RSM Tenon
Connected for Success

Competing in the new normal

The 2013 outlook for the UK's hospitality and leisure sector

A quarterly benchmark from RSM Tenon

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PART 1: The outlook for 2013

The UK's hospitality and leisure sector sees tough trading ahead in 2013, but its leaders are now well attuned to that state of mind.

- 46% are optimistic about the year ahead, against 19% who are pessimistic
- Confidence on revenues is greater than on profitability
- For many businesses, economic uncertainty and volatility is now the "new normal", and provides new opportunities for those strong enough to exploit them
- Looking back, 34% felt 2012 was worse than expected, with 26% thinking it was better than expected

For the UK's hospitality and leisure sector, the start of 2013 has been chillier than hoped in several respects. Not only has snow disrupted trading across the UK, but key economic forecasters now expect GDP growth to be smaller than hoped. Most recently, the International Monetary Fund (IMF) has cut the forecast for the UK economy to just 1% for 2013, slightly down from its late 2012 forecast of 1.1%. For the hospitality and leisure sector, where growth often closely tracks overall GDP growth, the news is about as welcome as a cold Sunday lunch. Just 23% of those polled think 2013 will be a turning point for the economy, while nearly twice as many (37%) disagree.

But such conditions are hardly new for the sector's veterans. For many, economic uncertainty and volatility is now simply the "new normal", with management teams focussed on how to continue dealing with this. As a result, despite the lack of an obvious upcoming stimulus in the year ahead, such as last year's Olympic Games, nearly half (46%) of those surveyed for this study remain confident about the overall outlook. A further 35% are neither optimistic nor pessimistic, although a significant minority of nearly one in five (19%) are pessimistic.

How confident are you about the overall outlook for 2013, and specifically about hitting your profit and revenue figures?

How did your business perform overall during 2012?

* *May not total 100%, as respondents could select more than one option*

> "The amount of distress in the marketplace throws up opportunities, and that's why we're picking up management contracts, because owners need the best returns on their assets, and they need the best people running them to achieve that."

This is not to suggest that conditions are expected to be easy. Nevertheless, the best-run businesses will continue to find opportunity. "It's quite a positive challenge to run a business in difficult times," notes **Jamie Lamb, CFO of Kew Green,** a hotel management company, which runs about 30 hotels under franchise from brands such as Intercontinental and Marriott. "The amount of distress in the marketplace throws up opportunities, and that's why we're picking up management contracts, because owners need the best returns on their assets, and they need the best people running them to achieve that."

Richard Spanner, a partner in Prestige Hotel Management, a hotel management and development company that launched in early 2012 and is now developing a range of sites across Scotland and elsewhere in the UK, says these kinds of conditions have specifically shaped his firm's prospects. "We are very confident for 2013, and bringing new products to the market gives you an edge when obviously many competitors are looking tired from a lack of investment," he explains. Furthermore, Prestige has picked up two management contracts on the request of banks that have had to move in after the prior firms faltered, highlighting the opportunities that exist for those prepared to rethink how they compete in straitened times.

Eric Brown, general manager of the Best Western Scores Hotel in Scotland's St Andrews, overlooking the 1st tee and 18th green of the famous Old Course, has noticed a similar phenomenon. While no local rivals have gone under, many are either losing money, or struggling to invest under tough debt loads. As a result, he's been able to lead wide-ranging upgrades and expansions on his hotel and use that to outperform the market on revenue per available room (RevPAR), even though profits remain scarce. Across the wider market, this appears to be the norm for many businesses polled. Although nearly six in ten (59%) of firms are confident about revenues for 2013, only half (50%) feel the same about profit levels. This in turn will continue to drive several underlying trends in the market, as this report outlines.

Nevertheless, the core underlying conditions remain tough. **Rob Hayes, the owner of Banjos,** a sandwich business operating in the West Midlands, with over 30 staff and 18 delivery vans, sums up the challenges. "We depend on our customers having money, and certainly the feedback we're getting at the moment is that while people may be at work, they've either had their hours cut, or their pay rise cut, so while unemployment has remained low, many people out there are actually earning less than they were," he says. But while this remains hugely difficult, there is also a twist in the tale: for those companies strong enough to remain afloat during these times, they're gaining an edge on weaker rivals. "The competition is somewhat diminished, as many smaller rivals have gone bust," as Mr Hayes puts it.

