

Hospitality industry forecasts for 2008

In 2007 most hospitality businesses experienced generally good sales growth and improving margins, especially in London. Having said that, never has it been more difficult to make realistic forecasts for the hospitality industry for the year ahead. If interest rates fall by 0.5% and consumers cut their spending in response to tightening credit, and disposable incomes are severely constrained, then 2008 will be a difficult year for the hospitality industry. But we believe that the hospitality industry is reasonably well-placed to secure modest increases in revenues in the face of general economic adversity. The evidence so far suggests a general economic slowdown in the UK and across the world but talk of a UK recession is wide of the mark. Moderate hospitality industry growth is quite possible in 2008 provided hospitality businesses provide good value for money and excellent quality services for increasingly discerning customers.

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Hospitality industry predictions for 2007

This article considers what happened to the UK economy and the hospitality industry during 2007, 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 2008.

Back in December 2006 we said that 2007 could 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 again would 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 were 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 could 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

Generally this forecast was reasonably accurate, given increasing global instabilities, especially oil price rises and a growing credit crisis across the world emanating from America but by no means confined to the USA. What we could not predict was the first run on a British bank since 1866. The Northern Rock crisis and surrounding “credit crunch” reveals how fragile the global financial economy really is, how bankers have taken considerable risks by “lending long” and “borrowing short” in search of higher returns, and how ill-prepared the UK financial regulatory system is to supervise these financial institutions.

The economy last year

Despite the banking and credit crisis, which began in September 2007, flooding, foot and mouth disease, bird flu and blue tongue outbreaks, the UK economy remained in a reasonable condition during 2007. GDP grew by 3% during the year following a growth rate of 2.8% in 2006. The economy slowed down towards the end of the year following five successive increases in interest rates since August 2006. UK GDP is set to fall below trend during 2008, moving from 2.8% in 2006 and 2007 to 2.1% in 2008. Interest rates have probably peaked at 5.75% and may fall to 5.25% or 5% in 2008. There is evidence that higher mortgage rates and average earnings growth below RPI inflation is squeezing personal disposable incomes and this will probably lead to more constrained household consumption but Deloitte are forecasting a 2.6% increase in household real disposable income in 2008 compared with an increase of just 1.1% during 2006 and 2007. If this does indeed happen this will be good news for the hospitality industry.

The UK government budgetary position continues to give cause for concern, raising questions about chronic government over-borrowing. During 2007 overall taxation continued to increase in relatively small steps. These economic conditions have dampened business confidence. In March inflation had reached 3.1% and therefore breached the government’s inflation target of 2.5%. This triggered the first Governor of the Bank of England letter of explanation to the Treasury since the Bank’s monetary policy committee had been established in 1997. In November inflation again breached the inflation target which raised some alarm.

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 doomster commentators are beginning to warn of stagflation (high inflation running side-by-side falling economic growth) although such talk is not helpful. But there is no doubt that small businesses are beginning to face growing liquidity problems and lower interest

rates would undoubtedly help, as would easing of the business tax burdens and regulatory conditions.

The hospitality industry last year

According to the International Passenger Survey UK residents continued to visit destinations abroad during 2007 but a slowdown, the first in many years, can be seen. The total number of UK residents' visits overseas, not seasonally adjusted, stayed static at 54.3 million during the 9 months ending in September 2007 compared with the same period a year earlier. During the 9 months to September 2007, visits by overseas residents to the UK decreased by 1%, from 25.1 million to 24.8 million. Visits from residents of Europe stayed the same at 17.8 million.

During the 9 months ending September 2007, overseas earnings, not seasonally adjusted, increased by 2.5% to £12.3 billion and expenditure by UK residents increased by 4% to £28 billion compared with the same nine month period in 2006. This resulted in a trade deficit to the UK of £15.7 billion.

