Practice Article

Impact of the global recession on the hospitality and tourism industry

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Collated by Peter Jones

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In June 2009 an Expert Panel of senior managers from across different sectors of the hospitality and tourism industry were asked for their thoughts on the global recession. Panel members were:

- *David Herbert* – a co-owner of Phoenix Food & Beverage Ltd who will open a new fine-dining restaurant and destination bar and operate the food & beverage services at The Montcalm in London when it re-opens this August as a five-star hotel. He is a former Director of London Fine Dining Group where he was responsible for the operations, marketing and development of six fine-dining brands including Aubergine, Zafferano and Ken Lo's Memories of China.
- *Simon Hudspeth* – an independent consultant specialising in property valuation, hotel development and asset management. As a former Director of two leading firms – Christie & Co and HVS International – he has conducted, managed and directed thousands of hotel consultancy, valuation and advisory assignments throughout the United Kingdom, Europe, Asia, the Middle East Africa, Asia and Australia. His strong operational experience includes 15 hotel openings.
- *Simon Soni* – Head of Inflight Services for Virgin Atlantic. Before taking up this position in early 2009 he had worked in a variety of senior management positions for British Airways.
- *Chris Tarry* – an aviation expert and investment analyst. In December 2002 he established CTAIRA to provide research, consulting services and advice on and to the transport and aviation industries in the areas of strategy and strategic development; industry and market forecasting; and performance measurement and evaluation. He is, and has been, an advisor to government departments and Parliament on aviation issues.
- *Tim Walton* – Vice President of Development for Marriott International, covering the areas of UK, Ireland and the Mediterranean. He's served a total of seven years with Marriott and was previously with Le Meridien Hotels & Resorts. He is a graduate of the University of Surrey and has also held positions on property in hotels and in hotel consultancy.

Our Expert Panel were asked three broad questions related to the effect of the recession, firms' responses to it and its longer-term impacts. Here are their thoughts:

1. *In what ways is the global recession affecting your sector of industry?*

David Herbert: The restaurant industry has become more polarised during the recession, with both the fast-food/casual dining and the fine-dining ends being better off than the mid-market 'popular' dining restaurants, where the market is more saturated and whose target audience has become more careful with their discretionary spend, and more likely to dine at home. The wealthy are more recession-proof than most and tend to continue to dine out, albeit less often. Those who tend to use fast-food/casual restaurants will most likely continue to do so as the cost is not really a big consideration. Within the London 'fine-dining' sector of the industry, there appears to be a clear divide among those businesses that continue to attract high-spending clientele and are to a large extent unaffected by the recession, and those businesses that, despite lowering their prices and spending marketing funds on promotions, seem to be finding great difficulty in survival.

Simon Soni: In the airline sector we are seeing a significant drop in passenger volume and also significant pressure on yields. This demand impact is coupled with upward pressure on unit costs – specifically in our case with regard to flight catering – food costs. As the airline drives volume through discounting, to retain market share, the cost charged by contracted suppliers remains high.

Chris Tarry: The rate of change of GDP as well as the level of GDP per capita remain the main drivers of fundamental traffic growth for the airline industry, which is now in the third phase of a 'downturn', which started in late 2007/early 2008 with the rapid rise in the oil price. However until the middle of 2008 airlines were able to recover a meaningful portion of these additional costs as demand was still relatively favourable. Fuel began to diminish as an issue in the third quarter of 2008 but at the same time traffic began to decline as the industry entered the second phase of the downturn; at the current time international traffic is close to the levels last seen in 2004. In an industry where cash is king and the consequences of falling traffic on cash inflows is immediate airline managements have responded as always in such circumstances by cutting fares to attract traffic and generate some cash. However in a declining market what usually happens in such circumstances is that there are a number of redistribution effects that are accompanied by ever lower fares and an event that was initially cyclical ends up with a number of structural outcomes. Although we have seen a number of capacity reductions, the actions of competitors has negated this – in particular while the 'end to end' airlines between Europe and Asia have made capacity reductions, the growth in seats and frequencies by airlines in the Gulf between Europe and the Gulf and the Gulf and Asia has resulted in fares falling in many cases by some 50 per cent (in particular those for business class travellers), whether flying direct, or with an intermediate stop in the Gulf. This is clearly positive for travellers but potentially catastrophic for some airlines. The role of the internet in airline marketing and sales means also that there is almost a perfect market for air travel in terms of pricing information – despite the continuing role of covert corporate deals.