"If you have an unbranded hotel, you are at risk of declining revenues, because the world is really brand focussed now, in a number of ways, from how people shop and eat to how they choose accommodation"

Refreshing products and services, followed by cost cutting and introducing new offerings will be at the core of the sector's growth plans.

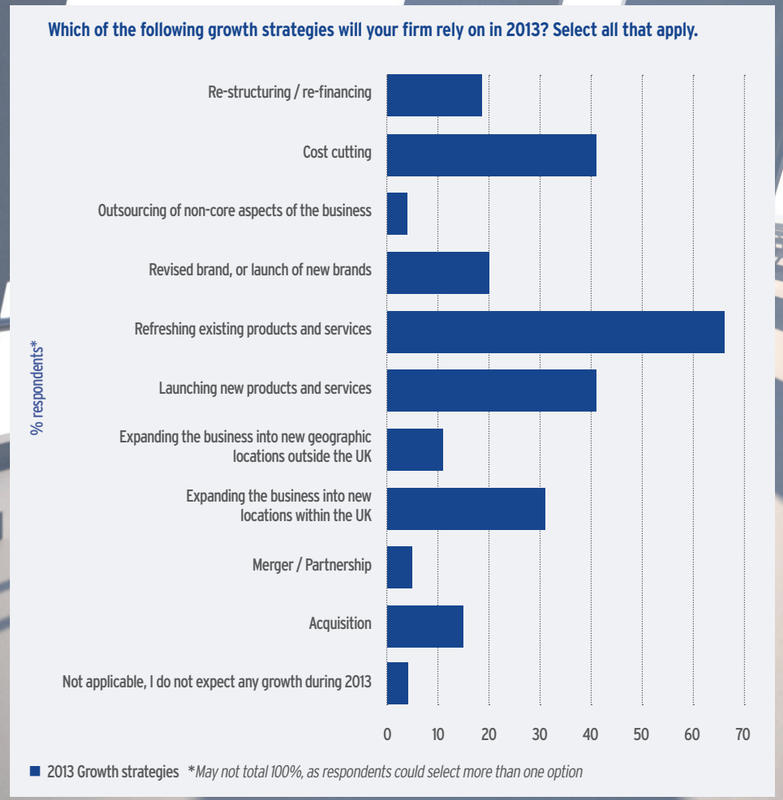
- 66% will focus on refreshing existing products and services as their primary growth strategy
- Tough conditions are likely to continue a move towards brands and niches such as "affordable quality"

Rewind two years and it was hard to find any hospitality and leisure business that wasn't solely focussed on shedding costs as far as possible, in the face of brutal market conditions. But while cost cutting remains high on the agenda, the industry is clearly more focussed on investing in refreshing existing offerings in order to ensure they remain competitive in the market. Overall, two-thirds (66%) of those polled say that this will be their core growth strategy, well ahead of cost cutting and the launching of new products and services (both 41%).

At the Best Western Scores Hotel, Mr Brown provides a useful example of this. Despite market pressures, he is leading wide-ranging investments into the hotel, in order to both refresh the look and also open up new revenue opportunities. This has ranged from adding 20% capacity in the form of six new junior suites, refurbishment and upgrades of existing rooms, as well as landscaping the rear of the hotel to allow for a marquee for up to 100 people – an especially prime opportunity for corporate hospitality relating to any golf events. "We're doing this ahead of the curve, and using this to punch above our weight and bolster our ranking on TripAdvisor," he explains.

A further trend that is evident within the sector is an ongoing flight towards quality and the protection of a stronger brand, especially for hoteliers. Kew Green's Mr Lamb puts it bluntly: "If you have an unbranded hotel, you are at risk of declining revenues, because the world is really brand focussed now, in a number of ways, from how people shop and eat to how they choose accommodation,". Prestige's Mr Spanner agrees, adding that this is also a crucial aspect for anyone seeking finance: "The banks do place a lot of value against having a global brand, where marketing spend is spread across hundreds of hotels, instead of trying to push a single unit or a small group. If it's an unbranded hotel outside of a city centre, you've got to have something absolutely remarkable for banks to consider having a look."

