

A Look Back Over 2007

2007 was a year when we saw the relatively favourable economic conditions of low inflation, low interest rates and growing prosperity we have almost taken for granted over the past 10 years begin to falter. As has often been said, a year is a really long time and 2007 will probably go down in economic and political history as a turning point year, when floods, foot and mouth disease, financial instabilities with the first run on a major bank since 1866, and other events have made trading conditions for hospitality businesses much more difficult. Cracks are beginning to appear in the economy and more worryingly, in consumer and business confidence in the UK banking system and the current Labour government.

We forecast back in December 2006 that things would start to slow down during 2007 and this has indeed happened. While 2008 may not have highly adverse hospitality trading conditions nevertheless a slowdown can be expected and consumers are likely to be very value conscious.

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Industry fortunes during 2007

Back in December 2006 we said that 2007 would be a year of possibly slower economic growth and consequently somewhat slower growth for the hospitality industry outside of London. We forecasted however a relatively reasonable hospitality growth provided interest rates did not rise and consumer disposable incomes continued to rise. 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 lower than in 2006. Hotel and restaurant groups would 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 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 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 would remain somewhat cautious during 2007 and would continue to lend only on projects which can demonstrate clearly above average revenue and discounted 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

In the event this forecast has proven to be relatively accurate up to around the end of July but the economic situation has worsened somewhat since July and the picture is now much more complex across the country.

The UK economy in 2007

The economy has slowed down as the year has progressed in reaction to successive increases in interest rates, with no less than five rate increases since August 2006. UK GDP is set to fall below trend towards the end of 2007 and remain below trend during 2008, moving from 2.8% in 2006 and 2007 to 2.1% in 2008. Interest rates are thought to have peaked and at the last meeting of the Bank of England monetary committee in early October the rate was held at 5.75%. There is evidence that higher mortgage rates and average earnings growth below RPI inflation is squeezing personal disposable incomes and this will inevitably follow through to a more constrained household consumption.

The UK government budgetary position continues to be very stretched, continuing to raise questions about government over-borrowing, and taxation continues to increase albeit in relatively small steps. These economic conditions will certainly dampen business confidence. Earlier in the year in March the Governor of the Bank of England had to explain by letter to The Treasury why inflation had reached 3.1% and therefore breaching the government's inflation target of 2.5%. This was the first such letter since the Bank's monetary policy committee had been established in 1997 and considerable importance was attached to it by economic commentators.

The manufacturing sector is currently performing more strongly than the service sector, and indeed the service sector saw third quarter falls for both domestic and export sales and orders but all-important cash flow was thankfully stronger.

Some commentators are beginning to warn of stagflation (high inflation running side by side falling economic growth) although such talk is premature and not particularly helpful. But 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 new 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, with a doubling of investment in transport, with additional spending on health (up 4% per annum in real terms, although down on 7% per annum since 1997) and education (up by an average of 3% in real terms as opposed to 2.4% in the March Budget plans).

In his pre-budget report the Chancellor abolished capital gains tax tapered relief and introduced a single rate of 18% with a £30,000 charge for non-domiciled taxpayers resident for seven years. The main rate of corporation tax was cut by 2% to 28% by 2008 and this will be welcomed, as will the changes to inheritance tax rules and allowances. Air passenger duty will be replaced in November 2009 with charges on air flights probably levied according to type of aircraft. The overall tax changes reduce government tax revenues by £385 million in 2007 and £370 million in 2008 but raises a net £1.2 billion in 2009 and £1.4 billion in 2010.

The industry during 2007

PriceWaterhouseCoopers forecast the following average room rates, occupancy levels and revenue per available room for the UK, London and Provinces in 2007:

UK Hotel Forecasts 2007

	2004	% <i>change</i> 2003- 2004	2005	% <i>change</i> 2004- 2005	2006	% <i>change</i> 2005- 2006	2007*	% <i>change</i> 2006- 2007
Average Room Rate (£)								
UK	73.91	-0.4	78.84	+6.7	80.65	+2.3	85.17	+5.6
London	100.98	+1.0	101.91	+0.9	107.96	+5.9	118.55	+9.8
Provinces	61.04	-1.5	64.00	+4.9	66.14	+3.3	68.36	+3.4
Occupancy (%)								
UK	73.20	+3.1	72.44	-1.0	75.29	+3.9	75.69	+0.5
London	76.20	+5.2	74.83	-1.8	81.13	+8.4	81.72	+0.7
Provinces	71.21	+1.5	70.91	-0.4	71.25	+0.5	71.54	+0.4
Revenue per available room (£)								
UK	54.10	+2.7	57.11	+5.6	60.72	+6.3	64.46	+6.2
London	76.94	+6.2	76.26	-0.9	87.59	+14.9	96.88	+10.6
Provinces	43.46	0.0	45.38	+4.4	47.12	+3.8	48.91	+3.8

* forecast

Source: PricewaterhouseCoopers Forecasting Model, September 2007.

