

Executive Report

The magazine for the tourism, hospitality and leisure industry

Summer/Autumn 2009

Exploring hidden depths.

Navigating the new normal

Aviation and travel – has the landscape changed permanently?

Survival of the fittest

How are sports businesses coping in the downturn?

A catalyst for change?

Two years on, what has been the impact of the smoking ban on UK pubs and restaurants?





Welcome Alex Kyriakidis

The future is – business unusual! Are you ready?

Natural disasters, terrorist attacks, geopolitical risks, a ban on smoking, epidemics, global recession and now a pandemic ... the travel and tourism industry finds itself at the forefront of unprecedented challenges. The new buzzword is "business resilience management". Planning for a doomsday scenario is an emerging art form reminiscent of the planning for Y2K. Customer relationship management takes on a new meaning when plummeting demand forces the industry to drop prices and the brand promise becomes too costly to deliver. Managing the fine balance between cost reduction and losing the human capital talent in which the industry has long invested and may regret when the upturn comes is hugely challenging. And yet, somehow, these risks must be proactively analysed, the opportunities for enhancing revenues and reducing costs must be actioned, and the brand promise must be maintained.

In this edition of our executive report, we look at some of the changing trends in our industry as a result of the above, as well as assess the impact of pandemics. One thing is crystal clear, the future is ... business unusual!

As ever, we value your feedback.

Best regards

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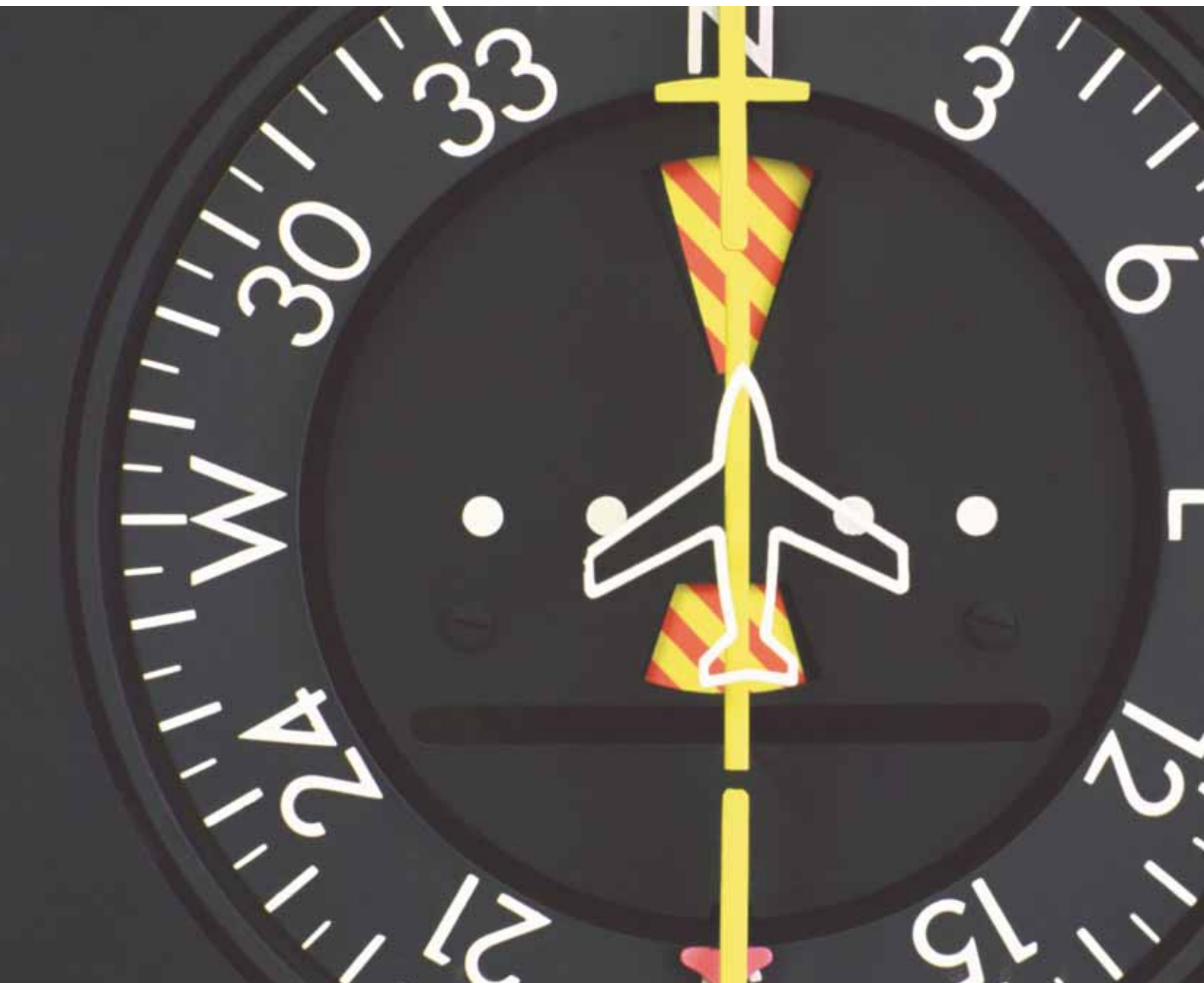


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Navigating new normal



the

After months of economic uncertainty, airlines and tour operators have seen significant changes in demand for their products.

When airlines even talk about reducing the size of cutlery on in-flight meals to make planes lighter and save on fuel costs, it speaks volumes about the severity of the current crisis in the travel industry.

After months of economic uncertainty, airlines and tour operators have seen significant changes in demand for their products. Recent statistics from the Civil Aviation Authority (CAA) demonstrate the extent of these changes. For the first four months of 2009 overall passenger numbers for UK airports declined by -10.4% compared with the same period in 2008. Domestic travel fell by -11.7%, EU travel by -12.1% and non-EU travel by -6.8%.

Changed landscape

This has resulted in a number of heavy losses for operators, including a pre-tax loss of £148 million for British Airways Plc for the quarter ended June 2009, the first time that they have recorded a loss for this quarter since privatisation. The International Air Transport Association (IATA) now estimates that the global airline industry will lose \$9 billion in 2009.

Airlines and tour operators need to respond quickly to these changing conditions. This is a major challenge for an industry that has to bear the huge fixed capital costs of operating aircraft, ships or hotels.

The new normal?

This article analyses the impact of changing economic circumstances on aviation and travel, looks at how operators are responding and asks whether the travel landscape has changed permanently.

Hedging your bets

The industry has been badly hit by the volatility of fuel prices and exchange rates. Although 2008 saw oil reach \$147 a barrel, travel companies were able to survive initially by hedging, buying months ahead at lower prices.

With the onset of recession, oil prices plummeted, dropping as low as \$34 a barrel. Many airlines have been unable to take advantage of this, having hedged at a higher price than current market rates. Ryanair, for example, hedged 80% of its fuel at \$124 a barrel, losing €102 million for the last quarter of 2008.

The danger now is that oil prices, having started to rise once again in recent months, may be heading for further dizzy heights. This time round, with balance sheets weakened by the credit crunch, carriers may struggle to 'buy forward' at today's prices.