David Herbert: Nobody can give a reasoned explanation as to the required ingredients for success during this recession. Certainly in the restaurant sector location helps, as does reputation and perhaps Michelin-status, but for some reason the most severely affected businesses tend to be the French fine-dining restaurants. This is likely to be due to the fact that many of these establishments rely heavily upon corporate entertainment, especially for the success of their private dining rooms. More accessible cuisines, such as Italian, Chinese and Indian appear to have a stronger following from the private or leisure customer as they don't seem to carry the stigma of being 'expensive' as does French cuisine; even if this is not entirely true. Certainly this is important for corporates who are constantly reminded to take care where they are seen to be entertaining at the moment.

Simon Hudspeth: From a hotel development perspective, there has been a sharp decline in general trading performance across most markets. This has led to fewer transactions and consequently less work for all advisors. There continues to be huge uncertainty in the finance sector with very little lending. What lending there is at very high margins and fees, low LTVs – this means that investors and developers have to find more equity, and their weighted average cost of capital (WACC) goes up. Investors and lenders are also pricing greater risk into return expectations and capital rates thereby lowering the value of hotel properties. As a result there are very few transactions due to the large gap between value perceptions of buyers (who are looking for 'bargains') and sellers (who don't want to sell cheap). One further effect is that there have been redundancies in the real estate advisory sector, in hotel companies and in investment groups and banks.

Tim Walton: The global recession has resulted in a marked downturn in levels of demand across our hotel estate. This downturn has occurred on a broadly global basis, though North America and Europe have probably been the hardest hit. In the United Kingdom, trade remains difficult – particularly for hotels in the five-star sector that are highly reliant on demand from the financial services sector. Although there has been some recent pick-up in leisure related demand (largely as a result of the strengthening of the Euro and the US$ against sterling), corporate related demand (both groups and individuals) remains difficult. From a development perspective, conditions remain challenging. Although there is some evidence of falling construction costs, the investment fundamentals have been adversely affected by the weak market situation. In addition, the lending market remains illiquid and there is a dearth of available finance for hotel construction projects at this time.

2. *What action are you and companies in your sector taking in response to these challenges?*

David Herbert: Many restaurants are introducing lower-priced menus and special offers, often advertising these online with TopTable in an attempt to win customers, although they find that these customers are not their normal demographic and tend to result in an overall lower spend. The danger here is that great care must be taken to ensure the food margins are sufficient without the support of the other menu items or liquor spend. Often restaurants fall into the trap of introducing an attractively priced menu only to find that it becomes more popular than main menu and returns a poor margin, leading to a decline in their overall profitability.

Sensible companies are reviewing their costs; some are extending their creditor days as far as they can, although suppliers are also seeking to achieve the opposite. Restaurants, particularly within the fine-dining sector are notoriously poor at managing labour costs, this has now become a focus, staff contracts are being reviewed with the agenda being to migrate the majority of staff to 'zero hours' agreements and for pay to be calculated by the shift rather than the hour. This allows businesses greater flexibility to staff according to demand, also reducing the cost, as shift lengths will vary, usually to the advantage of the business.

Simon Soni: Airlines are making reductions in capacity to reduce the number of empty seats, undertaking pricing reviews and reductions, and introducing targeted cost reductions coupled with internal cost reviews such as headcount and business process reviews.

Chris Tarry: Just like any other industry the rules of economics apply to airlines too. In this respect, even in more normal times, there is too much capacity relative to demand, at the price level required for an adequate return to be produced. Generalisations are always dangerous and there have always been a small number of airlines that are attractive in terms of returns. On current forecasts of near term deliveries industry capacity is predicted to increase by some 17 per cent over the next

3 years – an outcome, which will have damaging consequences for an industry, which already has more capacity than it needs. Although most, if not all, airlines have announced cost reduction programmes the reality is that although these are an important reaction, against the background of the fall in revenue combined with the rise in the fuel cost since the start of 2009 as the third phase started, they are little more than cosmetic – airlines cannot cut costs sufficiently rapidly, and in most cases cutting costs involves spending cash and airlines have real pressures in this area. We have already seen a number of airlines seeking and receiving new money whether from governments or from the equity markets to try to strengthen their balance sheets but there is a fine line between a capital raising issue that is viewed as supporting a good recovery story and one that is viewed as a 'rescue rights' issue or 'emergency fundraising'. In terms of cutting cost although actions may result in some headlines – the important thing is that any actions taken must not compromise the ability of the business to recover.