The key indicator of average room rate shows a very healthy growth rate during 2007, rising by nearly 6% for all UK hotels but by an incredible 10% for London hotels, driven especially by corporate demand. Provincial hotels showed, as usual, a smaller increase of just over 3%. Historically this is a large average room increase generated by strong economic growth, although in 2005 UK hotel average room rates increased by nearly 7% while in the same year London hotels' average room rate increased by a poor 0.9%. Occupancy however, barely increased during the year, and for all UK hotel sectors the rate of increase of occupancy was under 1%, with again London showing the largest increase of 0.7%. Relatively high average room rates combined with barely improving occupancy levels have led to a decreasing rate of growth of revenue per available room, that is, RevPAR is currently stalling; but RevPAR did increase and in the case of London hotels increased by a very healthy 10.6%, while for provincial hotels RevPAR increased by nearly 4%. As interest rates have risen over the past two years (and at the time of writing in mid-October it is not clear yet whether interest rates will start to go down or up), household debt is historically high and the growth of earnings is lagging behind prices. The recent Northern Rock bank turmoil, the surrounding sub-prime credit crisis and a growing lack of confidence in the UK banking system (and especially its regulatory system) means hospitality demand is starting to slow down. A strong pound has had effects on US and Japanese visitors especially to London while poor summer weather has certainly affected many UK hospitality businesses.

In the eight months to August 2006 actual occupancy in UK hotels increased by 1.6 points from 73.1% to 74.7% compared with the same period to August 2005 according to TRI Hospitality Consulting. Achieved room rates also increased by between 3.3 and 7.3%, with an increase of 6.1% in London. Revenue per available room and total revenues all increased during the year to August, again particularly in London.

Looking at the very latest figures available from TRI Hospitality Consulting - during August UK occupancy levels fell by 0.3% but this disguises a very small rise of 0.2% in London and a somewhat larger drop of 0.7% in the provinces. UK room rates increased by a very credible 6.1% and London did even better at 8.1% while room rates in the provinces increased but at a lower 3.5%. Consequently UK hotel revenue per available room increased by nearly 6%, London hotels increased by 8.3% and in the provinces by a somewhat disappointing 2.5%. Total revenue per available room for the UK (defined as the combined total of all hotel revenues divided by the total fixed bedroom stock) increased by 2.6% during August 2007 (compared with August 2006) but London hotels increased Total RevPAR by an impressive 6.7% while in provincial hotels there was no increase at all. All the available evidence is showing a general slowdown in occupancy levels in the last quarter of 2007 particularly in provincial hotels (although hotels in Scotland particularly in Aberdeen, Glasgow and Edinburgh and London appear to be doing better than the UK average).

UK Hotels Comparative Performance, August 2006 and August 2007

	<i>August 2006</i>	<i>August 2007</i>	<i>% change 2006-2007</i>
Occupancy (%)			
UK hotels	78.20	77.90	-0.3 points
London	85.40	85.60	+0.2 points
Provinces	74.50	73.80	-0.7 points
Room rate (£)			
UK hotels	75.41	80.00	+6.1
London	91.46	98.91	+8.1
Provinces	65.99	68.32	+3.5
Revenue per available room (£)			
UK hotels	58.97	62.30	+5.7
London	78.15	84.67	+8.3
Provinces	49.15	50.40	+2.5
Total revenue per available room (£)			
UK hotels	2977	3054	+2.6
London	3162	3374	+6.7
Provinces	2880	2880	0

Source: TRI Hospitality Consulting, HotStats August 2007, based on a sample of 501 hotels, mostly 3 and 4-star hotels, averaging 169 bedrooms

It is quite possible that occupancy levels will continue to drift downwards slightly while achieved room rates and revenues may stabilise (that is not grow at all) through into the new year. This is not entirely surprising given the time of year and cooler weather.

Bearing in mind that we are not reviewing the whole year's data nevertheless the number of overseas visitors to the UK from January up to July 2007 continued to increase, as noted in previous years. The total number of overseas residents' visits to the UK increased by 6% in the 12 months ending in July 2007 compared with the same period to July 2006 (an increase from 31.2 million to 32.9 million). The principal reason for this growth was an increase in visitors from Western Europe (up 7% to 23.7 million), North American visits remained the same at 4.6 million (whereas in the corresponding time period in 2006/07 these increased by 4%) while visits from other parts of the world increased by a 6% (to 4.6 million visits). Clearly the numbers of visitors from outside Europe have increased but appear to be slowing down as we enter the fourth quarter of 2007.