Currency headache

Exchange rates, particularly the Euro and US Dollar, have also fluctuated wildly against Sterling. This has been a major headache for operators based in the UK or those in Euroland who derive a large portion of their revenues from Sterling.

In the case of airlines, all fuel and aircraft related costs such as parts, rental and capital expenditure are denominated in dollars and a high proportion of the remaining direct operating costs are in Euros.

Most companies with so much exposure to currency markets will have a hedging strategy in place. However it is extremely difficult to beat the market in stable conditions, let alone in the current environment where balance sheets are in such a weak state.

Cabin pressure

For the flag carriers the largest impact has been felt at the front of the cabin. The collapse in the M&A market and corporate belt tightening has led to a decrease in the premium business travel from which the bulk of a typical flag carrier's profits are derived.

Operators such as British Airways, BMI and Air France have announced significant losses this year and even those that remain profitable, such as Lufthansa, Virgin Atlantic and Iberia have seen their profits eroded.

As Figure 1 shows, although economy travel has fallen, the decline in premium travel has been far more profound.

Uphill task

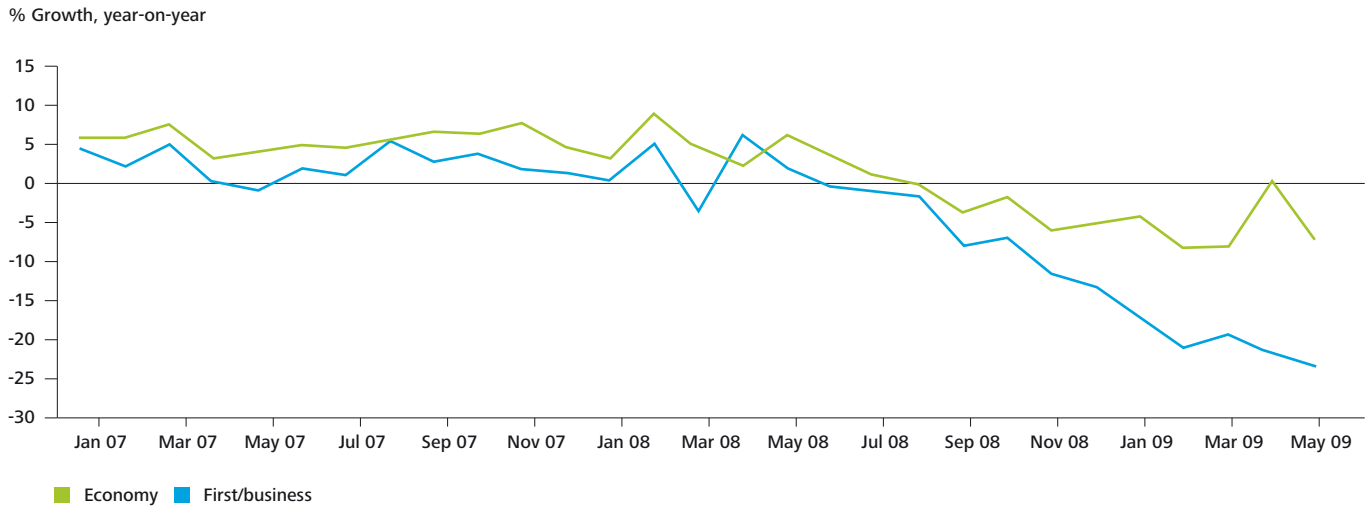
The credit crunch and the subsequent demise of investment banks had a huge impact on transatlantic airlines. In the space of a few months these carriers lost a significant portion of their core customer base.

The corporate world has cut travel spending, and other methods of domestic transport such as rail are being adopted. Whilst this change is largely driven by the short-term need to cut overheads, growing environmental concerns and public resentment over the expense accounts of executives suggest that, in the long-term, the flag carriers face an uphill task in regaining their former customers.

Those businesses that are still travelling are increasingly turning to economy flights, and low cost carriers such as Ryanair and easyJet are taking market share from the flag carriers. Ryanair posted a pre-tax profit of €134.6 million for the quarter ended June 2009. Budget hotels are also reaping the benefits of this trend with chains such as Travelodge expecting to gain market share as business customers 'trade down' from 4* and 5* hotels.

This is a major challenge for an industry that has to bear the huge fixed capital costs of operating aircraft, ships or hotels.

Figure 1. Passenger traffic growth by ticket type



Source: IATA Premium Traffic Monitor May 2009

Spending power

Within leisure travel, job market uncertainties and the falling value of Sterling have impacted consumer confidence. Holidaymakers who had become accustomed to a strong pound have seen their spending power slashed in their favourite destinations.

Airlines have been quick to spot this opportunity with additional routes being set up to resorts outside the Eurozone in Turkey and Egypt, and tour operators have also shifted capacity to these regions.

Despite this, CAA statistics for the budget airlines continue to show good results for Euroland package resorts, with Monarch reporting huge demand for the Canary Islands as a destination for summer 2009. Flights purchased in Sterling are not being affected by the exchange rates, although it remains to be seen whether levels of spending on holiday will remain high if the exchange rates stay at such low levels.

All-inclusive trend

Fragile consumer confidence has prompted a renewed interest in package holidays offering protection to the holiday maker under the CAA's Air Travel Organisers Licensing scheme (ATOL). All-inclusive destinations are enjoying particularly strong demand, enabling customers to budget more accurately for the full cost of their holiday in advance.

In May 2009 Thomas Cook reported that 41% of its summer bookings were all-inclusive, compared to 30% in summer 2008. Along with TUI's UK brands Thomson and First Choice, Thomas Cook is introducing an all-inclusive only brochure for 2010 in an attempt to capitalise on this trend.

Leaving it late

Late booking is another key trend affecting the leisure sector, caused partly by fears over company failure in the wake of the XL Group collapse that led to many passengers being stranded or having their holidays cancelled. With unemployment reaching 2.43 million in the UK, and further rises expected, consumers are also reluctant to commit to large expenditure before they need to.

Travellers are delaying booking as much as possible in order to minimise risk. This puts increased pressure on the traditional business model of holiday companies, making it harder than ever to predict departure patterns. Airlines and tour operators who have already cut their headcount are less able to respond to changes in demand at a moment's notice.

Travel companies are being forced to put contingencies in place just in case bookings are even lower than originally expected. Many players in the industry are pinning their hopes on a surge of late bookings for summer 2009.

Domestic opportunity

Other external factors, such as the swine flu pandemic, recent aircraft accidents and political unrest in countries such as Sri Lanka, Pakistan and Thailand have also resulted in consumers giving much more thought as to whether to holiday abroad, and if so where to?

So far though, it appears that UK consumers are unwilling to sacrifice their 'main' annual holiday in the sun. City breaks, on the other hand, are considered more of a discretionary spend and are suffering more, as the fall in economy passengers within Europe and declining European hotel rates demonstrate.

One consequence of the current climate may be an increase in domestic tourism. Despite the perennial uncertainties of British weather, initial predictions of a heat wave summer and the attraction of Sterling may have persuaded more travellers to stay closer to home. We are also seeing a change in the method of transport used for domestic holidays, with flights becoming less popular in favour of cheaper road and rail options.

