor of the Exchequer had forecast in his Pre-Budget Report presented in November 2008 that the economy would go into a deep but relatively short-lived slowdown, which it was believed would end by the middle of 2009. Not unnaturally growth forecasts have been revised downwards from 2% to 0.8% for 2008 in the light of circumstances although this forecast is likely to be revised even further downwards. How long the downturn will last is not clear – commentators are divided, with some saying conditions will not pick up for years while others feel that the downturn will be relatively short-lived.

In one of those strange perversities of history, while economic growth fell sharply, inflation rose during 2008 and in October reached a peak of 4.5% according to the consumer prices index or 4.2% according to the retail prices index. This was clearly above the government's 2% target. The cost of gas, electricity, food and fuel rose sharply during 2008 and this had an impact on real disposable incomes. Real household incomes were static during the first half of 2008 and for the whole of 2008 have actually fallen by 0.6%. Average earnings growth dropped in 2008 to 3.5%, compared with 3.9% in 2007. It is estimated that house price falls have much further to go despite average price falls of 15% during 2008. As the housing sector continues to be in the doldrums, so is consumer spending. The reduction in VAT from 17.5% to 15% for 13 months from December 2008 has so far failed to stimulate consumer spending despite heavy discounting in the retail sector.

For a long time sterling has been overvalued but during 2008 the sterling exchange rate fell sharply particularly against the euro and dollar. This does help UK companies who export their products, including tourism, and will help them to compete more aggressively once global demand picks up but unfortunately global demand will probably stay muted during the next 18 months.

Construction, retailing, real estate and financial services had a bad 2008. Unemployment is rising and currently about 2 million, and is expected to increase by at least a further 1 million by 2010. Meanwhile public finances are not unnaturally in a parlous state and now even more so since the huge government financial support for the UK banking sector and partial nationalisation of several banks. Weaker corporation tax receipts and a sharp slowdown in income tax receipts compounded the problem of worsening public finances during the second half of 2008. The UK government budgetary position will continue to give real cause for concern, raising questions about chronic government over-borrowing. Government borrowing now stands at £118 billion although the true figure may be more but no one can be sure.

The hospitality industry in 2008

According to the latest International Passenger Survey data published in February 2009 in the three months ending in December 2008 there was a fall in the number of visits into and out of the UK compared with the same period in 2007. The number of overseas visitors to the UK (seasonally adjusted) fell 12% while UK residents' visits abroad declined by 6%.

Examining year-on-year and quarterly trends tells a depressing story. In the 12 months to December 2008 overseas visitors decreased by 2% from 32.8 million to 32.0 million (not seasonally adjusted) when compared with the 12 months to December 2007. The largest fall was in North American visitors – down 13% to 3.8

million, while visits from Europe decreased by 1% to 23.7 million. Visitors from other parts of the world were broadly static at 4.5 million (again not seasonally adjusted).

In the 12 months to December 2008 visits abroad by UK residents decreased by 1%, from 69.5 to 68.8 million (not seasonally adjusted) when compared with the same period in 2007. In particular, visits to Europe fell by 1% to 54.5 million; visits to North America were relatively the same at 4.6 million, while visits to other parts of the world grew by 1% to 9.8 million.

During October to December 2008 the number of visits to the UK (seasonally adjusted) fell by 5% to 7.4 million when compared with the period July to September 2008. In the same period spending by overseas visitors fell by 1% to £4 billion.

During the first nine months of 2008 UK hotels generally saw reductions in occupancy but room rates and RevPAR improved. In the nine months to September 2008, average UK hotel occupancy and in the Provinces fell by nearly 1% to 75% compared with the same period to September 2007, according to TRI Hospitality Consulting. In London the position was virtually static. In the same period UK room rates increased by over 3%, nearly 6% in London and just over 1% in the provinces. Revenue per available room therefore, increased by over 2% on average in UK hotels and by over 5% in London. By January 2009 the profitability of UK provincial hotels fell by nearly 29%, with total revenue and room revenue down by 11 and 13% respectively. In London average occupancy for January was down to 67.5% and average room rate fell nearly 8% to £102.84.

UK Economic Forecasts

The Deloitte Economic Review, First Quarter 2009, makes for sober reading. Economic growth is forecast to decrease by 2.5% during 2009; it might fall even further. Deloitte believe that a period of deflation (falling prices) is likely with conditions probably right for such an occurrence. The argument goes that energy prices will fall sharply (although we have so far not seen large falls in electricity and gas prices, although oil has fallen rapidly from over $140 a barrel in the summer of 2008 to around $40). Retail competition is fierce and the beginning of 2009 has seen intense price discounting particularly of white goods and clothes, while the 13 month reduction in VAT to 15% has enhanced the downward trend. Meanwhile house prices continue to fall. Some companies may attempt to increase profit margins by actually holding prices steady during a deflationary period.

Unemployment is set to significantly increase to over 3 million by 2010 (possibly to 3.25 million). As a consequence wages growth will slow quite sharply and might even decrease.

The aggressive reduction in interest rates to virtually zero by the Bank of England has significantly reduced the cost of borrowing but at the same time has significantly disadvantaged savers. Herein lies a Catch 22 – the government needs consumers to spend but a significant number of consumers, especially pensioners, rely on the interest on savings for income enhancement, and banks and building societies need savers in order to boost the funds available for lending. Under conditions of near zero interest rates savers are unlikely to be persuaded that they will benefit from a rise in the real value of savings.

UK Hotel Forecasts 2008-2009

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 2009.