Overseas visitors to Britain: to the end of July 2007

	<i>12 months ending July 2006</i>	<i>12 months ending July 2007</i>	<i>% change 2006/2007</i>	<i>Year to date (to July 2007)</i>	<i>% change Jan-July 2006/2007</i>
From	Visits (000)	Visits (000)		Visits (000)	
North America	4,560	4,580	0	2,050	-5.3
W. Europe	22,284	23,740	+7	11,307	+4.3
Rest of World	4,328	4,590	+6	1,957	+7.3
Total visits	31,172	32,910	+6	15,314	+3.3
Total spend (£million)	15,170	16,100	+6	6,960	+3.4

Source: International Passenger Survey; data is not seasonally adjusted

The total number of UK residents visiting abroad (not seasonally adjusted) increased by 1% during the 12 months ending in July 2007 compared with the 12 months ending in July 2006 (from 68.3 million to 69.3 million). UK visitors to North America increased by 3% (to 4.8 million). UK visitors to Western Europe remained roughly the same (54.5 million) while visits to the rest of the world increased by an impressive 9% (to 10 million).

UK residents' visits abroad: to the end of July 2007

	<i>12 months ending July 2006</i>	<i>12 months ending July 2007</i>	<i>% change 2006/2007</i>	<i>Year to date (to July 2007)</i>	<i>% change Jan-July 2006/2007</i>
To	Visits (000)	Visits (000)		Visits (000)	
North America	4,668	4,790	+3	2,218	+2.1
W. Europe	54,412	54,480	0	24,362	-1.8
Rest of World	9,222	10,020	+9	5,210	+6.8
Total visits	68,302	69,290	+1	31,790	-0.2
Total spend (£billion)	33.34	35.12	+5	16.06	+4.1+

Source: International Passenger Survey; data is not seasonally adjusted

During the 12 months ending July 2007 (not seasonally adjusted) Britain's overseas earnings increased by 6% to £16.1 billion and UK residents' expenditure increased by 5% to £35.1 billion, compared with the previous year. As a consequence the balance of tourism trade appears to have worsened in the 12 months ending August 2006, resulting in a deficit of £19.1 billion (compared with a deficit of £18.3 billion in the previous year).

The picture however, worsens when reviewing seasonally adjusted tourism trends in the three months to July 2007 (which at the time of writing is the latest available data). A

general slowdown is evident (as it was for the same period in 2005 and 2006). The number of overseas visitors to the UK fell by 5% to 8.0 million but the number is exactly the same when compared with the three months to August 2005. Overseas earnings fell by 3% to £3.9 billion while the number of UK residents going abroad decreased by 4% to 16.8 million (which is exactly the same as the corresponding period in 2005). The spending of UK residents abroad decreased by 4% to £8.8 billion.

During the year there were as usual mixed results for Britain's hospitality companies. In March Blackstone acquired Hilton Hotels with 2,800 hotels for £10 billion. In May Principal Hotels backed by the private equity group Permira, bought Hayley Conference Centres (17 sites and 1300 rooms) for £358 million. The group is being re-branded as Principal Hayley Hotels and Conference Venues. Hotel chain operators have increased their presence in the UK hotel sector and now control around 260,000 rooms compared with 250,000 rooms in 2004. Middle market hotels are being squeezed between new higher-end budget hotels and lower-priced budget hotels while we are seeing new innovative hotels being opened like Yotel at Gatwick which opened in July. Certainly the budget hotel sector continues to grow and now comprises some 85,700 rooms.

J.D. Wetherspoon in the 50 weeks to mid-July increased like-for-like sales by 5% with overall sales up by nearly 7%. Final profit before tax results for the year to 29 July were £62 million. Some 15 new pubs have been opened this year. Following the ban on smoking in public places where food is served Wetherspoons have found food sales have increased but bar sales have slowed.

Whitbread has been affected by the financial market crises and the group has delayed a possible £600 million bond issue which had been intended to raise finance.

The UK contract catering and food service market is worth around £3.768 billion with over 17,000 outlets (a growth of 2.4%), employing nearly 115,000 people and serving 1.54 billion meals a year according to the British Hospitality Association. The food service market continues to be dominated by four companies: Sodhexo, Compass, Aramark and Elior.

Finally the Caterer and Hotelkeeper magazine launched a campaign in April to "say no to a bed tax". Sir Michael Lyons, who is heading up the inquiry into local government funding reform, is being asked to drop a bed tax from any proposals which emerge.

Conclusions

2007 was a more difficult trading year than 2006, partly because the economy is noticeably slowing down although not as much as had been expected. Interest rates stay relatively high and there is a belief that the Bank of England's next rate move will be downwards, but so far there is no sign of this. Confidence in the UK banking system took a severe knock in September following the Northern Rock banking crisis and raised questions as to whether any other UK bank will need to call on the Bank of England and government to bail it out. There is no question that there is a nervousness not seen for many a year and this is not helped by government continuing to increase its borrowing. On the other hand, Britain has had nearly 10 years of considerable economic stability, of relatively high economic growth, low unemployment, low inflation and rising real

disposable incomes. The economy was inevitably going to cool at some point in the not too distant future. What this means for the hospitality industry is that customers are going to look for value for money coupled with excellent service and businesses will have to work harder to attract and retain customers.