Within the restaurant sector, this push towards branded offerings is also seen in the success of various higher-end chains, such as Patisserie Valerie, which has increased the number of its outlets across the UK by over 50% over the past two years, especially outside of its traditional London base. The firm's "affordable luxury" positioning is a key aspect of its success, showing how well this fits into the market. Elsewhere, the continued strength of a range of quality-led dining and "fast casual" dining options also highlights this trend across the country. One prominent example is the continued expansion of Mexican street food chain Barburrito, which is putting £3.25m into a nationwide rollout plan.



Cut VAT, not corporation tax

Nearly any business owner would instinctively welcome a lower headline corporation tax rate on their business. But within the hospitality and leisure sector, the real sore point often lies with the UK's high indirect taxes – and especially the VAT rate. "If you look at a lot of European countries, tourism and hospitality attracts a much lower rate of VAT," says Kew Green's CFO Jamie Lamb. "We're at 20%, but the only help the government is giving to companies is lowering the corporation tax rates, but most hotel businesses hardly make any money, so that's no real help at all."

This is a commonly held view within the sector. "We know the government is still trying to balance its books, but you pray it doesn't touch VAT," says **Prestige Hotel Management's Richard Spanner.** Furthermore, there is strong concern about the shift to pension auto-enrolment, along with other shifting rates: "Increases in payroll taxes, national insurance, VAT, business rates, and lumping on bureaucracy like auto enrolment and CRC levies is just crushing the industry really," says Mr Lamb. Already, 43% of respondents say that tougher labour rules, such as the pension auto-enrolment rules, have prompted their firms to rethink their hiring strategy, often switching to increased use of part-time staff.

Nevertheless, trade bodies such as the British Hospitality Association (BHA) do see some action coming through. "I am pleased to say that the government is listening. That said, I would like to see some more action too," says **chief executive Ufi Ibrahim.** She notes that the Campaign for Reduced Tourism VAT, aimed at reducing the rate to 5% and led by the BHA, is now gathering pace after launching with the backing of some 400 hospitality businesses in December 2012. "There is more to do, but I have high hopes that this year the Government will finally recognise how important our sector is as a growth engine for the UK economy," she says, highlighting a response from the Chancellor on tax relief for refurbishing, which has increased from £25,000 to £250,000 within the Annual Investment Allowance. Furthermore, for many in the sector, there's also a clear interest in gaining some personal relief on any efforts to bolster job creation. A strong majority (62%) agreed with the notion that corporate tax efforts are well and good, but greater tax relief for entrepreneurs is what is really needed.

"The Eurozone hasn't collapsed, the Americans may sort out their fiscal cliff, so the biggest risk may be domestic, that the UK economy will fail to lift enough to give a decent year's trading,"

Weak demand and rising input costs are the sector's primary challenges for 2013.

- 78% cite weak demand as the biggest challenge to 2013, followed by rising input costs (59%)
- Given globalised exposure on many costs, some companies are rethinking how they structure their deals and partnerships, to ensure greater resilience
- 76% expect costs of key inputs or suppliers to rise, while 60% say they will be forced to push up their own prices

If there has been any silver lining to the UK's struggle in and out of recession over the past five years, it has been to help dampen some of the more typical worries for hospitality and leisure businesses. For example, despite employment remaining relatively strong at an aggregate level, labour costs are far less of a worry than they historically have been, with only about one-quarter (26%) citing this as a key challenge. And whereas access to finance was under huge pressure not so long ago, just 21% consider this a major challenge.

Instead, it is the sustained issue of weak consumer demand, cited by nearly eight in ten respondents (78%), which tops the list of worries. "The Eurozone hasn't collapsed, the Americans may sort out their fiscal cliff, so the biggest risk may be domestic, that the UK economy will fail to lift enough to give a decent year's trading," explains **Ufi Ibrahim, chief executive of the British Hospitality Association (BHA).** Others agree: "The market is very, very difficult indeed. The feedback we get from our customers is that there's nothing particularly positive out there," says Banjos' Mr Hayes. "Our customers are struggling with a lack of resources which makes it difficult to put prices up, but we're getting constant price increases from our suppliers," he notes.