Back in November 2008, given a rapidly deteriorating economy, the PricewaterhouseCoopers baseline scenario (based on the assumptions of 1% GDP growth in 2008 and a 0.5% GDP decline in 2009) anticipated UK hotel occupancy falling by 2.6%, a massive 11.8% drop in London and a very modest 0.3% increase in the provinces. Corporate hospitality demand was expected to fall as budgets were cut and London would experience the greatest fall in this demand. UK RevPAR was forecast by PricewaterhouseCoopers to fall by 4.3% as room rates fell for the first time since 2003. RevPAR in London was forecast to fall by 11.9% although London average room rates were expected to stay roughly the same as 2008. At the same time the PricewaterhouseCoopers downside scenario (based on 0.9% GDP growth in 2008 and a 1.9% GDP decline in 2009) would see UK occupancy fall by 1.9% and fall of 8.7% in London, with average UK room rates falling by 7.7%, 3.7% in the provinces and a huge 15.9% in London. RevPAR under this scenario would fall by 23.3% in London and 9.4% in the UK. It was thought at the time in November 2008 that the actual results would be closer to the baseline scenario but for understandable reasons PricewaterhouseCoopers could not be sure.

	2006	**% change 2005-2006**	**2007**	**% change 2006-2007**	**2008***	**% change 2007-2008**	**2009***	**% change 2008-2009**
Average Room Rate (£)								
UK	77.12	+3.0	80.78	+4.8	82.57	+2.2	75.29	**-7.7**
London	103.02	+5.8	112.4	+9.1	114.6	+2.0	96.41	**-15.9**
Provinces	63.25	+1.8	65.03	+2.8	65.32	+0.4	62.90	**-3.7**
Occupancy (%)								
UK	77.9	+2.0	77.9	+0.1	76.0	-2.4	74.6	**-1.9**
London	80.5	+7.9	81.1	+0.8	79.1	-2.5	72.2	**-8.7**
Provinces	70.4	+0.3	70.2	-0.2	68.6	-2.3	68.7	**+0.3**
Revenue per available room (£)								
UK	60.14	+5.1	62.99	+4.8	61.93	-1.7	56.11	**-9.4**
London	83.04	+14.3	91.27	+10.0	90.77	-0.6	69.62	**-23.3**
Provinces	44.56	+2.1	45.69	+2.6	44.73	-2.1	43.21	**-3.4**

* forecast

Source: PricewaterhouseCoopers Forecasting Model, November 2008 revised with reference to PricewaterhouseCoopers *Hospitality Directions Europe: Revisions to Forecast, January 2009* and historic data from STR Global.

Since then the position has unfortunately changed for the worst as economic growth forecasts are revised ever-downwards; unemployment increases, disposable incomes and consumer spending fall. PricewaterhouseCoopers have downgraded the economic outlook with the worst case (downside scenario) now becoming in just two months the base forecast. As GDP is forecast now to fall by 1.8%, UK RevPAR is forecast to fall nearly 10%, with London RevPAR forecast to fall by a staggering 23% due in large part to a continuing fall in room rates but PricewaterhouseCoopers believes the number of Eurozone visitors may help alleviate the London position but the “evidence points to an unprecedentedly poor hotel outlook for the year” according to Liz Hall, Head of Research, Hospitality and Leisure, PricewaterhouseCoopers.

Our forecasts for the hospitality industry

2009 will be a year of very definitely negative economic growth, falling from a near 1% growth in 2008 to a 2.5% *decrease* in 2009 according to the latest Deloitte Economic Review. This would be the worst year for growth since 1947. While any kind of forecasting is profoundly difficult in the current turbulent global economic environment, this would mean:

- A decrease, on average and in real terms, in the demand for hospitality services throughout 2009 but this will again be variable according to sector and region; restaurants and pubs will have a particularly difficult time but many hotel groups will continue to offer good value special packages and customers will continue to seek perceived value for money, good accommodation, good cuisine and excellent service but there is a danger that widespread discounting of hospitality prices will be counter-productive in the long run

- Acquisitions will be again be few and far between as attitudes to risk harden further, and bank lending is constrained although some bargains may become available as some businesses unfortunately get into cash flow difficulties. Venture capital companies will be conspicuous by their absence in the acquisitions market. Hotel and restaurant groups will continue to adjust property portfolios at the margins to sustain better performing brands, by attempting to sell off under-performing properties while modestly investing in high margin, good-performing units with even better future potential under new ownership

- Investment in refurbishment and capacity expansion will be held back partly by a continued reluctance of banks to lend to businesses in the first half of 2009 and partly by a natural but short-term reluctance of business managers to invest in times of difficult trading conditions

- Business and property values will fall by 5 to 12% outside London and by up to 15% in London, as the property markets continue to readjust; this offers business opportunities for astute investors who take a medium-term view (that is, beyond 2010)

- Lenders will be very cautious and even more risk averse during 2009 and will continue to lend only on projects which can demonstrate clearly well-above average revenue and discounted profits streams; cash flows will be watched even more closely than usual

- Business planning and marketing, as always, will continue to need to be very focused, paying particular attention to underlying market trends and consumer reluctance to spend by keeping a level head and establishing a very clear market positioning based on value for money offerings and truly superb service; this is not a market for the faint hearted

Conclusions

No one can be under any allusions that 2009 will be a desperately difficult year for hospitality businesses and some will sadly go to the wall. Those that think and plan creatively, keep costs under control and invest in imaginative marketing will find that consumers will still be taking holidays (indeed many more are likely to holiday at home, taking probably shorter but more frequent holidays) and consumers may not eat and drink away from the home quite as readily as they have done in recent years, but nevertheless, they will eat and drink in pubs and restaurants. Nerves will be frayed but need to be held.