Consolidation rumours

According to IATA, airline load factors stood at 75.3% in June 2009 compared to 77.6% in June 2008. With passenger numbers down by more than -7% when compared to the same month in the previous year, this points to a reduction not just in demand but in supply. The collapse of several airlines in the past year including XL and Zoom, coupled with cuts by the remaining carriers and tour operators, have reduced overall capacity in the market.

The logic of current market conditions would suggest that consolidation is the way for airlines to gain a competitive advantage of scale. Whilst actual M&A activity remains slow, some developments are taking place, such as British Airways recent announcement of plans for a joint business arrangement with American Airlines and a more formal merger with Iberia.

The recent financial troubles faced by Arcandor, the majority shareholder in Thomas Cook, have led to rumours of a potential bid for the listed tour operator. Again in Germany, the cash-rich carrier Lufthansa has been linked with an ever growing list of airlines, the troubled SAS Scandinavian Airlines being the latest addition.

It remains to be seen whether countries are prepared to let their national airlines merge, following an abandonment of the various bi-lateral agreements. Even the ambitious plans for Open Skies 2 between the US and Europe seem currently doomed, as the new US administration appears to be adopting a more protectionist stance with its current aviation policies.

**A flexible response
in the face of
unpredictable
booking patterns, cost
reductions and
innovative revenue
streams are all needed.**



Perfect storm

As the landscape of travel has changed, operators have found themselves cast adrift in a 'perfect storm' of rising costs and shrinking revenues. Some airlines have responded by focussing even more closely on squeezing spend from their customers. Charges for checking bags have risen, becoming increasingly disproportionate to the fare, and the cost of breaching your allowance can be punitive.

The other strategy is to reduce costs even further, a major challenge in an industry that claims to have cut costs down to the bone already. BA recently announced that it had cut spending by 20% to £580 million from £725 million, and had lengthened its schedule of orders for 12 Airbus A380 aircraft.

Staffing difficulties

Besides fuel, the biggest cost for an airline is its staff. The CAA's recent statistics on airline staff costs demonstrated that BA is paying, on average, nearly £10k more for its cabin crew per annum than its nearest competitor easyJet, and more than double that of Virgin Atlantic. As BA looks to drastically cut costs and struggles with a pension deficit of around £3 billion, it has been discussing with the unions the options of staff working for free, taking unpaid leave, and agreeing to a pay freeze for the next two years. These proposals are yet to be accepted.

In a heavily unionised industry growing talk of staff cuts has inevitably led to threats of strike action. Virgin has announced cuts and many other airlines, particularly in the US, are also facing the prospect of difficulties with staff. In the short-term airline management is set to become more challenging.

Strike action would add to the industry's woes, with the threat of disruption likely to further dissuade travellers from booking business flights and holidays. Potentially this is more bad news for the bottom line and the cash balance of already beleaguered airlines.

Survival strategy

The airline and travel industries are in the midst of deeply uncertain times. A flexible response in the face of unpredictable booking patterns, cost reductions and innovative revenue streams are all needed.

Operators need to focus on those areas where consumers are spending money, such as economy business travel, all-inclusive holiday destinations, non-Eurozone/domestic holidays or cheaper, greener transport. They may need to shift away from previous 'cash cows' such as premium business travel, if they are to return to profitable results.

Whether this can be achieved quickly enough to avoid any further large scale failures is a key question. Whilst some commentators are seeing green shoots appear in the UK economy, for aviation and travel the recovery appears to remain some way off.

A survival strategy, rather than one of growth, will be the focus of discussion around most airline and tour operator boardroom tables over the next couple of years. It is clear that the landscape of travel has changed and, in some cases, these changes may be permanent. Welcome to the new normal.

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Saudi Arabia its past to tar



builds on get tourists

Visiting Saudi is more of a pilgrimage than a ‘typical’ vacation, and the Kingdom recognises it must develop a tourism industry that celebrates its religious heritage and archaeological treasures.

The Middle East has seen a phenomenal expansion in tourism in the last decade. While the biggest players have been the Gulf States, the Kingdom of Saudi Arabia is also keen to welcome more tourists, and shares a similar ambition to diversify an economy that is over-reliant on oil.

Building tourism in Saudi – the birthplace of Islam – however, calls for different tactics. Visiting Saudi is more of a pilgrimage than a ‘typical’ vacation, and the Kingdom recognises it must develop a tourism industry that celebrates its religious heritage and archaeological treasures.

Provisional figures from the World Tourism Organisation (UNWTO) reveal that arrivals were up 28% last year, suggesting that initiatives to attract more international visitors are working. And while hoteliers in other Middle Eastern destinations are seeing painful declines in profitability, business is still good in Saudi.

Here, we look at the figures in more detail.

Dependency on oil

Saudi Arabia has one of the strongest economies in the Middle East, with average gross domestic product (GDP) growth of 4.3% over the past five years, according to the Economist Intelligence Unit (EIU).

Record oil prices, the country’s self sufficiency and the lack of sub-prime financing problems made analysts wonder whether the Kingdom would escape the global economic downturn. However, sharp falls in the price of a barrel of oil earlier this year, plus fluctuating demand, has confirmed Saudi Arabia’s economic soft spot.

The dependency of the economy on the price of oil means GDP is forecast to contract by 1% this year according to the EIU, and the Government anticipates a budget deficit for the first time since 2001. Even surplus cash from previous years has not been sufficient for Saudi to escape the reality of the current squeeze on credit.

Traditional culture

Saudi Arabia, where religion is revered, has a different culture to many parts of the world, and its traditional approach covers all aspects of life – from dress codes, to business and to politics.

The tourism authorities do not see these as obstacles, however, given the millions of Muslims around the world whose faith requires them to visit the holy sites at least once in their lifetime. The Saudi Commission for Tourism and Antiquities (SCTA) is therefore promoting tourism as an integrated economic programme, with the country's historical and religious attractions as the foundation for growth.

Its appeal to an international audience is based on the promise of a 'completely different experience' but, while Saudi is still a conservative country, there are some initiatives for modernisation. The local stock exchange, the Tadawul All Share Index, for instance, is now open to foreign investors, and earlier this year, King Abdullah appointed the country's first female minister. The US-educated former teacher became deputy education minister and will oversee a new department for female students.

Meanwhile, the SCTA is also encouraging its own citizens to stay in Saudi, urging them to spend their vacation money at home rather than abroad.

Staying positive

Historically, much of Saudi's oil revenue is invested abroad but things are changing. The Government is developing four Economic Cities, which are due to complete by 2020, and is also making significant investments in tourism, and encouraging private investors to do the same. Given solid growth in the tourism sector, it is an appealing option.

As we said earlier, tourist arrivals to the Kingdom increased 28% in 2008, according to the UNWTO, increasing the demand for hotel rooms. The country has achieved four years of double-digit growth in revenue per available room (revPAR), and even in the current downturn, has continued to grow 4.0% year-to-June 2009, as can be seen in Figure 1.

Saudi Arabia is one of the few countries in the Middle East to remain in positive territory. Across the region most countries have seen revPAR decline as the global economic crisis depresses demand, with the United Arab Emirates (UAE) experiencing the most severe decline, with revPAR down 28.5%.

Jeddah had the country's strongest revPAR growth, up 20.4% to US\$120. This gateway city for pilgrims travelling to the holy cities of Makkah and Medina is also benefiting from an investment surge, as a 20-year real estate and regeneration plan takes shape.