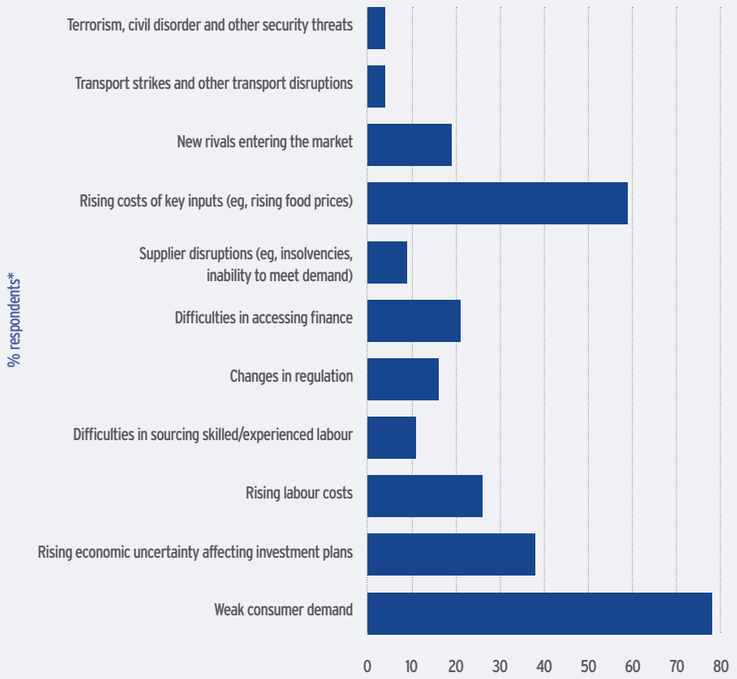
“The poor grain harvest in America and Russia last year pushed up the price of our bread by 18%. But I cannot increase my sandwich prices by 18%”

This worry over rising input costs is easily the second-highest concern overall, cited by about six in ten respondents (59%). Overall, about three-quarters (76%) expect key inputs and suppliers to bump up on costs this year, while just 3% hope for a cut in prices. Mr Hayes notes that while the UK’s headline consumer inflation may not seem high, his business is seeing significant double-digit increases in costs on key inputs, whether bread, meats or otherwise, often affected by events far beyond anyone’s control. ‘‘The poor grain harvest in America and Russia last year pushed up the price of our bread by 18%. But I cannot increase my sandwich prices by 18%,’’ as he puts it. But with limited scope to pare back costs, prices across the sector are nonetheless expected to climb. Overall, 60% of those polled believe they will have no choice but to push prices up.

This difficult, and increasingly globalised, cost environment is progressively driving companies to get more creative about how they operate and structure their businesses. Prestige Hotel Management is one example. It is rethinking all aspects of its business, from how it sources finance through to how it structures its deals and partnerships on any site developments. ‘‘We’ve been very inventive about how we’ve raised money, using all sorts of models, and very strongly based on partnerships,’’ says Mr Spanner. This may involve a lower equity position in new deals, but also ensures a structure where construction partners are incentivised to ensure good cost control, given that they’re cut into the final deal too. At Kew Green, Mr Lamb notes that his company has stopped outsourcing its refurbishment, but has instead bought this in-house. ‘‘We now have our own team and it cuts out the middle man, so we’ve been able to increase our coverage in terms of the money we do have to spend and how far it will go,’’ he says.

Indeed, all these actions are aimed at ensuring that businesses are far more resilient than before, and especially in comparison to more highly-leveraged rivals elsewhere in the market. ‘‘It’s a new era where everyone is getting creative about doing more with less resources,’’ notes Ms Ibrahim.

Which of the following challenges is your business most concerned about for 2013? Select up to three.