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
January 2007	2350	2720	999	1290
February 2007	2050	2760	1000	1380
March 2007	2474	2790	1091	1360
April 2007	2931	2860	1291	1390
May 2007	3002	2790	1319	1330
June 2007	2760	2650	1410	1340
July 2007	3240	2630	1795	1370
August 2007	3240	2550	1770	1290
September 2007	2770	2660	1600	1370
Year to date	24817	24410	12275	12120
% change 2006-2007	-1%		+2.5%	

Source: monthly series derived from the International Passenger Survey (IPS) 2007

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
January 2007	4626	5810	2203	2800
February 2007	4233	5790	2316	3150
March 2007	5082	5880	2665	3090
April 2007	5959	5810	2876	2940
May 2007	5529	5740	2737	2970
June 2007	6747	5700	3407	2950
July 2007	6560	5690	3490	2930
August 2007	8320	5750	4520	2940
September 2007	7240	5770	3855	2910

Year to date	54296	51940	28069	26680
% change 2006-2007	0%		+4%	

Source: monthly series derived from the International Passenger Survey (IPS) 2007

In the three months to September 2007 (compared with the previous three months in 2007 - the latest figures available at the time of writing) seasonally adjusted results from the International Passenger Survey show that UK residents' visits abroad stayed broadly the same at 17.2 million, but decreased by 1% when compared with the same three month period in 2006. UK residents' expenditure abroad stayed static at £8.8 billion, seasonally adjusted, in the three months to September 2007 compared with the previous three months.

During the three months to September 2007 overseas residents' visits to the UK (seasonally adjusted) fell by 6% to 7.8 million compared with the previous three months, and decreased by 10% when compared with the three months to September 2006. Overseas earnings decreased by a marginal 0.75% to £4 billion in the three months to September 2007 when compared with the previous three months.

During the first nine months of 2007 UK hotels, especially those in London, had a good year compared with the previous year, with average room rates and consequent revenues increasing strongly. London in particular, may have had static occupancy levels on average but room rates increased by over 10% and revenue per available room by nearly 10%. Historically these are extremely good year-on-year increases and the industry would be hard put to match these increases in 2008 regardless of economic slowdowns. Occupancy levels in Provincial hotels improved by nearly 9%, which compares well with the past four years. Revenue per available room for the eight months ending August 2007 increased by nearly 9% for London hotels, just over 6% for all UK hotels and around 4% for Provincial hotels. The following Table gives detailed estimations provided by TRI Hospitality Consulting.

UK Hotels Performance, 2006-2007 (nine months to September)

	2006	2007	% change 2006-2007
Occupancy (%)			
UK hotels	75.5	75.4	-0.1points
London	83.0	82.6	-0.4points
Provinces	71.45	80.2	+ 8.7points
Room rate (£)			
UK hotels	78.99	86.40	+9.4
London	99.24	109.51	+10.3
Provinces	69.02	71.53	+3.6
Revenue per available room (£)			
UK hotels	60.97	65.13	+6.8
London	82.65	90.64	+9.7
Provinces	49.37	51.20	+3.7
Total revenue per available room (£)*			
UK hotels	24,512	26,000	+6.1
London	28,292	30,760	+8.7
Provinces	22,529	23,410	+3.9

* eight months to August

Source: TRI Hospitality Consulting, HotStats August and September 2007, based on a sample of up to 530 hotels, mostly 3 and 4-star hotels, averaging 166 bedrooms.

