# Why hotel chains grew in Britain 1987 to 2006 and how can this be improved

In the previous two editions of Hotel Analyst we reviewed the secular growth of hotel chains in Britain as well as the transformation and turbulence that occurred among hotel chains. In the last of this trio of notes we move on to explain why these dramatic changes occurred and to make two proposals, one to improve the structure of the hotel business and one to improve the performance of hotel chains.

### Developments in economic structure and hotel demand

The fundamental and most powerful driver of the growth in hotel chains in Britain over the past 20 years was the development in the structural balance of the economy. Over the period there was comprehensive growth in the contribution to GDP by service businesses, up from 22% to 36%.

**Changes in British Economic Structure 1987-2006**

| | Agriculture | Industry | Citizen Service | Service Businesses | Total GDP |
|---|---|---|---|---|---|
| 1987 | 1.7% | 38.7% | 37.5% | 22.1% | 100.0% |
| 2006 | 1.0% | 26.2% | 36.5% | 36.3% | 100.0% |

Source: World Bank and Otus & Co

The contribution of agriculture and industry declined sharply over the period, citizen services remained broadly flat, while crucially, service business escalated. As a result, the story of hotel demand in Britain since 1987 is that the fastest growing segments of the economy were also the segments that provide the highest volumes of business and leisure demand into hotels. The decline in the significance of agriculture had little impact on the hotel business because agriculture produces only microscopic volumes of domestic business demand into hotels. In the case of the industrial sectors – manufacturing, utilities and mining – only a small proportion of employees, mostly sales and marketing executives travel on business and need hotels. So, although the decline in manufacturing was not positive for the hotel business, the loss of room nights was not material. Throughout the period, citizen services remained the largest employer by far, but the proportion of employees in citizen services involved in business travel and requiring hotel stays is minor and spending is tightly regulated by the government. During the period the volume of hotel demand generated by citizen services increased, but spending growth rose no better than in line with inflation. Then there was the fabulous growth in service businesses such as retailing, financial services, communications, logistics, professional services, travel and hospitality. All of these businesses and more have been transformed over the past 20 years, triggered by the Thatcher reforms that were designed to reduce unemployment and to expand the economy. High proportions of executives in service businesses need to travel on business and stay in hotels as an integral part of their jobs and this is the crucial benefit to hotels. There are two reasons for this, first, many service businesses such as retailing and hospitality operate out of a mass of venues and requires a range of executives travelling to the venues. Secondly, many service businesses such as financial services, communications and personal services involve a high instance of executives travelling to clients. Whereas salesmen are the main business travellers in manufacturing and utility companies there is a necessity in service businesses for executives across the whole corporate structure to travel on business and to stay in hotels. A further benefit that grew strongly for the first 10 to 15 years of the period was conference and meetings demand in hotels from service businesses. Most of the growing service



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businesses did not have an office infrastructure throughout the country to accommodate meetings such as corporate meetings, training sessions or promotional meetings and they used hotels as quasi offices. This meant that the benefit to hotels was not only in selling more rooms, but also in selling conference packages. It was for this reason that it was not uncommon early in the period for provincial chain hotels to convert bedrooms into meeting rooms to meet the demand of their larger corporate clients.

Domestic business demand was not the only demand source that experienced secular growth. Domestic leisure demand also grew strongly. The previous 20 year period from the late 1960s had seen a decline in domestic leisure demand into hotels as holiday makers increasingly went on package holidays to the Mediterranean resorts. At this time the short break market into hotels was embryonic and in the main involved visits to London, but by the late 1980s hotel based short breaks was expanding nationwide and the volume of demand was rising significantly. This was a natural development that mirrored the switch in Britain from buying consumer durables to buying services. It also matched the shifting structural balance of the economy towards service businesses. In terms of domestic leisure demand over the period from 1987, hotel short breaks became the focus in Britain rather than longer holiday hotel stays. This demand growth was derived, in the first instance, from the pre-baby boomer generation, some of whom had begun to benefit from the capital appreciation of owning their home as well as having other means of saving such as insurance policies, pension schemes and stock market investments. Couples were still earning when their families had grown and left home. They already owned a wide range of consumer goods making them a key market for spending on services and hotel short breaks became one of the services that they began to buy. As hotel chains developed hotels in locations throughout the country where domestic business demand needed to be so they were faced with the challenge of filling these hotels at the weekends. The solution was not to promote the location, but to promote the activities that were organised into short breaks at hotels. The approach paid off and was a factor in the terrific growth in weekend demand. However, the demand story did not end there. The period also benefited from the growth in foreign demand into Britain from both business and leisure travellers. The big spenders at the start of the period were Americans, but progressively over the period their significance declined as the volume, frequency and spending in Britain by continentals grew, as did demand from other long haul destinations. Otus estimates that in 1987 hotel chains achieved room occupancy of around 65%, generating 30 million room nights sold. By 2006, we estimate that all hotel chains in Britain achieved room occupancy of 70%, generating 69 million room nights sold an increase over the period of 39 million room nights sold. As a result hotel chains grew their share of total hotel room nights sold in Britain from 34% to 63%. In parallel, room nights sold in unaffiliated hotels fell from 57 million to 40 million.