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PART 2: A snapshot of the first quarter

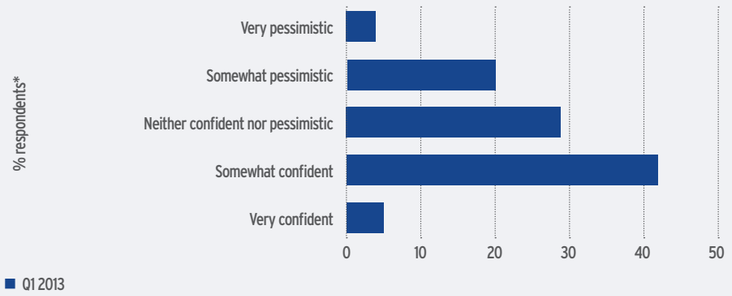
- Although few are "very" confident about Q1, nearly half (47%) believe they will hit revenues during the period
- Investment for the quarter is focussed on sales and marketing (58%), followed by refurbishment (50%)
- Looking back, 65% hit their revenue goals during the Christmas period, while 66% made profit targets

Confidence about revenues, less so about profits

Despite a sizeable minority of companies feeling that 2012 didn't go quite as well as hoped, there remains reasonably positive sentiment about the first quarter – and two-thirds of those polled hit their numbers for the crucial fourth quarter Christmas period. As a result, despite the adverse weather and economic downgrades, there is nonetheless a fairly cheery tone on the outlook for the first quarter. Overall, 47% believe they will hit their revenue targets for the quarter, the highest such sentiment since the second quarter of 2012, just prior to the Olympics. "The weather could have an impact on our industry this time of the year, but our members are used to this and will have prepared for it," notes the BHA's Ufi Ibrahim.

By contrast, though, while the profit outlook is not bad for the quarter, with 45% expecting to hit their goals, it is lower than it has been since the start of 2012. "Costs are a big issue, particularly the fixed costs and business taxes that apply," notes Ms Ibrahim. "Generating demand is also a real struggle for many hospitality and tourism businesses – particularly in the quieter periods."

How confident are you about hitting your revenue targets during the next quarter of this year?



Which of the following do you believe your firm would materially benefit from during the next quarter? And which is it actively investing in? What firms would benefit from Vs what they're investing in

May not total 100%, as respondents could select more than one option

Maintaining investment

Nevertheless, in terms of investment, the industry is prioritising two specific areas for the quarter ahead: sales and marketing efforts, to help drum up demand, and refurbishment, to help maintain fresh offerings for clients. "You need to keep investing in hotel products," says Kew Green's Jamie Lamb. "It's one of those businesses that when you stop investing, as many have had to do over the recession, it becomes increasingly obvious, and if you're struggling financially it just gets worse and worse."

In contrast to this, investment in people is getting much shorter shrift during this quarter. The proportion of firms investing in staff training is sharply down from last quarter, at an absolute level of 18% lower than the quarter prior. Similarly, there is little appetite to add to the overall staff count, not least given concerns over shifts in labour laws: just 16% of those polled say they will invest in additional people during this quarter. Over four in ten (42%) say that the cost of employment, such as national insurance, is a material barrier that is slowing the rate of hiring.

About this report

During December 2012 and January 2013, in partnership with Longitude Research, RSM Tenon surveyed 100 hospitality and leisure businesses from across the UK.

Respondents represented all sectors, with 43% representing hotels, spas and other lodgings, and 30% representing restaurants, bars, pubs and clubs. All respondents were from management: founders, owners, CEOs and managing directors accounted for 47% of the sample; other directors, CFOs, and board members accounted for a further 41%. The majority (55%) of firms polled had annual turnovers of up to £10m, while 19% had turnover of £50m or more. Businesses were evenly represented from across the UK.

To complement these survey results, we also conducted in-depth interviews with several experts and business owners, as well as additional desk research.

We are very grateful to all participants who gave their time to provide us with their valuable insight into their strategies, ambitions and fears.
Our thanks are due in particular to the following (listed alphabetically by surname):

- Eric Brown, GM, Scores Hotel
- Rob Hayes, Owner, Banjos
- Ufi Ibrahim, Chief Executive, British Hospitality Association
- Jamie Lamb, CFO, Kew Green
- Richard Spanner, Partner, Prestige Hotels

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