Weathering the Economic Storm

How hospitality companies can thrive in challenging times

Audit, Tax, Consulting, Financial Advisory
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If you listen to executives from consumer-related companies in the US, they will tell a story of terrible hardship for consumers, of sales that are stagnant or worse, of costs rising faster than they can increase prices, and of consumers retrenching on most types of discretionary spending. And yet the overall economic numbers will suggest a modest downturn in economic activity but not necessarily a true, full-blown recession.

Why the difference? The answer is exports. The strength of US exports, which is related to the weakness of the dollar, has partially offset the considerable weakness of the consumer sector. On the other hand, if the credit crunch worsens substantially, the entire economy may feel the hardship now felt by consumer related industries. Time will tell.

For hospitality companies, of course, the storm that has hit US consumers is what matters. Moreover, many aspects of this storm are likely to linger even after the economy recovers from its current doldrums. These include elevated food and fuel prices, troubled credit market conditions, and excessive consumer debt levels. That means that hospitality companies not only have to shield themselves from an economic downturn, they also must undertake measures to adjust to a changed business environment.

In this publication, we examine the outlook for the US consumer of hospitality services and offer our views on what hospitality companies should consider to prosper during troubling times.
What is happening now?

The US economy is reeling from the collapse of the housing market bubble. As of this writing, home prices in the US are down roughly 20% from their peak in 2006. The current drop has caused massive losses for financial institutions as well as increased risk spreads due to the uncertainty about the size and scope of losses. In addition, the loss of wealth for consumers means that they can no longer use their homes as cash machines. In the past decade, mortgage refinancing was a significant source of funding for consumer spending, particularly on big-ticket products and services. This has now ended. For the foreseeable future, consumer spending will be constrained by consumer income – a novel concept. Moreover, spending will likely trail income as consumers pay down debts and attempt to accumulate liquid savings.

In addition, the collapse of the housing market, and especially the market for assets backed by sub-prime mortgages, has created a monstrous situation in credit markets. Major financial institutions have failed, credit markets have seized up, and the Federal government has had to intervene in a manner not seen since the 1930s. As of this writing, it remains to be seen when and how normalcy will be returned to credit markets. In the interim, with risk spreads very high, credit is not readily available for either consumers or businesses. Economic activity will likely suffer until financial market participants are convinced that the worst assets have been written off. Moreover, this will require that house prices stabilize so that the volume of bad assets does not increase substantially.

If this were not bad enough, the economy is also reeling from the effects of dramatically increased commodity prices, especially the price of oil, which rose seven-fold in the past decade. Even after adjusting for inflation, oil prices achieved their highest level ever in the summer of 2008 (although they fell considerably since then). On the other hand, due to improvements in energy efficiency, consumer spending on gasoline as a share of income is still lower than it was in 1980. That being said, high gas prices are taking a toll, especially on lower income consumers. The effect of high food and fuel prices has been to push consumers toward discount retailers, toward eating at home rather than in restaurants, toward traveling shorter distances, and toward less spending on non-food and non-fuel products and services. Importantly, the high cost of transportation is having a negative effect on consumer spending on hospitality.

The combination of a housing debacle, credit crunch, and high commodity prices has rendered an economy at or near recession. Employment is weak, real wages are stagnant, and policymakers are caught between a rock and a hard place. On the one hand the Federal Reserve has cut interest rates in order to offset an economic downturn and to stimulate lending in an otherwise weak credit market. On the other hand, the Fed will be concerned lest high commodity prices, a weak dollar, and expansive money supply growth fuel a new round of ruinous inflation. Consequently, it is reasonable to expect that, once the economy starts to recover, the Fed will keep interest rates relatively high in order to quell inflation. This could mean a weak recovery.

As for the weak dollar, although it is potentially inflationary, it does have a few positive implications for the US economy. First, it has stimulated strong growth of manufactured exports. Second, it makes the US an inexpensive place for foreign tourists. Third, it makes staying home an attractive option for Americans otherwise interested in traveling abroad.

