

### **Hospitality industry forecasts for 2007**

Last year most hospitality businesses experienced reasonably good sales growth, particularly in London. With this recent scenario it is still possible, despite worsening economic indicators, to prepare a moderate growth forecast for the hospitality industry. If on the other hand interest rates rise further and consumers cut their spending, then 2007 will be a more difficult year for the hospitality industry than currently predicted. The evidence so far still suggests moderate hospitality industry growth but hospitality businesses will need to be providing excellent quality services for increasingly discerning customers.

### **Contributor**

#### **Gary Akehurst**

University of Wales Aberystwyth, School of Management and Business. Previously of Greene Belfield-Smith Division, Deloitte & Touche Consulting Group, London

### **Hospitality industry predictions for 2006**

This article considers what happened to the UK economy and the hospitality industry during 2006, reviews the “relatively faster growth” forecasts prepared this time last year, examines medium-term trends for the British economy and hospitality industry, and makes forecasts for 2007.

Back in December 2005 we said that 2006 should be a year of slightly faster economic growth and consequently somewhat faster growth for the hospitality industry. We predicted a relatively faster growth provided interest rates did not rise and provided oil price increases peaked in early 2006. This meant:

- ◆ A moderate increase, on average and in real terms, in the demand for hospitality services but this would again be variable according to sector and region; customers would continue to seek value for money, good accommodation, good cuisine and excellent service
- ◆ Acquisitions, especially by venture capital companies, would increase at a rate higher than in 2005. Hotel and restaurant groups would continue to adjust property portfolios to sustain better performing brands, by selling off poor performing properties while investing in high margin, good performing units with even better future potential under new ownership
- ◆ investment in refurbishment and capacity expansion would continue at a moderate pace (but not at the rate experienced in recent years) especially in businesses with a considerable turnover and profits track record or potential
- ◆ business and property values would increase by a modest extent across the UK but by somewhat more than the average in some areas where hospitality properties were keenly sought; sale and manage back deals would continue to be popular

- ◆ lenders would remain cautious during 2006 and would continue to lend only on projects which could demonstrate above average revenue and profits streams
- ◆ business planning and marketing, as always, would continue to need to be very focused paying particular attention to underlying market trends and very clear market positioning

Generally this forecast held up reasonably well but on balance the forecast was somewhat more cautious than actual events revealed particularly in the London hotels and eating out markets. It is all too easy to take a cautious, indeed pessimistic line when inflation is edging upwards and energy prices are going through the roof but good business is to be had provided the quality of product and service is there and management is up to the challenges of increasingly competitive hospitality markets.

### **The economy last year**

The UK economy remained in a reasonable condition during 2006. GDP grew by 2.6% during the year following a growth rate of 1.9% in 2005 and real GDP growth has returned to its long-run average rate. Before the Chancellor of the Exchequer's December Pre-Budget Report growth was expected to slow in 2007, as parts of the world economy (especially the USA) slow down. The Treasury has revised upwards the estimate of trend growth (the pace at which the economy can grow without increasing inflation). The limit will now be 2.75% instead of 2.5%.

The labour market remained quite healthy during 2006 with employment continuing to rise strongly. Economic commentators suggest that with rapid workforce growth (partly fuelled by inward migration from the emerging European economies and higher participation by older people) there is still considerable slack in the labour market and effectively the economy's capacity has been expanded. Productivity however, still remains as mediocre as ever. Public sector pay growth has fallen below that in the private sector 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 fallen off.

Consumer spending has in the second half of the year regained some reasonable growth but it remains fragile despite the fact that consumer disposable incomes have risen and continue to grow. One reason for consumer spending fragility is the rise in interest rates, first in August by 0.25% and a further 0.25% rise in November to 5%. Rises in interest rates in quick succession may well adversely affect consumer confidence and the housing market outside London has weakened somewhat as the rate of house price inflation has weakened. High debt levels could leave the economy vulnerable to a downturn in the global economy or rise in global interest rates. The savings ratio remains at historically low levels.

Consumer price inflation is at about the Bank of England Monetary Policy Committee's target, 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. The Treasury remains at risk of breaking its own rules on balancing revenue and spending over the economic cycle and on keeping investment below a sustainable ceiling of 40% of GDP.

## The hospitality industry last year

According to the International Passenger Survey UK residents continue to increase the number of their visits abroad, although the rate of growth slowed down during 2006 to around 2%. Spending by UK residents going abroad increased by 4% which is a decrease on the 2005 growth rate. Overseas residents' visits to the UK increased again during 2006 but the rate of growth slowed further to 7%. There was however a welcome 7% increase in the number of visits from North America. Earnings from overseas visitors increased by 8%, which is slightly down on the 10% rate of growth experienced in 2005.