## Hotel chain synergies

When mass hotel demand emerges, the wholesale markets are not far behind and this was the case in Britain over the period. Offline travel agents, online travel agents, leisure travel managers, corporate travel managers, hotel representative companies, hotel booking agents and conference organisers have all grown over the period. When the wholesale markets are active in processing hotel demand they need consolidated hotel room stock to make the process effective. This was one of the drivers of the dramatic growth of hotel chains in Britain over the past 20 years. Unaffiliated hotels were unable to meet the escalation in demand for a catalogue of reasons including: having hotels without the necessary type or quality of facilities, having hotels that were too small, being in the wrong locations, or being managed ineptly. In addition, hotel chains provided operational synergies and had greater cash flow to invest in brand infrastructure and demand generation. Their labour productivity was also higher as the result of attracting graduates to careers, in contrast to unaffiliated hotels who merely provided jobs. These benefits were not lost on the capital markets and hotel chains gained access to a wide range of capital sources. Simultaneously, unaffiliated hoteliers were confronted by the progressive and irreversible decline in access to capital. On all fronts, including greater and more effective demand generation, more effective performance and greater and more attractive access to the capital markets, hotel chains could only increase their share of the market and unaffiliated hotels could only decline.

## Current issues

There is a host of issues about the future direction of hotel in Britain, but there is only space here to discuss two: the problem of unaffiliated hotels and what can be done about them and then the question of the portfolio management of hotel chains. First, the problem of unaffiliated hotels increases as their share of the market declines. As hotel chains have grown so unaffiliated hotels have been left to dominate supply in marginal regions such as the Scottish Highlands, the Lake District and the West Country where the dominant demand is from leisure customers and the heavy seasonality means that many hotels still close for several months per year or at best have minimal demand over the winter months. As a result, unaffiliated hotels have progressively become marginal hotels. The first shock that this fact delivered to the banking system was in the early 1990s when the recession, double digit interest rates and Gulf War I created the conditions for 20,000 to 30,000 rooms, almost entirely in unaffiliated hotels, being managed by receivers and resulting in most of the major lending banks having to take failed hotels onto their balance sheets. This experience made the banks aware of the high risk associated with lending to individuals to build new unaffiliated hotels and since then it has been increasingly difficult to raise capital to construct such hotels. Consequently, buyers of unaffiliated hotels have been restricted to acquiring old hotels, predominantly in more marginal locations. They have been smaller hotels whose historic performance has been poor, which raises

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questions about the capital that has been invested in their maintenance. Too frequently they are owned and managed by amateurs whose hotels make Fawlty Towers appear attractive. There is no better recipe for further decline. However, the issue is how quickly the worst of these hotels will be removed from the market. Sadly, there is no systematic data on hotels that are removed from the British market, but the persistence of several of the major banks in lending to prospective entrepreneurs to acquire unaffiliated hotels is limiting the rate of removal. The fastest way to remove obsolete hotels from the market and the biggest service that these banks can provide to the hotel business is to stop lending to individuals to acquire unaffiliated hotels. In our analysis there are up to 50,000 unaffiliated hotel rooms whose removal from the market would be a boost to the hotel business, but until their lenders realise the economic and reputational risk that they endure the removal of obsolete hotels will be slow and act as a drag on the more effective development of hotel chains.

The second issue that hotel chains need to address is their portfolio management. There are three elements to the portfolio management of a hotel brand. First, there is the management of the supply variables, which include the market level, the configuration and the size of the hotels. Then there are the location variables including the structural developments of the economy as well as the conurbation size and type in which the hotels are located. The second element of portfolio management is the creation and management of the brand infrastructure to generate premium demand for the brand and the third element of the portfolio management of a hotel brand is the corporate variables including the management of the pattern of affiliation between the brand and its hotels and the management of the market share of the brand in each country and city. None of this is easy and requires technology and insights not only about what has happened in the past, but also about what is likely to happen in the future. The problem for hotel chains in Britain is that the over the past 20 years portfolio management has been more reactive to single hotel development opportunities and too little concerned with proactive development based on an effective understanding of developments in economic structure as well as trends and expectations in sources of hotel demand and in hotel supply. As a result the performance of most hotel chains has been sub-optimal.

The overall growth of hotel chains masks the fact that 109 of the 163 hotel brands in operation in Britain at that end of 2006 had less than 10 hotels. The shorter the hotel brand the fewer the synergies and weaker the performance. The short chains achieve minimal premium over an unaffiliated hotel and in these cases portfolio management is invariably based on the chief executive's thoughts at any time rather than systematic analysis. The larger chains have greater synergies, but in our experience systematic portfolio management has been sacrificed for portfolio growth. The chains do not have the technology or the insights to interpret the data on all of the variables or to assess the implications for any hotel brand, which are the bases on which main boards should be making decisions about the future direction of the company. Consequently, in our analysis hotel chains in the UK have not yet achieved the level of medium to long term performance that they ought to and the change that needs to occur is the introduction of systematic portfolio management. If the portfolio management of hotel chains was effective then we would not have 109 brands with less than 10 hotels and neither would we have the astonishing average annual brand turnover of 10 over the past 20 years. Finally, there is the most telling example of the strategic failure, for which we have the data to substantiate. Over the past five years, most hotel brands in all of the key cities in Britain have lost market share.

## Conclusions

The structural development of the British economy has been the prime driver of demand into hotels over the past 20 years. The emergence of the wholesale hotel markets required hotel chains for their effectiveness and the superior performance of hotel chains over unaffiliated hotels opened access to the capital markets that were closed to the unaffiliated hoteliers. We believe that hotels chains in Britain have reached the stage at which the basis on which decisions about future development and growth needs to be brought onto a more systematic basis. Central to this is the adoption of systematic portfolio management by the larger chains. The case for doing so is that it is the way to improve the performance of hotel brands to enable them to deliver the returns that hotel owners and investors crave.

**Paul Slattery, Otus & Co Advisory Ltd, paulslattery@otusco.com**
**Ian Gamse, Otus & Co Advisory Ltd, iangamse@otusco.com**


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