Makkah was the next best performer with revPAR up 6.2% to US\$78 year-to-June 2009. Medina took third position, with revPAR up 2.8% to US\$52. Even with the slowdown in revPAR growth, and 14.1% decline in Riyadh's hotel performance, these figures look healthy, given the general fall in global tourism as a result of a weaker economy.

Saudi Arabia is one of the few countries in the Middle East to remain in positive territory ...

Figure 1. Hotel performance across Saudi Arabia year-to-June 2009

	Occupancy (%)	Change (%)	Average room rates (US\$)	Change (%)	RevPAR (US\$)	Change (%)
Saudi Arabia	61.1	-3.5	167	7.8	102	4.0
Jeddah	68.9	2.0	175	18.1	120	20.4
Makkah	58.1	6.3	133	0.0	78	6.2
Medina	57.2	-5.0	91	8.2	52	2.8
Riyadh	66.1	-19.6	261	6.8	172	-14.1

Source: STR Global

Ambitious goals

Several initiatives are driving the expansion of tourism, with a subsequent boost in employment, and more details will be announced in a new national tourism master plan, due out by the end of this year.

The UNWTO estimates that around 14 million international tourists visited Saudi last year, while the SCTA's official website predicts that domestic tourist trips (termed overnight tourists) from July to September this year will have risen 3% to 9.4 million.

The SCTA plans to drive up both figures dramatically. It wants to double the number of international visitors by 2020, and give its 24.9 million citizens plenty of reasons to stay in their own country. The Saudis who travel overseas are said to spend around US\$10 billion on international travel and the Government is keen to capture some of this.

It has therefore been making some important changes, in order to make the Kingdom more appealing to both Saudis and visitors, including rolling out nationally a revised hotel classification system, originally developed for hotels in Makkah and Medina.

There is also a tourism strategy and action plan for the Red Sea, which includes 21 holiday destinations, an historical city centre development project and a heritage villages' development programme. Work is also progressing on the Al-Uqair tourism destination in Eastern province, the Farasan Islands, Jizan province and the Souk Okaz cultural destination in Al Taif.

Visa requirements to enter the Kingdom have been eased, with further changes in the pipeline.

Significant investments in the country's transport infrastructure, including trains and major highways are being made, while airports are expanding. Improved access is essential to support business development within the four new Economic Cities and an increased demand from the Meetings, Incentives, Conventions and Exhibitions (MICE) sector.

Underpinning all of this is a recognition that the country needs more trained employees if it is to meet its plans for tourism expansion, and there are plans for a fifth hotel training college to be opened in Taif.

In addition, visa requirements to enter the Kingdom have been eased, with further changes in the pipeline. There is talk of a single visa application scheme throughout the Gulf Corporation Council (GCC), which will enable visitors to travel across all the GCC's six member countries – Bahrain, Kuwait, Qatar, the Sultanate of Oman, Saudi Arabia and the UAE. Inter-region travel would also become even easier if proposals for a single currency go ahead.



Religious pull

Saudi Arabia's cultural and archeological heritage, as well as its tradition of hospitality, appeals to many visitors, and one of the SCTA's objectives is to preserve and promote this historical legacy.

Earlier this year, Madain Salih was listed by UNESCO as a World Heritage Site (the first in Saudi) and two others are on UNESCO's Tentative List.

But, of course, the main draw of Saudi is its position as custodian of the cradle of Islam, and millions make the Hajj and Umrah pilgrimages each year. The fastest growing hotel markets are naturally Jeddah, Makkah and Medina and the Government intends to ensure facilities here match the demands of an expanding number of pilgrims.

There are said to be around 1.5 billion Muslims in the world today – roughly 22% of the world's population – and each is required to visit Makkah at some point. Even if only a fraction of this number can afford to make the trip, the demand for accommodation, and flights, will continue to be strong.

More hotels

Massive investment in tourism and clear objectives to drive growth are attracting many development companies, including Jabal Omar, one of many working on a mixed use development around the Haram in Makkah. The project, named Jabal Omar, includes 39 residential and hotel towers.

International branded hotel companies are also moving in. InterContinental Hotels Group, for instance, has opened 23 hotels in the Kingdom, and signed a deal in 2008 to open a total of 12 under the Holiday Inn Express brand. This was part of an exclusive franchise development agreement with Siraj Capital Ltd with the properties set to open over the following five years.

Meanwhile, Hilton Hotels Corporation has an agreement with the Abdulmohsen Al-Hokair Group for Tourism and Development to open 13 Hilton Garden Inn properties in key locations across the Kingdom.

The fastest growing hotel markets are naturally Jeddah, Makkah and Medina ...

And more flights

A more liberal attitude to the country's aviation industry has expanded the operations of both international airlines and Low Cost Carriers (LCCs), who want to replicate the success this business model has had across Europe.

Nas air, based in Riyadh, was launched in 2007 and has continually enhanced the number of its routes across the GCC. Five new destinations have been added to its network recently, and there are more to come this year. British Airways Plc has also re-introduced flights to both Jeddah and Riyadh.

Middle East competition

Saudi Arabia gains some advantage by being able to look at the experiences of its Middle East neighbours during a decade of rapid tourism growth, but Saudi, unlike the more liberal destinations in the region, has some unique challenges.

First, its traditional culture, extreme climate, and strict entry regulations mean that its appeal to international travellers as a vacation destination may be limited. Its focus on domestic tourists is a sound one but, as many Saudis will have little disposable income and those that do have plenty of cash currently prefer to take their vacations elsewhere, this will be a tough strategy to deliver.

Improving the infrastructure for religious tourism is therefore paramount but other countries in the region, who have a wealth of historically and culturally important sites to offer, will be competing for this market. Jordan, Iran, Iraq and the Palestine territories all target a share of the religious tourism market, but Saudi's trump card is having Makkah and Medina within its borders.

Second, nobody can enter the Kingdom without a sponsor, including business visitors, and it is vital that international hotel companies have a strong local partner to support their development plans. Any visitor, business or otherwise, also needs to respect local customs.

An attractive choice

Saudi Arabia's economy is cash rich and generally strong, and although a contraction is predicted this year, recent increases in the price of oil could act as a cushion and keep a deficit at bay. The Kingdom is in a much stronger position than many other parts of the world, and its hotel business is holding steady.

Given this background, and with the strategic programme of tourism expansion combined with investment in infrastructure and enhanced aviation links increasing accessibility, we expect to see visitor numbers rise.

As the country relaxes its visa rules and takes further steps towards modernisation, tourism is likely to make a much larger contribution to the Kingdom's coffers.

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Survival of



the fittest

Sport came into the recession riding a wave of growth and, while not immune to the downturn, we believe sport is more recession resistant than many other industries.

The most common question we have been asked over the past year by the under pressure Chairmen, Chief Executives and Finance Directors of sports businesses is 'how are other sports and teams coping in the recession?' The instinctive reaction, fuelled by regular bad news stories in the press, may be to think that sport is struggling, due to a collapse in attendances and revenues coupled with ever spiralling wage costs. The argument could be that sport has gambled on success during the boom times, spent more than it can afford, and is hopelessly positioned to cope with the downturn now that someone's turned off the funding tap. It's a catchy headline – but is it true?

