The Transformation of the British Hotel Business: 1987 to 2006

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Those of us who have been active in the hotel investment community over the past 20 years have probably not realised that we have participated in a greater transformation in the British hotel business than in any previous period in history. Even the second half of the 19th century, which benefited from the payoffs of the Industrial Revolution and produced a spate of urban, resort and railway hotels added only half the number of rooms per decade than were built in the last 20 years. What's more, the past two decades saw the addition of 10 times more chain affiliated rooms than during the whole of the second half of the 19th century. We will examine here why the recent surge occurred and we will explore some of the specific changes in market level, hotel configuration and location that emerged. In the next two editions of Hotel Analyst we will track the fate of specific hotel brands over the period and we will consider the implications for the future of the recent changes in the structure and conduct of the hotel business.

Overview

The period saw the addition of around 70,000 hotel rooms, which was an unremarkable average annual growth of less than 1%. However, the very remarkable transformation was the 4% average annual growth in chain-affiliated rooms, which added 147,000 rooms to portfolios. This boosted hotel room concentration in the country from 29% to 54% and established hotel chains as the dominant force in the business.

The Structure of the British Hotel Business: 1987 to 2006

UK hotel room stock	1987 Rooms	1996 Rooms	2006 Rooms	Change 1987-2006	CAGR 1987-2006 %
Total rooms	430,000	450,000	500,000	70,000	0.8%
Quoted company rooms	104,805	124,550	104,990	185	0.0%
Private company rooms	18,235	46,500	164,650	146,415	11.6%
All chain rooms	123,040	171,050	269,640	146,600	4.0%
Unaffiliated rooms	306,960	278,950	230,360	-76,600	-1.4%
Concentration %	**29%**	**38%**	**54%**		

Source: Otus & Co and The UK Hotel Groups Directory, 1988

The shift in the structure of the British hotel business was not all about the growth of hotel chains, it was helped along by the decline in the number of unaffiliated hotel rooms, which itself was accelerated by the trading downturn during the recession of the early 1990's and the collapse of international travel due to Gulf War I. At that time in Britain there was a marked increase in bankruptcy and liquidation among unaffiliated hotels that required the lending banks to take those hotels onto their balance sheets or to find alternative uses for the properties. Before that time banks were quite relaxed about lending to independent hoteliers to build new unaffiliated hotels, but from this point onwards banks reduced this lending sharply and progressively. This was a crucial development in restricting the unaffiliated segment to old, small hotels in poorer locations and therefore cheaper hotels.

As the expansion of the hotel business during the second half of the 19th century was borne out of the economic transformation that resulted from the Industrial Revolution, so the faster changes over the past two decades were driven by the economic transformation that was driven by the Service Revolution. When Margaret Thatcher came to power at the end of the 1970's the British economy was in a mess having endured a decade of slow economic growth and recession, industrial relations trauma, very high inflation, very high levels of unemployment, significant parts of the manufacturing economy controlled by the government and burgeoning growth in citizen services. Previous governments had also been in denial about the

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natural growth of service businesses. The new government instituted wide-ranging changes to boost the economy including greater flexibility in the labour market, growth in home ownership, the extension of personal credit and the privatisation of businesses controlled by the government. All of these changes and more involved the expansion and development of service businesses and resulted in a shift in the structural balance of the British economy so that a greater proportion of GDP was generated by service businesses. By the late 1980's these developments established the British economy with a more developed structure and better performance than its partners on the continent.

The British hotel businesses not only benefited from these changes, but also as a service business, it was part of the solution. The growth in service businesses produced a stepped increase in domestic business demand into hotels from fast growing businesses such as retailing, financial services, communications, logistics, travel and hospitality. It was not just a boost in bedroom demand, but also demand for meetings and conferences from the new and expanding service businesses that did not have their own office infrastructure to accommodate meetings. Domestic short break demand also grew sharply as a result of the economic changes as did the volume of inbound business and leisure visitors.