Forecasts

2008 will be a year of slower economic growth, falling from 3% in 2007 to 2% in 2008 according to Deloitte, and consequently somewhat slower growth for the hospitality industry outside of London. But the Deloitte growth forecast assumes interest rates will fall by 0.75% to 5%, whereas we believe, because of growing inflationary pressures, the Bank of England will reduce interest rates to no more than 5.25% by the year end. In the light of tightening financial constraints we nevertheless forecast a relatively modest overall hospitality growth provided interest rates fall by 0.5% by the third quarter and consumer real disposable incomes do not fall too drastically. This would mean:

- ◆ A relatively small 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 perceived value for money, good accommodation, good cuisine and excellent service
- ◆ Acquisitions, especially by venture capital companies, will be few and far between as attitudes to risk harden, although a mega-merger or buy-out cannot be ruled out as bargains will be available. 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 more moderate pace (and not at the rate experienced in recent years) primarily in businesses with a considerable turnover and profits track record or potential
- ◆ Business and property values will be static across the UK but may fall by 2 to 5% outside London; this in itself offers business opportunities
- ◆ Lenders will be very cautious and more risk averse during 2008 and will continue to lend only on projects which can demonstrate clearly 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, keeping a level head and establishing a very clear market positioning

The following table summarises the key economic indicators and forecasts. This year we use the Deloitte Economic Review, Fourth Quarter 2007 in the absence at the time of writing of a fourth quarter economic survey of the British Chambers of Commerce.

UK Economy Key forecasts - % change over previous year

	2005	2006	2007 estimate	2008 forecast	2009 forecast
Demand					
GDP	1.8	2.8	3.0	2.0	2.5
Consumer Spending	1.5	1.9	3.0	2.0	2.3
Government Consumption	2.7	2.4	1.7	2.0	2.0
Fixed Investment	1.5	8.0	5.5	3.5	4.0
Stockbuilding (% of GDP)	0.3	0.3	0.2	0.1	0.1
Domestic Demand	1.6	3.2	3.3	2.3	2.6
Exports ¹	8.2	11.7	-5.7	1.3	2.5
Imports ¹	7.1	11.7	-3.8	2.3	2.7
Output and Profits					
Manufacturing Output	-1.2	1.4	1.0	0.5	1.5
Services Output	3.0	3.6	3.5	2.5	3.0
Company Profits ² (nominal)	1.7	4.0	10.0	1.0	4.0
Labour market					
Unemployment (%)	2.9	2.9	2.7	2.6	2.7
Employment (%)	1.3	0.8	0.5	0.8	0.6
Productivity (output per worker)	1.0	2.1	2.5	1.2	2.0
Income and Saving					
Average earnings ³	4.0	4.1	3.8	4.1	4.3
Real Disposable Income	2.9	1.1	1.1	2.6	2.7
Saving Ratio	5.5	5.0	3.0	3.5	3.9
Prices					
RPI	2.8	3.2	4.3	2.8	2.3
RPIX Retail Prices	2.2	3.0	3.2	2.4	2.1
Nationwide House Prices	3.3	9.3	8.3	0.7	0.0
Balance of Payments and Public Finances					
Current Account (£billion)	-30.5	-47.8	-48.0	-53.0	-45.0
% of GDP	-2.5	-3.7	-3.5	-3.7	-3.0
Public sector net borrowing (£billion, financial year) ⁴	38.2	30.2	35.0	31.0	35.0
PSNB as % of GDP	3.1	2.3	2.6	2.1	2.4

¹ includes VAT fraud distortion

² gross trading profits of non-financial corporations

³ including bonuses

⁴ a positive PSNB figure indicates a budgetary deficit, negative PSNB indicates a surplus

Source: Deloitte Economic Review, Fourth Quarter 2007, pages 12-13

The forecasters are predicting a marked slowdown in GDP growth after relatively strong growth in recent years. GDP growth is expected to slow from 3% in 2007 to 2% during 2008 (although this is the mean point of a range 1.9 to 2.1 and historically 2% is still a respectable growth rate.). Consumer spending is also forecast to slow from 3% in 2007 to 2% in 2008 but picking up slightly to 2.3% in 2009. Consumer growth has been sustaining the UK economy for many years so even this spending slowdown is likely to be felt in some quarters but (and here we stick our necks out) we believe that the slowdown in growth of hospitality demand will not be so acute as that for other consumer spending (notably in the retail shops). 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.