As we know, the wider economy does not offer much comfort. The consensus among economic forecasters seems to be that the global economy will suffer the most severe contraction in a single year since the Second World War. Discretionary spending, such as advertising, is seen as being the worst hit. Despite some tentative recent improvements in the outlook for 2010 and beyond, professional sport faces extraordinarily turbulent conditions.

Sport came into the recession on a high. Almost across the board there is more revenue being generated in sport than ever before. Perhaps the most high profile example, and a competition born in a previous recession in the early 1990s, is the English Premier League. Between 1992 and 2008 it outpaced the UK economy, itself on an extended bull run, by a ratio of 3:1. Its clubs grew their revenues at an average annual rate of 16.4%¹ compared to 5.4% in the economy generally.² And contrary to popular myth, the boom in English football runs deep. The 'have nots' of Football League 2 (the fourth tier) grew revenues at 9.2% per annum³ over the period. So, sport came into the recession riding a wave of growth and, as we will show, while not immune to the downturn we believe sport is more recession resistant than many other industries.

Natural strengths

While sports differ in their sources of revenue, there are some broadly common themes that bring comfort in a downturn. One advantage that sport has over many other industries is the presence of multi-year broadcast and sponsorship deals which, when coupled with the primarily seasonal nature of ticketing and corporate hospitality packages in certain sports, gives sport breathing space to adjust to a changed environment. Whilst this may merely delay, rather than avert, the impact of the recession, it allows sports businesses time to react and adjust their business plans in a way not afforded to companies in most other sectors.

Sport, particularly team sport, also benefits from a more loyal and tribal following than that found in almost any other industry. While consumers may switch between normal brands, when it comes to sport most fans pick their team, or have it picked for them, and stick with it through the good times and the bad. This provides much needed stability to sports teams in uncertain economic times.

Nonetheless, sport cannot be complacent. Among its key revenue streams, corporate hospitality and sponsorship are most 'at risk', due to both affordability and what corporate partners are comfortable to be seen to be doing at a time when they face tough cost cutting decisions. High profile withdrawals by financial services firms and automotive companies, two of the hardest hit sectors, from golf, tennis and F1 – some of the sports that rely most on sponsorship – and pressure from politicians and unions on those who remain, demonstrate the strain. Unsurprisingly, we are seeing relatively few new commercial deals and there is a reluctance to commit to long term contracts.

Some business partners have also attempted to renegotiate, or even renege on, existing deals. This represents a real risk when such revenue has been mentally 'banked', and often spent, by the sports organisation. In such an environment, we are commonly hearing that 'flat is the new up' in respect of any new deal values. We are also seeing evidence of a 'flight to quality' in sport, where the largest properties in the biggest sports are least affected, but smaller sports and teams struggle. A notable example is Manchester United's new four year shirt front sponsorship deal with Aon, at an increase of approximately 40% on the value paid by the troubled AIG.

Old habits die hard

Although conditions are likely to be difficult in the short term, the fundamentals remain strong. Sport is woven into the fabric of many countries' national identity and deeply integrated into many people's everyday lives. Nowhere is this more clearly illustrated than in attendance figures for sporting events. For example, in the 2008/09 season England's Premier League recorded attendances of over 90% of capacity for the 16th consecutive season.⁴

Attending sport is habitual for fans, and the evidence suggests that, even during a recession, many sports fans will sacrifice other luxury items before they will give up their sport 'fix'. For some, the fear of falling to the bottom of a season ticket waiting list is enough of a deterrent to somehow find the funds for this year's renewal. For many, the enjoyment and camaraderie it brings provide a welcome distraction from the harsh realities of the 'real world' during difficult times.

While many claim that ticket prices are too expensive and people cannot afford to watch top sport anymore, the recent figures suggest that demand to watch live sport remains strong.

Royal Ascot attendances in June 2009 were down only 3% compared to 2008, with only 10,000 fewer attendees over the five days of the meeting⁵ while people camping outside Wimbledon in order to secure a ticket remains a feature of the British summer. Meanwhile, the German Bundesliga, the best supported football league worldwide, was played in front of record average crowds of over 42,000 in the 2008/09 season.⁶

The new 'going out'?

It is not just live attendances at sports events that are holding up. Armchair fans are also continuing to indulge their passion for sport. This is not just millions watching Andy Murray or the Olympics for free. Again, contrary to some conventional wisdom, the best Pay TV providers, who have provided much of the funding of sports' revenue growth in the last 10 to 20 years are doing very well out of a growing trend towards 'Entertainment'. Subscription numbers and revenues per user are up at BSkyB and it would seem sport is as crucial to the business model when the economy dips as it was when it rose. The English Premier League was able to secure a deal with ESPN within 48 hours of the announcement that Setanta was entering into Administration.

We are seeing evidence of a 'flight to quality' in sport, where the largest properties in the biggest sports are least affected, but smaller sports and teams struggle.



A small price to pay?

Even with strong event day and TV audiences and the security of long term deals, sport recognises it cannot assume immunity from the economic malaise around it. We are already seeing adjustments in pricing strategy. The 2009/10 European football season has just begun and we will soon have our first evidence of season tickets sales in the new, harder environment. Many teams have carefully reviewed marketing and pricing strategies and, whether in an effort to boost sales or perhaps to show solidarity with their key stakeholders, price freezes or even reductions are commonplace for 2009/10 at even the largest clubs, including Arsenal, Chelsea and Liverpool.

Now more than ever, value for money is key. This is especially true for those corporate hospitality buyers who are small businesses and often fans in their own right, who have 'traded up' from a general admission ticket to a hospitality package, rather perhaps than some larger enterprises with weaker brand loyalty.

Even the US National Football League (NFL), the world's largest sports league in revenue and average attendance terms, announced 10% price cuts for its play-off matches, stating 'we want to be responsive to the economic challenges facing our fans'. Even given this cautious mood, they still achieved a 70,000+ crowd for the second NFL regular season match played at London's Wembley stadium.

Again, at the very top end of sport there is clear evidence of sustained demand. The Wimbledon debenture issue in 2009 was a huge, oversubscribed success.

Time for a cap?

As is well recorded, sport, in contrast to most other industries, struggles to convert revenue growth to bottom line profit. It is therefore timely, with slower revenue growth in many sporting competitions, to consider whether this will bring an end to upward spiralling wage costs. Could the time for a salary cap finally have come in football? Such caps are already in place in other sports, adopted in less stressed circumstances, either as a fixed amount per team or as a percentage of team revenues. For example, in three of the 'big four' North American sports leagues as well as both codes of rugby in England.

However, it is clear in word and deed, and not just at Real Madrid, that there is little appetite for, or belief in, salary caps at the top of European football. The clubs see their challenges as different to those of the NFL, the US National Basketball Association (NBA) and the US National Hockey League (NHL) which are by far the most financially lucrative leagues in the world in their respective sports, so face little risk of the playing talent choosing to join a rival league.

Football clubs compete for the best talent in a global sport with 'open leagues' allowing promotion and relegation. When one adds in the fact that players enjoy free movement between leagues in the European Union, unilateral action by a league or federation on salary caps is risky and challenging while the development of a centralised system of financial control is fraught with even more difficulty in practice than in theory. We expect instead that the market will, as it has in the boom, find an equilibrium of very limited profits and failing clubs at the fringes.