The US economy’s weakness has begun to weigh on the hospitality industry, despite increased tourist activity from overseas. Following strong revPAR growth in 2007 of 5.7%, revenue per available room in the US market has edged up only 1.0% during the first eight months of 2008, according to Smith Travel Research. Further, occupancy rates were down 2.6% from the first eight months of 2007. Preliminary results through early fall suggested that demand was continuing to slow. Despite weakening demand, the supply of new hotels rooms is expected to continue to increase, which should further pressure profits into 2009.

What to expect over the longer term

Recessions come and go. Downturns hurt hospitality companies and recoveries help. Yet when the economy recovers from its current doldrums, things could be a bit different. This means that companies might want to plan not for a strong consumer recovery, but for a modest recovery and a new business environment.

First, there is a good chance that oil prices will remain high, if not necessarily as elevated as they were during the summer of 2008. High priced oil, if perceived to be permanent, will alter consumer behavior. They will purchase more fuel-efficient cars, drive shorter distances, and spend less on non-energy products and services. Their vacation behavior could change significantly as well. As for business travel, it too could be stymied by high energy costs, especially as the technology of video conferencing improves.

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1 S&P Case Schiller Home Price Index, Standard & Poor's
2 Bureau of Economic Analysis and Energy Information Agency
Second, consumers will not derive wealth increases from their homes anytime soon. The housing market will take far longer to recover than the overall economy. In addition, credit conditions will remain weak for some time to come. Only when there is relative transparency about the size and location of potential losses, and only when the banks have been substantially re-capitalized, will risk spreads decline significantly. Thus, conditions will not be ideal for merger and acquisition activity, especially those deals funded by bank loans. Past experience suggests that full recovery of financial markets could actually take several years.

Third, when the economic recovery comes it may be far more export focused than in the past. Consumer spending will likely grow slowly in relation to the economy. The weakness of the consumer will be related to the housing market, excessive debt, and commodity price inflation. Should the dollar remain weak, this will mean increased inflationary pressures at home and higher costs for Americans traveling abroad.

Last, the overall economic recovery will likely be weak for the first two years as the Fed attempts to rein in inflationary expectations. The Fed is concerned lest a 1970s-style situation unfolds.1 During the 1970s, the Federal Reserve permitted inflation to get out of hand rather than attempt to stymie economic growth. The end result was high inflation that only ended after two brutal back to back recessions in the early 1980s.

The bottom line, then, is that even after the general economy recovers, the business environment will likely contain challenges for hospitality companies that were not present at mid-decade. Below is a discussion of some of the issues facing the industry and several marketing and sales actions – so important to the success of most hospitality companies – that should be considered as a response to these difficult times. While there are other options, including changes in staffing, pricing and property maintenance, that companies have at their disposal to help them survive, marketing and sales offer perhaps the best opportunity to improve both the expense and revenue sides of the ledger.

Re-evaluate Marketing and Sales Functions

Retool and reconnect with the customer
Hospitality companies currently are facing the challenges of overall cost cutting while finding ways to increase demand. Global inflation, a sharp pullback in lending, the weakened US dollar, and higher gas prices all contribute to the current non-typical cycle.

Below is a review of ways marketing and sales functions can not only reduce the financial burdens of hospitality companies but can also lead to stronger customer relationships in the long run. The four key actions discussed below that may help hospitality companies navigate through tough times are:

1. Optimizing performance management capabilities
2. Improving spend effectiveness across sales and marketing channels
3. Re-evaluating customer segments and touch-points
4. Focusing loyalty programs on value

1. Optimizing performance management capabilities
Marketing can be one of the most difficult areas of analysis and decision-making for hospitality companies. Why? Because marketing requires mastery of both “soft” and “hard” skills. Although many marketing problems lend themselves well to quantitative analysis, hospitality companies have not traditionally incorporated mathematical constructs to monitor progress toward achieving revenue growth. However, hard times call for both accountability and clear metrics.