Fixed investment will slow down in 2008 as will stock building as holding stocks costs money. Service sector output has in recent years been one of the engines of UK economic growth but here again during 2008 output growth is forecast to slow down to 2.5% (from 3.6% in 2006 and 3.5% in 2007). Manufacturing output growth will slow to a virtual standstill in 2008 but as yet a recession in the manufacturing sector is not forecast..

Unemployment growth is forecast to fall slightly in 2008 according to Deloitte although it is really too close to call. Average earnings growth will slow down a fraction during 2008 but the annual growth in real disposable incomes could increase from 1.1% in 2007 to 2.6%. Should this happen it will be very welcome news indeed for the hospitality industry. The *bête noir* of the UK economy – productivity growth (defined as output per worker) is likely to halve during 2008 to 1.2% although this is not as low as productivity growth in 2002 (1%) and 2005 (again 1%). Deloitte are forecasting the retail prices index (the commonly accepted definition of price inflation) will fall from 4.3% in 2007 to 2.8% in 2007 although the evidence still points towards higher inflation, indeed some commentators are suggesting that stagflation is just round the corner, that is, stagnating output at a time of rising prices. Stagflation is a troublesome beast to eliminate in any economy and we believe that such talk is best-avoided at this time; we have no need in the hospitality industry for commentators to talk up the chances of recession.

Finally, the public sector net borrowing requirement deficit is likely to be trimmed in 2008 from £35 billion to £31 billion as the government cuts public spending, although several commentators believe the government will be forced to increase its borrowing because rising taxes during a marked economic slowdown could be dangerous.

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 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
Average Room Rate (£)								
UK	78.84	+6.7	80.65	+2.3	85.17	+5.6	89.89	+5.5
London	101.91	+0.9	107.96	+5.9	118.55	+9.8	128.35	+8.3
Provinces	64.00	+4.9	66.14	+3.3	68.36	+3.4	71.16	+4.1
Occupancy (%)								
UK	72.44	-1.0	75.29	+3.9	75.69	+0.5	76.19	+0.7
London	74.83	-1.8	81.13	+8.4	81.72	+0.7	82.43	+0.9
Provinces	70.91	-0.4	71.25	+0.5	71.54	+0.4	71.94	+0.6
Revenue per available room (£)								
UK	57.11	+5.6	60.72	+6.3	64.46	+6.2	68.49	+6.2

London	76.26	-0.9	87.59	+14.9	96.88	+10.6	105.80	+9.2
Provinces	45.38	+4.4	47.12	+3.8	48.91	+3.8	51.19	+4.7

* forecast

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

Continuing strong corporate travel demand and strong volumes of leisure travel have been important elements in the PricewaterhouseCoopers estimates for 2007, especially for London. PricewaterhouseCoopers says that for 2008 the global credit squeeze will mean more cautious investors but strong corporate demand, which allowed many hotels (particularly in London and other major cities) to increase room rates between 2003 and 2007, should enable room rates to be increased during 2008, although the economic constraints on the financial services industry may have impacts on the hospitality industry. High hotel performance is driving construction and conversions of rooms, with some 11,300 rooms currently under development but PricewaterhouseCoopers says that there are “few supply concerns as barriers to entry remain high.”

Conclusions

2008 shows every sign of being a difficult year, when economic growth will slow and a continuing credit crunch will make both investors and consumers more cautious. Consumers will suffer increased credit charges as financial institutions attempt to improve profit margins and attempt to recover from, as yet undisclosed liabilities in mortgage transactions. But all is not gloom and doom, and while various commentators are prophesying very difficult economic conditions bordering on recession, we believe that the hospitality industry should hold its nerve, provide excellent value for money and be alive to the needs of very discerning customers. We forecast a modest increase in hospitality demand during 2008 and the growth of room rates and profitability should continue to be reasonable while ensuring a necessary liquidity.