Simon Hudspeth: Hotel companies are making cost savings where possible, including staff redundancies. With regards hotel development there is no growth and no new activities. Consulting and advisory forms are engaged in a frantic search (what I would describe as ambulance chasing) for advisory and agency work around distressed property. This includes acting as Official Receivers, interim management or administrators; advising on 'bad loan books'; and managing forced sales through defaults, breaches of loan covenants or failure to meet lease or rent payments. The focus is on chasing those in distress or likely to become distressed, whether they be owners, operators, lenders, funders or landlords. Much of this work is being carried out on a performance related fee basis.

David Herbert: As far as development in the restaurant sector is concerned, cash-rich companies are taking advantage of the recession by acquiring new sites, often at no premium and with a rent-free period or by investing in refurbishment of current sites although materials and contractors are currently able to be found at lower prices. Some companies are negotiating downward rent reviews with their landlords in order to reduce overheads.

Tim Walton: The silver lining for branded operators like Marriott is that at a time like this, the brands, systems, global sales, marketing and distribution systems help our hotels to increase the RevPAR spread over the competitive market. Therefore, although nobody is insulated from the downturn, our brands and the tools behind them help to improve our market share. We have also been looking hard at unit level costs and, through active cost management, have strived to protect operating margins. With conditions remaining unfavourable for new hotel development, Marriott and certain of our competitors are seeking out opportunities to convert unbranded hotel stock. This remains a challenge in Europe where much of the hotel inventory is unbrandable (due to small bedroom sizes, non compliance with fire and life safety standards and so on), but some opportunities do exist.

3. *What do you predict will be the long-term impacts of this recession on your sector of the industry?*

David Herbert: Depending upon the recovery time from this recession, there may ultimately be fewer players in the fine-dining marketplace all competing for their share of a reducing market. Those businesses that are able to maintain high standards of food quality and service and provide value for money are more likely to survive, particularly if they are not dependent upon corporate entertainment. There also appears to be a trend where restaurants with a long-standing reputation and largely non-faddish interiors are still enjoying a good trade. London's economy, like those of most other capital cities will bounce back faster than other UK towns and cities and its restaurants will most likely reflect this too.

Simon Soni: I think there will be a reduction in the number of airlines and probably supply companies through some significant company failures. Onboard there will be a reduction in product offering – which will then rebuild over the coming years.

Chris Tarry: Although consolidation is seen as inevitable such actions will not be a panacea to the problems of the industry and indeed acquisition in the current circumstances is likely to be a more risky activity than a year ago – near term the main issue for all airlines is cash and how to reduce the outflows and seek new sources. The financial consequences of even more capacity entering the industry is a real danger as it has the potential to prevent the industry from generating the returns it needs for airlines to be attractive to the providers of capital however there are significant 'stakeholder' issues that are likely to prevent the necessary 60 per cent reduction in the delivery schedule of narrow-bodied aircraft by 2012. For the future there is also a need to be clearer in distinguishing between those airlines that will be able to do little more than 'ride' the economic cycle and those that have structural opportunities – even now the Chinese domestic market is growing at c 20 per cent driven by GDP growth of 6 per cent in the first quarter of 2009. Although attention has often focused on the problems of the legacy carriers, there is no guarantee of relative success or survival for the so-called low cost carriers and in some cases they are more vulnerable given the high seat load factors that they require, their relative inability to reduce costs and the consequences of fare reductions increasing the break even load factor.

Although much of what is currently affecting the airline industry has been seen before – it is the combination of falling traffic, falling average fares and at the same time rising fuel that is new. Although the failure rate of airlines in 2009 to date has been low we fear that the second half and particularly the final quarter of 2009 will be particularly difficult for the industry and a number of airlines in particular – there comes a point when sustaining the unsustainable is no longer possible.

Tim Walton: Although it is not clear when demand will pick-up, at some point it certainly will. At that point, trading margins will be strong due to the extensive cost cutting and efficiency building that has occurred over the recent term. For those hotel companies that are thinly capitalised or that are encumbered by weak brands and sub-standard product, there may be no future and, as a consequence, further consolidation is likely to occur. For hotel companies such as Marriott with a strong capital structure, robust brands and a sound operating model, the long-term potential remains positive.

Simon Hudspeth: In my view, the whole approach to financing hotel development will be based in the future on more responsible lending. There will be less hotel development and construction, as well as lower land and property values for the next 2–4 years. The transaction market for 2009–2010, that is sales and purchase of hotel properties, will be sluggish. In 2010–2012 we are likely to see inflation, which will help speed recovery in trade, and hence values. Even so, hotel asset values will remain below their 2007 peak until at least 2014.