One challenge for hospitality companies is to justify their marketing, advertising, promotion and sales budgets for every planning cycle. In other words, they should establish controls and metrics to track progress. While some best-in-class hospitality providers have devised metrics and measurement techniques to help monitor marketing and sales performance, the industry in general has not been as systematic as other industries in the implementation of control metrics. Some key opportunities that can help an organization optimize its performance management capabilities include:

Develop a budget process driven from top-down targets
For hospitality companies, marketing and sales functions are often excluded from the corporate strategic planning process. While many providers receive goals from the CEO, these goals often do not translate into the development of marketing and sales budgets. This can create a widening gap between marketing and sales budget allocation decisions and targeted growth expectations. Linking marketing and sales budgets to the top-down corporate strategy goals can help narrow this gap, building toward one cohesive overall business objective.

Build zero-based budgets
People are creatures of habit. In a down market, old habits can be the roadblock that prevents innovative thinking. Budgets that worked in good times almost never translate into optimal budgets in down times. A zero-based budget process can be effective because it requires securing budget approval annually. This process can help eliminate the notion of entitlement when spending the company’s dollars. Marketing and sales organizations should consider using the zero-based budget process and re-prioritizing the marketing and sales spend portfolio annually.

Measure the results
It used to be said that 50% of the marketing spend was ineffective. However, recent thinking suggests that less than 30% of the marketing spend is effective, in part because of the proliferation of options, including multi-channel marketing, digital medial channels, internet marketing programs, and consumer collaborations. Internet marketing is very special because it often is measurable – something difficult to achieve with the media advertising of the past. Internet marketing can enable hospitality companies to identify potential opportunities, adjust their business activities, and better track ROI against the marketing dollars spent.

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1During the 1970s, the Federal Reserve permitted inflation to get out of hand rather than attempt to stymie economic growth. The end result was high inflation that only ended after two brutal back to back recessions in the early 1980s.
2. Improving spend effectiveness across sales and marketing channels

In addition to better budgeting and better calculation of marketing spend, companies may want to optimize their targeting efforts across their sales and marketing channels. Ideally, one key role of marketing is to help drive the prospective customer to a lead-generation “source/widget.” The leads can then be picked up by the sales team and developed into pursuits. The measurement of the success of this approach is the effectiveness of the marketing and sales activity to reach the targeted audience and drive action. Two key opportunities that can help an organization improve its sales and marketing channels are:

Identify emerging cost-effective channels
For some time now, travel has been the most popular product sold online, accounting for around 35-40% of total online retail revenue. Yet the industry as a whole has been slow to allocate significant marketing dollars to online marketing and sales activities. The Internet should not only be viewed as a distribution tool but also as a platform to engage and interact with the customer on a more personal level. User-generated content, including blogs, wikis, special-interest online groups; audio and video podcasts; mobile phones, PDAs and iPods; and Web sites such as MySpace, Facebook, and YouTube should be considered as alternative marketing platforms that could help differentiate brands at a discount to traditional marketing and sales channels.

Shop for the best deals
Economic downturns and recessions may be the perfect time to re-negotiate marketing/advertising contracts and vendor relationships. Hospitality companies have the opportunity to use market conditions to re-negotiate lower prices, especially when it comes to agencies (e.g., advertising agencies, event planners), sourcing, and media buy. Many hospitality companies have long relied on relationships based on pre-negotiated prices, but now may be the perfect time to re-evaluate and re-negotiate.

3. Re-evaluating customer segments and touch-points

The customer is changing, and travel-oriented companies need to be proactive, not reactive, in their outreach in order to prevail in a difficult environment. Economic pressures and the corresponding pullbacks in personal and business travel are creating a need for companies to re-evaluate their understanding and classification of their customers.

Business travelers are the industry’s leading sources of revenue. Yet in this slowdown, corporations are cutting discretionary costs, including business travel. Business travelers are also changing their traveling behavior to help their companies reduce spending: choosing to fly in coach, staying at less expensive hotels, or reducing business travel altogether and opting for cheaper alternatives such as video conferencing.

In addition, many companies are experimenting with changes in their travel spending habits in three important ways. First, companies with corporate offices located around the world are installing video/web conferencing capabilities and are conducting meetings over the Internet, using available services. Second, companies are mandating that more day trips be taken, where travelers fly in and out the same day to avoid a hotel stay. Third, companies have decreased the number of conventions and conferences that their employees can attend.