### Visits and Spending by overseas residents to the UK 2006

	Overseas visitors to UK all visits (000) not seasonally adjusted	Overseas visitors to UK all visits (000) seasonally adjusted	Overseas visitors to UK Earnings £ million at current prices not seasonally adjusted	Overseas visitors to UK Earnings £ million at current prices seasonally adjusted
January 2006	2266	2600	957	1220
February 2006	1794	2520	771	1170
March 2006	2310	2670	1024	1300
April 2006	2884	2750	1277	1330
May 2006	2801	2630	1301	1280
June 2006	2685	2520	1350	1250
July 2006	3330	2590	1745	1370
August 2006	3520	2610	1670	1200
September 2006	2890	2800	1485	1330
Year to date	24480	23690	11575	11450
% change 2005-2006	+7%	-	+8%	-

Source: monthly series derived from the International Passenger Survey (IPS) 2006

### Visits and Spending by UK residents abroad 2006

	UK residents going abroad all visits (000) not seasonally adjusted	UK residents going abroad all visits (000) seasonally adjusted	UK residents going abroad Expenditure £ million, current prices not seasonally adjusted	UK residents going abroad Expenditure £ million, current prices seasonally adjusted
January 2006	4440	5680	2310	2780
February 2006	4090	5700	1968	2720
March 2006	4592	5680	2380	2800
April 2006	6008	5760	2797	2820
May 2006	5760	5910	2584	2790
June 2006	6820	5620	3282	2790
July 2006	6420	5510	3265	2780
August 2006	8010	5520	4270	2760
September 2006	6930	5480	3495	2630
Year to date	53070	50860	26350	24860
% change 2005-2006	+2%	-	+4%	-

Source: monthly series derived from the International Passenger Survey (IPS) 2006

In the three months to September 2006 (the latest figures available at the time of writing) compared with the previous three months, seasonally adjusted results from the International

Passenger Survey show that UK residents' visits abroad decreased in number by 5% to 16.5 million, and remained broadly the same when compared with the three months to September 2005, while UK residents' expenditure abroad decreased by 3% to £8.2 billion in the three months to September 2006.

During the three months to September 2006 overseas residents' visits to the UK increased in number by 1% to 8.0 million compared with the previous three months and increased by 10% when compared with the three months to September 2005, while overseas earnings increased by 1% to £3.9 billion in the three months to September 2006.

During 2006 UK hotels, especially those in London, generally had a good year compared with the previous year, with average room rates and consequent revenues increasing quite strongly. The following Table gives detailed estimations.

### UK Hotels Performance, 2005-2006

	2005	2006	% change 2005-2006
<b>Occupancy (%)</b>			
UK hotels	73.1	74.7	+1.6 points
London	78.4	83.5	+5.2 points
Provinces	70.6	70.6	+0.1 points
<b>Room rate (£)</b>			
UK hotels	76.17	79.90	+4.9
London	93.79	99.53	+6.1
Provinces	67.01	69.24	+3.3
<b>Revenue per available room (£)</b>			
UK hotels	55.65	59.69	+7.3
London	73.49	83.15	+13.2
Provinces	47.29	48.91	+3.4
<b>Total revenue per available room (£)</b>			
UK hotels	23,722	25,089	+5.8
London	26,657	29,495	+10.6
Provinces	22,379	23,068	+3.1

Source: TRI Hospitality Consulting, HotStats August 2006, based on a sample of 479 hotels, mostly 3 and 4-star hotels, averaging 166 bedrooms

### Forecasts

2007 could be a year of possibly slower economic growth and consequently somewhat slower growth for the hospitality industry outside of London. We forecast however a relatively reasonable hospitality growth provided interest rates do not rise and consumer disposable incomes continue to rise. This would mean:

- ◆ A moderate increase, on average and in real terms, in the demand for hospitality services but this will again be variable according to sector and region; customers will continue to seek value for money, good accommodation, good cuisine and excellent service

- ◆ Acquisitions, especially by venture capital companies, will increase at a rate lower than in 2006. Hotel and restaurant groups will continue to adjust property portfolios to sustain better performing brands, by selling off under-performing properties while investing in high margin, good-performing units with even better future potential under new ownership
- ◆ Investment in refurbishment and capacity expansion will continue at a moderate pace (but not at the rate experienced in recent years) especially in businesses with a considerable turnover and profits track record or potential
- ◆ Business and property values will increase by a more modest extent across the UK but by somewhat more than the average in some areas where hospitality properties are keenly sought; sale and manage back deals will continue to be popular
- ◆ Lenders will remain somewhat cautious during 2007 and will continue to lend only on projects which can demonstrate clearly above average revenue and discounted profits streams
- ◆ Business planning and marketing, as always, will continue to need to be very focused paying particular attention to underlying market trends and very clear market positioning

The following table summarises the key economic indicators and forecasts. This year in the absence of the latest quarterly economic forecasts produced by the Royal Bank of Scotland, which we have used in previous years, we use the British Chambers of Commerce (BCC) Quarterly UK Economic Forecast published in November 2006 and the Deloitte Economic Review, Fourth Quarter 2006.