Many teams have carefully reviewed marketing and pricing strategies and price freezes or even reductions are common place for 2009/10 at even the largest football clubs, including Arsenal, Chelsea and Liverpool.

Crunch time

Two other areas which have seen a sharp fall in activity during the economic downturn are mergers and acquisition activity and stadia construction. Potential owners of 'trophy assets' such as major sports franchises, F1 teams and football clubs have reduced liquidity and as a result we have seen relatively few changes in sports franchise owners during the past year.

Similarly, while there has probably never been a better time in recent years to be going to the construction market for facility development – given a fall in the cost of raw materials and low levels of competitive activity for building contractors – there is a shortage of willing commercial lenders, or sufficiently wealthy individuals, who are willing, and able, to provide the necessary funding to undertake a major capital project.

This recession provides modern sport's most stringent economic test yet. Sponsors will be asking whether their sponsorship represents value for money, and fans face some serious soul searching as they consider whether or not to renew their season ticket. The majority, we believe, are likely to do so.

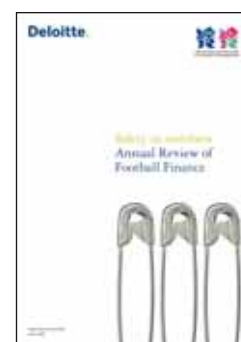
For larger teams and sports events, playing to sold out stadia and big TV audiences, with strong demand for corporate packages and wide commercial appeal to current and potential sponsors, the impact may be limited. However, for smaller sports businesses, where demand is more variable, and the product more niche, the downside may be more pronounced.

Overall, due to the high proportion of advance contracted revenues, and strong customer loyalty, sport is more recession resistant than many sectors. But it is not recession proof. We expect the recent trend towards a flight to quality and polarisation of revenue to continue, which makes a diversified revenue stream – without too much reliance on sponsorship – as well as flexibility in the cost base, with some performers' pay more directly linked to revenue, two key ingredients for ongoing success.

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1 Deloitte Annual Review of Football Finance (ARFF) 2009
2 Office of National Statistics
3 ARFF 2009
4 ARFF 2009
5 Horserace Betting Levy Board
6 Deutsche Fußball Liga



Has luxury lost its lustre?

2009 continues to be a trying year as the industry battles a series of challenges stemming from the global recession, intensified competition, over-supply and shifting patterns of consumer spending.

Luxury hotels have long been considered resilient to economic downturns. However, this segment is bearing the brunt of the challenges facing the US hospitality industry and some analysts believe that luxury could be in for a prolonged slump.

This article examines the key challenges faced by the US luxury segment and likely future developments, in order to understand the potential path to recovery for this very important sector of the hospitality industry.

The summer/autumn period is typically one of the busiest travel times in the United States and an important season for hoteliers. However, 2009 continues to be a trying year as the industry battles a series of challenges stemming from the global recession, intensified competition, over-supply and shifting patterns of consumer spending.

As Figure 1 demonstrates, the downturn has affected all hospitality sectors but the sharpest impact has been felt in the luxury segment, with RevPAR down 28.1% year-to-date to June 2009.

Defining luxury

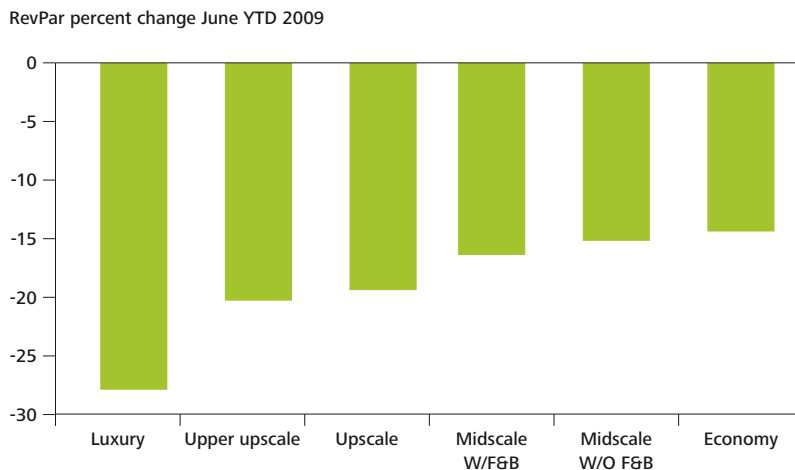
What exactly is a 'luxury hotel'? While Smith Travel Research's (STR) definition of the luxury segment is based on the rate a hotel charges, that rate is merely a proxy for a host of qualitative factors and subjective perspectives that come into play. High rates are also a means to communicate quality and exclusivity, in the absence of tangible attributes. Some have tried to capture such factors neatly in a rating.

For example, the American Automobile Association has used its Diamond Rating System.¹ This system is meant to give more clarity to every component of the hotel property, starting from its exterior to the details of the room décor.² A five star rating is indicative of a luxury property.

Condé Nast takes a different approach, publishing an annual Gold List of hotels based on 'comments of readers ... [that] are intended to reveal a property's character rather than to catalog its facilities.'

However popular these methodologies may be, none have become the *de facto* industry definition. Luxury is a perception centred on guest experiences, and 'the discerning luxury customer can tell the difference' according to Omar Palacios, Senior Vice President and CFO, *One&Only Resorts*.

Figure 1. US hotel RevPar change by segment



Source: Smith Travel Research (STR)

From a guest's perspective, luxury hotels exhibit three common characteristics: impeccable accommodation, quality service and a high price point.³ In short, guests are *paying* to experience luxury at a high end hotel.

From a luxury operator's perspective, according to Isadore Sharp, Founder, Chairman & CEO, *Four Seasons Hotels & Resorts*, 'Luxury, by definition, means something that appears to be the best of whatever it represents. It's a word that raises people's expectations, ... You pay for recognition, but probably the most important thing it represents is delivery on the promise of the brand's name.'⁴

Dark cloud of over-supply

Luxury hotel investment increased significantly between 2003 and 2007, driven by a weak US dollar that caused record growth in inbound tourism, an environment of cheap debt and booming disposable income.

Projects sprang from the drawing boards with ease. Lenders were driven by loan volume, brand managers wanted to increase market share, and operators wanted a slice of the lucrative management and incentive fees. Meanwhile, investors were attracted to projected returns on equity that were turbo-boosted by the high levels of operational and financial leverage. These investors were more than happy to contribute the minimal levels of equity investment required in a classic 'real option play'.

Delivering the definition

To deliver this definition of luxury, the business model has to incorporate certain key attributes. Below are three important features, along with their implications during the current challenging environment.