The surge in hotel demand during the 1980's also brought changes in the sources of capital for the hotel business. The 1980's and 1990's saw the stock market become the prime supplier of equity to the hotel business. In 1987 there were 51 publicly quoted companies with 104,800 hotel rooms in Britain amounting to 85% of all chain rooms and most of the rooms were owned or leased by the companies. By 1996, UK Hotels Plc had increased to 62 companies and their room stock had increased to 124,550 accounting for 73% of all chain rooms and the proportion of owned and leased hotels began to decline as, gradually, more hotels became managed and franchised by the brands. Over the next 10 years there was a marked downward shift in the sentiment of stock market investors about the hotel business. They considered the quoted hotel companies to be top heavy with hotel real estate and therefore to have a high risk profile, to produce too low a rate of growth in earnings and to deliver too low a rate of return on invested capital. Consequently, by 2006 there had been a procession of quoted hotel companies that were taken private. UK Hotels Plc had declined to only 22 companies and their room stock fell to 105,000, accounting for only 39% of all chain rooms. The valuation the stock market placed on public companies was invariably lower than the valuation achieved by private equity funds, real estate companies and high net worth individuals who valued hotel real estate at higher levels than the stock market and coped with higher gearing that produced higher returns on invested equity. For most of the companies that retained their stock market listing it was a time of transformation in the affiliation between hotels and the brands. The number of franchised and managed hotels increased sharply as major quoted hotel companies pursued programmes of sale and management back and sale and franchise back to lighten their balance sheets and improve the rate of return on invested capital. To all intents, over the past 10 years, the stock market has all but withdrawn as a source of equity for hotel companies.

Market level

In 1987 there were twice as many mid-market chain rooms as economy rooms, by 2006 there were broadly equal numbers of up-market, mid-market and economy rooms. Economy brands achieved electric growth adding 69,000 rooms, an annual average growth of 7.4%. This growth was achieved by two styles of hotel. First, there was the expansion of new, hard brands such as Premier Travel Inn, Travelodge and Express by Holiday Inn. Secondly, there was the redevelopment of softer branded pubs-with-bedroom such as Innkeeper's Lodge and Old English Inns. Up-market hotels grew in line with the market as a whole adding 48,000 rooms, while mid-market and deluxe hotels grew at sub-market levels. The collapse of the budget segment resulted from the disposal by chains of clapped-out hotels to independent owners or for alternative uses. Three activities produced changes in the supply profile of chain hotels - new build hotels, the acquisition of better quality and better sited unaffiliated hotels and the disposal to independents of hotels that were too small, of too poor quality, or in too unprofitable locations for the chains. The more that this pattern of migration between chains and independent owners occurred, the greater became the quality gap between chain and unaffiliated hotels.

The Market Level Profile of Chain Hotels in Britain: 1987 to 2006

Market Level	1987 Rooms	2006 Rooms	Change	CAGR %
Deluxe	2,185	3,565	1,380	2.5%
Up-market	39,290	87,215	47,925	4.1%
Mid-market	55,765	86,125	30,360	2.2%
Economy	21,700	90,965	69,265	7.4%
Budget	4,100	1,770	-2,330	-4.1%
Total	**123,040**	**269,640**	**146,600**	**4.0%**

Source: Otus & Co and The UK Hotel Groups Directory, 1988

Hotel configuration

There was significant development in hotel configuration over the period. Full feature hotels with restaurants, bars, conference and meeting rooms and leisure facilities added most bedrooms, 60,000, doubling their presence. This growth was driven by demand for conferences and meetings in hotels and by short break customers tempted by discounted hotel packages enhanced by the use of an on-site health club. Full feature is the largest configuration category by far, now accounting for 43% of chain rooms, but their rate of growth is slowing. Since 2000, less than 10,000 rooms in full feature hotels have been added to portfolios in Britain.

The most radical development in hotel configuration occurred in limited feature hotels, that is those with more than 75% of turnover generated by renting bedrooms and room only hotels where all turnover is from renting bedrooms. The room stock in these chain hotels increased by 71,000 mostly through new build economy and budget brands. Basic feature hotels typically deliver between 55% and 60% of turnover from renting bedrooms and they added little more than 500 rooms per year over the period. There are now 73,000 basic feature rooms in the chains, but from a position in 1987 when they accounted for half of all chain rooms they have now declined to a little more than a quarter in 2006. The typical profile of basic feature hotels is around 100 rooms, provincial and reliant on local demand for restaurant, bar and social functions. The problem is that over the past two decades the growth in high street restaurant and pub brands have deprived basic feature hotels of much of their non-resident demand, reduced their profitability and reduced their attractiveness to the chains.