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

	2004	2005	2006 estimate	2007 forecast	2008 forecast
<b>GDP and main demand</b>					
GDP	3.3	1.9	2.6	2.3	2.5
Household consumption	3.5	1.4	2.2	2.1	2.2
General Government	3.2	2.8	2.5	3.9	4.1
Investment	6.0	2.7	4.9	3.6	3.6
Exports	4.9	7.1	18.0	4.5	3.8
Imports	6.6	6.5	17.0	5.1	4.7
<b>Output</b>					
Manufacturing	2.0	-1.0	1.2	1.8	1.5
Services	3.9	2.9	3.4	2.7	2.8
Construction	4.0	1.6	0.9	2.7	2.8
<b>Retail Prices</b>					
CPI Retail Price Index	1.3	2.0	2.3	2.3	2.0
RPIX Retail Prices	2.2	2.3	2.9	2.9	2.4
All items RPI	3.0	2.8	3.1	3.4	2.7
<b>Labour market</b>					
Unemployment rate (%)	2.6	2.9	3.0	3.0	3.1
Average earnings	4.4	4.0	4.2	4.4	4.4
<b>Other indicators</b>					

Balance of Payments Current Account £billion	-19.3	-27.4	-31.0	-34.5	-36.0
Public sector net borrowing £billion*	40.5	38.8	41.0	38.3	37.7
Stockbuilding (% of GDP)	0.4	0.3	0.2	0.1	0.0
Company profits**	8.5	3.3	-1.5	2.0	4.6
Real disposable income	1.7	2.1	1.8	2.9	3.0
Savings ratio	3.7	4.8	5.1	5.3	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 and Deloitte Economic Review, Fourth Quarter 2006.

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. As disposable incomes are squeezed, the global economy slows down (particularly in the USA and Eurozone) and interest rates go possibly higher, growth will slow down. Annual RPI inflation rose to 3.6% in September and this may have a significant effect on the next pay round. If consumers expect interest rates to go higher this would have damaging effects on the economy. Furthermore unemployment is expected to increase in 2007 and is at the highest level for six years.

The service sector remains the main driver of the economy and services output is forecast to grow 2.7% in 2007 and 2.8% in 2008, higher than the expected GDP growth. Manufacturing output is forecast to grow at 1.8% in 2007 and 1.5% in 2008. Investment growth is expected to drop from 4.9% in 2006 to 3.6% in 2007 and 2008.

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
<b>Average Room Rate (£)</b>										
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
<b>Occupancy (%)</b>										
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
<b>Revenue per available room (£)</b>										
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, September 2006. Hotel Benchmark TM Survey Deloitte 2006

Continuing strong corporate travel demand and strong volumes of leisure travel have been 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 Middle East conflicts, terrorist attacks, health scares and economic downturns can seriously dent tourist and business traveller confidence very quickly. PricewaterhouseCoopers issues wise words of caution that as always hotels that can differentiate themselves through “brand, product and guest experience as well as location will benefit most from anticipated rate growth.” Fears of a government-imposed bed tax continue to cast a shadow over these forecasts.

UK hotel occupancy levels are expected to grow 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 (occupancy of 73.9%). The UK average room rate is expected to grow by 3.2% to £76.48 in 2006 and growing strongly by 4.3% to £79.76 in 2007 and 4.4% to £83.27 in 2008. If this does indeed happen, rates in 2007 will be greater than their previous peak in 2000. Growth of RevPAR (revenue per available room) is forecast to moderate 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 exhibits different characteristics to other UK cities and the provinces. London is in competition with other world cities and needs innovation and new concepts in order to even maintain market share. Hotels companies have however 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 get 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. Taking out inflation gives a real RevPAR growth rate which is less impressive. London RevPAR growth is 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 threaten profit margins.

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

## **Conclusions**

2007 should be a year of reasonable but not spectacular growth for the hospitality industry, especially in London markets. The big unknown is whether interest rates will continue to rise and in so doing seriously dent consumer confidence. Recent drops in the wholesale price of gas should bring some relief from the remorseless rise in energy costs in the second half of the year.