Figure 2. The luxury hotel business model

Key feature	Current implications
<p>1. To appear 'to be the best of whatever it represents' requires significant investments in facilities. Costing \$500,000⁵ or more per key in some cases during the last boom, luxury properties have significant fixed costs that increase their operational leverage.</p>	<p>The fixed costs that drove record profits and incentive fees when times were good have the opposite multiplier effect during downturns.</p> <p>The most significant outlay to maintain the brand promise is capital spending for maintenance and enhancements. This is also the first item owners tend to trim in order to save cash.</p> <p>The decline in maintenance spending means retrofits are delayed, and facilities start to deteriorate. This further erodes already depressed property values.</p>
<p>2. To deliver the consistent level of service that 'raises people's expectations' requires an increased level of attentive staff, and attention to details that maintain the overall atmosphere (e.g. fresh flowers in the lobby). So not only are fixed costs significant, operating costs are also a heavy burden.</p>	<p>According to Mark Heschmeyer of CoStar Group⁶, a 20% revenue decline could result in net cash flow declines between 35%-40% for hotels with high operating expenses. Making payroll could be a challenge if revenues start to drop enough.</p> <p>Operators have to decide what they can cut while still ensuring the property meets the stringent brand standards typical in the luxury segment.</p>
<p>3. The money required to build and maintain a luxury hotel means principals have to rely on different sources of capital, including debt. As financial leverage increases, debt service becomes the dominant source of cash outlay at high-end properties.</p>	<p>The competition among lenders drove down underwriting standards. According to Steve Van, CEO of Prism Hotels and Resort, '75% of loans from the 2006 and 2007 vintage were interest-only or partial interest-only, and [debt service] coverage came down to 1.0 [times] revenues'.⁷</p> <p>When financial leverage is so high, there isn't much cushion to absorb a decline in cash flows. The rating agency Fitch estimates that 'in the event that luxury hotel performance continues to decline as it has year to date, more than 50% [of the properties] may be unable to generate sufficient cash flow to pay debt service'.⁸</p>



Figure 3 statistics cover the entire spectrum from luxury to economy for the US market and illustrate the trend in over-supply at the top end of the scale. The 'ideal conditions' fostered by perfectly-aligned incentives from all players during the boom have helped create the 'perfect storm' of over-supply that is likely to cast a dark cloud over any forecasted recovery in the luxury segment.

Leisure patterns change

In addition to the supply issues, the demand challenges facing the luxury segment are also significant. The Conference Board reported last fall that the consumer confidence index had plummeted to its worst reading since 1967.⁹

Low consumer confidence translates into weak spending. American consumers are more cautious with their discretionary dollars, which have disappeared in part because of the loss of their home-equity-as-ATM, as well as increasing unemployment. Spending habits for leisure travel are vulnerable to downturns.¹⁰ Consumers cannot devote the same level of disposable income to luxury leisure travel as before.

Despite the sagging economy people still want to travel for leisure, however, the downturn will certainly affect how and where people travel. Consumers will be less willing to take a traditional seven-day trip due to cost and may instead take a mini-vacation. Travellers will also seek more 'bang for their buck' and many may opt to vacation closer to home.

Business bookings nosedive

Corporate bookings, the lifeblood of larger, high-end properties are also heavily impacted by the drop in US business travel. Certain sections of luxury hotels rely on business travel to make up much of their revenue, including income from business meetings and conferences. This was increasingly significant for the luxury segment during the last boom.

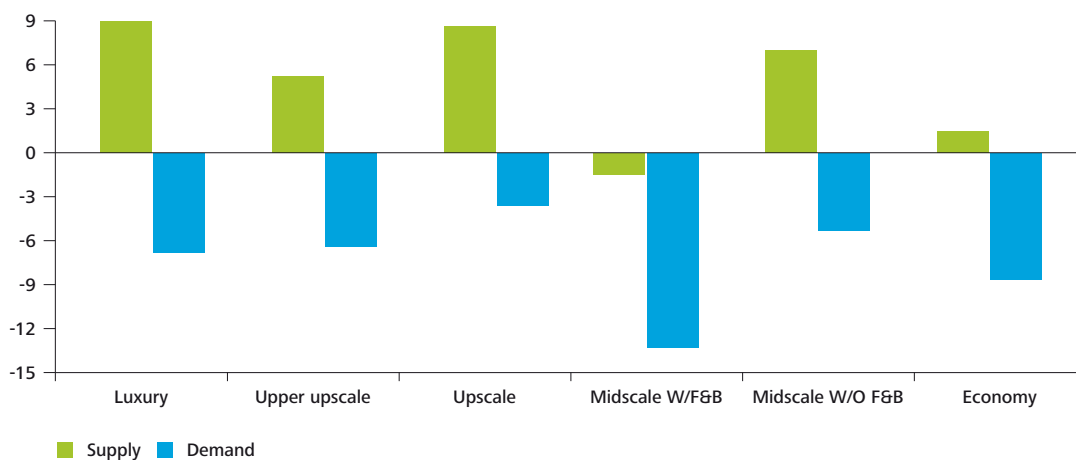
During the past year at the peak of the global recession, companies were frowned upon for holding conferences and events at luxury properties. Here, the numbers do tell the story. Through April 2009, the Las Vegas Convention and Business Authority reported that almost 30,000 room nights previously booked for 2009 had already been cancelled.

Corporate booking trends will remain down, as businesses continue to rein in controllable expenses to offset the impact of forecasted revenue declines on their bottom line. According to STR Vice President Jan Freitag, weekday group bookings fell 19.5% year-on-year for January and February 2009 for the luxury segment, compounded by rate decreases of 11.7%.¹¹

Luxury hotels rely on business travel to make up much of their revenue ...

Figure 3. US hotel supply/demand change by segment

Supply/demand percent change June YTD 2009



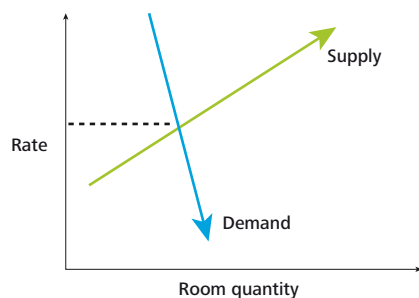
Source: Smith Travel Research (STR)

Some players in the luxury segment will emerge stronger from this fundamental shift in the market.

How deep will the downturn be?

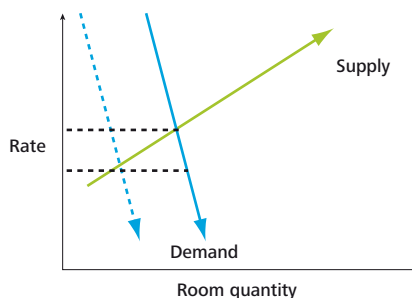
To predict the depth of the downturn for the luxury segment, we need to examine the underlying interplay between supply and demand. The following charts illustrate the environment between 2001 and 2008.

Pre-9/11



Pre-9/11, the luxury segment was characterised by inelastic demand, and cautious supply levels that worked together to create a high equilibrium rate at sustainable occupancy levels.

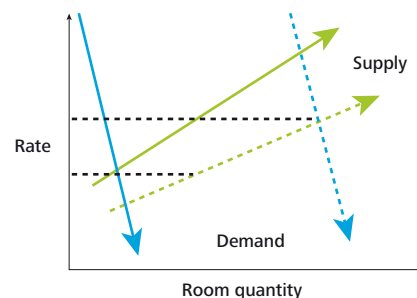
9/11 Shock



The 2001 events caused a temporary shock to demand resulting in a shift of the demand curve as operators cut rates to maintain occupancy levels in order to offset the low airlifts, and the general economic malaise.

Another key feature was the highly competitive and fragmented nature of the industry, which meant no one player had price-setting power. This caused the anaemic pace of price recovery, as operators realised the magnified impact of pricing on market share.