Hotel Configuration in British Chain Hotels: 1987 to 2006

Hotel configuration	1987 Rooms	2006 Rooms	Change	CAGR %
Resort	2,460	6,195	3,735	4.7%
Full feature	55,995	115,945	59,950	3.7%
Basic feature	61,200	72,800	11,600	0.9%
Limited feature	2,835	45,840	43,005	14.9%
Room only	550	28,860	28,310	21.9%
Total	**123,040**	**269,640**	**146,600**	**4.0%**

Source: Otus & Co and The UK Hotel Groups Directory, 1988

Hotel Location and British Chain Hotels: 1987 to 2006

City	1987 Rooms	2006 Rooms	Change	CAGR %
Major	42,670	73,270	30,600	2.7%
Primary	7,910	22,215	14,305	5.3%
Secondary	27,145	47,380	20,235	2.8%
Tertiary	19,680	41,200	21,520	3.8%
Quaternary	25,635	85,575	59,940	6.2%
Total	**123,040**	**269,640**	**146,600**	**4.0%**

Source: Otus & Co and The UK Hotel Groups Directory, 1988

Hotel location

The most striking feature of the locational development of chain hotels in Britain over the past 20 years was the material increase in the number of locations of chain hotels. In 1987 chain hotels were represented in 650 conurbations, but by 2006, 335 conurbations were added to reach a total of 985 locations. The only major hotel city, with more than 30,000 chain rooms in Britain is London. In 1987 it accounted for 35% of all chain rooms in the country and since then a further 31,000 chain rooms have been added, but now it only accounts for 27% of all chain room stock.

Britain has three primary hotel cities: Manchester, Birmingham and Edinburgh, which grew their chain room stock faster than the country as a whole and most of the rooms added over the period were in up-market and mid-market hotels. Secondary cities added 20,000 chain rooms over the two decades and tertiary locations added more than 21,000, but the biggest uplift was in quaternary locations. Each quaternary location has less than 500 chain rooms and is, in the main, a village or rural location. The new conurbations for chain hotels were predominantly quaternary and it was mainly economy and budget hotels that were sited there.

Economy Brand Location Exposure: Britain 2006

Brand	Major and Primary %	Tertiary and Quaternary %
Express by Holiday Inn	30%	44%
Innkeeper's Lodge	10%	66%
Old English Inns	0%	100%
Premier Travel Inn	19%	66%
Travelodge	23%	68%

Source: Otus & Co

As the table above illustrates the larger economy brands have portfolios that are skewed locationally towards the smaller locations where they have a significantly greater proportion of their British room stock. A characteristic feature of the smaller locations is that they generate lower volumes of demand and slower growth in demand.

Conclusions

The 20-year period was not simply characterised by a growth in the number and in the size of hotel portfolios. There were significant changes in the substance of chain hotels and in the rationality of their portfolios.

The growth in volume has been accompanied by growth in the diversity of demand and this has been reflected in the supply profiles of hotel chains. As the diversity of hotel demand increased so did the market level spread of chain hotels. As the diversity of hotel demand increased so did the hotel configuration spread of chain hotels and as the diversity of hotel demand increased so did the locational spread of chain hotels.

By the end of this period Britain had the most structurally developed economy in Europe. In parallel, it had the most concentrated hotel business in Europe and also the most diverse and sophisticated hotel capital markets in Europe. In our analysis the developments are far from complete. The volume and diversity of demand continue to grow and the gap between hotel chains and unaffiliated hotels continues to widen. We now estimate that around 50,000 unaffiliated hotel rooms in Britain are unacceptably poor in terms of life safety provision, the quality of facilities, services and products sold as well as the quality of their management and performance. Such hotels are an embarrassment to the hotel business to the economy and to our culture. They should be removed from the market to make way for newer, safer, better and more economic chain hotels.

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