Leisure travelers also are changing. In particular, micro-groups of consumers, including those who are eco-conscious, health-oriented, ultra-wealthy, or interested in “doing good” while away, are turning into profitable sources of income for certain hospitality companies. These changing behaviors and emerging trends offer challenges and opportunities to hospitality companies. In particular, a decrease in business travel translates into substantial revenue loss. Some key opportunities to help an organization improve its customer touch points include:

Address and evaluate changes in customer segmentation
The traditional model of customer segmentation is changing and is becoming less relevant with the new economic realities and changing consumer lifestyles. Additionally, historical segmentation analysis may be outdated as targeted consumers cascade downward into lower segments based on changes in behavior and economics. As current customer segmentation and profiles become obsolete, companies should re-think how to best segment their customer base and perhaps re-target different demographics to make up for the loss of customers and revenue. Companies should consider customer psychographics as well.

Develop a new customer segmentation strategy
With customer behaviors and economic positions changing, now is the time to respond. Hospitality companies should consider re-focusing their efforts on creating segments that are more targeted to their preferred customer base. Improved customer segmentation can enable marketing and sales functions to target and reach customers in a more cost-effective and efficient manner.

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4 Deloitte Consulting. Hospitality 2010. This report is an in-depth study into shareholder value in the hospitality sector. It focuses on the strategic implications of the mega trends that are shaping the future of the hotel industry, including brand, emerging markets and human assets and technology. Please go to: www.deloitte.com (go to “research”).

5 Market segmentation based on consumer psychological profiles around lifestyle, attitudes, beliefs, values, personality, buying motives, etc.
4. Focusing loyalty programs on value

The most effective brand loyalty programs can often contribute significantly to a hotel's total paid lodging room nights. Many hospitality providers are improving their loyalty program effectiveness through a combination of rewards (e.g., points, miles, and merchandise) and awards recognition (e.g., identifying needs, making sure guests are called by name, delivering personalized services). As an example, one company has had very positive results with its enhanced guest relations program, which emphasizes personal dialogue from all staff members with guests, to make them feel welcome in a distinctive way. These types of loyalty programs can help build a strong current customer base and can also attract prospective customers to help combat future economic downturns. Some actions that help an organization build customer loyalty during rough times include:

**Connect on an emotional level with customers**
As economic pressures change customer’s behaviors, it is increasingly important for companies to understand consumers’ concerns and fears. For example, customers may not value free hotel stays because they cannot afford the other costs associated with traveling (e.g., gas, airfare, food). Instead, customers may value gift cards or other items that can increase their disposable income or be redeemed at a future time. Many hotels have already begun to make this transition and are offering items such as gas cards to attract prospective customers and retain current customers.

**Keep pace with your competitors**
Economic hardships usually encourage customers to research loyalty programs and join the ones that offer the greatest rewards. Companies should continue to keep pace with the other competing loyalty programs to help them maintain a competitive position.

**Be innovative**
Don’t be afraid to think outside the box. Innovative approaches can help companies increase the value of their membership programs and differentiate their brands. One recent innovative approach was instituted by a hotel corporation whereby repeat guests can earn credit toward the purchase of the company’s stock.

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**Conclusion**

The sales and marketing disciplines have historically been some of the last departments that organizations focus on when they are looking to ride out an economic storm. Yet, sales and marketing groups in the hospitality industry have an opportunity to make significant contributions in driving profitability.

Since sales and marketing are generally the largest discretionary expense categories on the income statement, these departments will likely be pressured to cut costs and increase sales when budgets tighten. However, by focusing their efforts on financial discipline, better customer targeting, evaluating channels and encouraging loyalty, these departments can often help hospitality companies thrive in a difficult environment.

In the end, firms that can better integrate the objectives and resources of the organization with the needs and opportunities of the marketplace will likely capture more customers and emerge stronger from having weathered the storm.

“If you don’t know where you are going, any road will get you there.”

- Lewis Carroll, Novelist
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