Boom years – 2003-2008



As consumer confidence recovered and disposable income increased in tandem with the housing market, demand increased dramatically at every price point, causing the demand curve to shift to the right. At the same time, luxury projects increased dramatically to meet this higher level of demand.

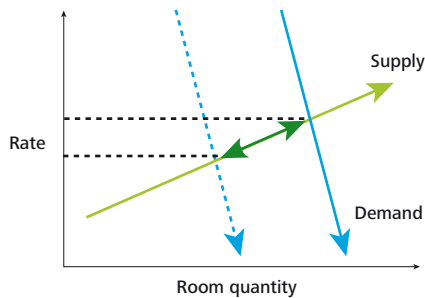
This chart also illustrates why it took so long for rates to recover to pre 9/11 levels. However the segment overall enjoyed significant occupancy expansion. Had supply been constrained, rates would have increased by significantly more and faster.

In order to increase occupancy and ensure future sustainable growth, luxury hotels may focus on their loyal base of repeat guests. Some operators are already developing innovative marketing programmes.

What happens next?

The key question now is where do we go from here? The next chart offers two alternative scenarios.

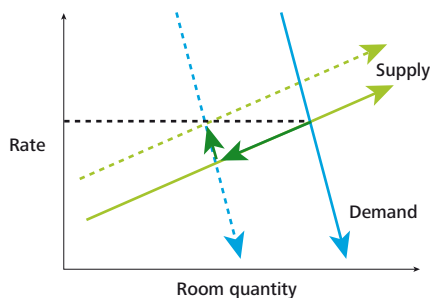
Scenario A



In scenario A, the current economic environment is viewed as a severe but temporary shock to demand.

In this case, reducing rates and suffering temporary declines in occupancy is justifiable, because the empty rooms will fill back up when demand returns to "expected" levels. With that, rates should also recover.

Scenario B



In scenario B, the demand shift is more permanent, in which case the rational response is to maintain rates, and cut supply.

However, because supply is not as flexible, this process will play out in two stages. First, price wars will drive rates down to meet lower demand levels. In the long-run, as supply adjusts, rates will recover, resulting in an equilibrium at lower, but sustainably profitable supply levels.

Permanent shift

There are a number of factors that appear to suggest that Scenario B is more likely. First, the sudden increase in demand between 2003 and 2008 appears to be linked to the temporary increase in disposable income fuelled by the housing market. Second, even though demand has some room to rebound, it is unlikely to rebound to the levels that the current supply of luxury hotels would indicate.

Continuing instability in the financial markets is also likely to remain a significant factor, causing a natural, but violent removal of excess supply. Lenders eager to clean up their balance sheet may force asset sales that will continue to put pressure on property prices. Refinancing will also be much more difficult as underwriting standards tighten in response to increased risk aversion and regulatory oversight. This will all contribute to a reduction in the supply of properties in the luxury segment.

In the long-run the luxury segment is likely to shift to a higher average rate, but at lower levels of supply. Unfortunately this transition will include significant price wars as hotels desperately chase the last dollar available to cover operating costs and debt service.

Price wars and loyalty programmes

The average daily room rate at some of the most exclusive luxury hotel chains around the world has dropped 16% to \$254.¹² The W Hotel chain recently initiated a 50% off sale for a large number of its global properties. The Ritz-Carlton is also targeting corporate executives and meeting planners with a 'Meetings Within Reach' promotion for groups booking ten or more nights at its properties worldwide.

Such significant incentive programmes combined with the defaults of some luxury properties as debt matures with low prospects for refinancing, will drive the de-leveraging process that will return the luxury segment to its more sustainable pre-9/11 rate and supply levels.

In order to increase occupancy and ensure future sustainable growth, luxury hotels may focus on their loyal base of repeat guests. Some operators are already developing innovative marketing programmes.

Back to the roots

Some players in the luxury segment will emerge stronger from this fundamental shift in the market. They are the ones who have the best tools to meet the challenges ahead. The future will bring new challenges and opportunities for brand managers, investors and lenders alike.

The luxury segment is likely to return to its roots as a niche within the hotel industry, with small, agile players catering for the specific desires of an elite clientele more immune to volatile economic conditions. Location and proximity to a rich client base will determine the winners. The challenge will be how to exploit luxury profitably on a smaller scale.

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Demonstrating brand value

More than ever, brand managers will have to demonstrate the value a flag brings to a luxury property. Thoughtful portfolio rationalisation will help successful brands to position themselves in a new luxury marketplace. There will likely be a clearer delineation between ultra-luxury on a small scale, and more mass-market destinations forced to compete at a lower price point. Some luxury hotels may be ready to shed a star and lower their standards to help preserve liquidity by decreasing rates to attract guests.¹³

Brand managers will have to protect the brand, while working with distressed owners who are struggling to make interest payments or refinance, by leveraging purchasing power to reduce costs and increase supply chain efficiencies. Managers will need to prioritise brand standards that truly add value to the guest experience. 'The brands that remain disciplined and focused on core development and operating principles will fare much better in this difficult period,' according to Omar Palacios, Senior Vice President and Chief Financial Officer, *One&Only Resorts*.

Successful brands will exploit new ways to enhance loyalty in an environment where fewer guests will reach the 25 stays or 50 nights per year required to qualify for Platinum status. Starwood's recent sale of loyalty points to American Express, as part of a \$250 million agreement, is an example of a creative way to monetise brand loyalty. Success will revolve less around yield management, and more around loyalty and guest experience management.

Pro-active investors

For investors the challenge will be to compete with new opportunistic players such as hedge funds and hospitality-specific Real Estate Investment Trust (REIT) vehicles as they enter the fray, scooping up debt that has been marked down and properties that have been forced onto the auction block. 'There is an opportunity – or may be an opportunity soon – for REITs that are positioning themselves to take advantage of other companies and bottom fish to purchase significant properties at bargain basement prices,' according to Susan Wachter, real estate professor at the Wharton School at the University of Pennsylvania.¹⁴

These new players may not have the same time horizon as traditional hotel investors. Their interaction with brand managers and operators is likely to be more pro-active than the more laissez-faire attitude of traditional investors. Transaction volumes will be much lower amid escalating cap rates. Successful investors will be those who re-evaluate their properties and pursue a carefully targeted marketing strategy that will guarantee short-term operating cash-flows, in order to wait out the turmoil in the commercial property markets.

Owners will have to decide which investments to abandon, which to sustain through additional equity injections and which to 'double-down' on. Boutique concepts may be fast-tracked as a smaller, but more profitable luxury niche market emerges.

Collaborative lenders

The most successful lenders will be those who realise that the best path to principal recovery may not be the auction block, and who therefore expand the range of options available to defaulting owners and cash-strapped operators.

Workouts will become more collaborative. Those with deep industry knowledge and connections will have the most success in negotiating and executing creative solutions. Successful lenders will partner with savvy operators and turnaround specialists with industry experience, who can not only manage a property, but also reposition it towards its highest and best economic use.

Goodbye to glamour

It is difficult to predict how this story will play out but we do know one thing with certainty. This downturn is different from the past, and the US luxury hotel segment will emerge quite different from where it stands today.

"We're thinking about a world where people are going to want to save money. I think it will be much less about cost and glamour than you might have seen in the last five years," (Chris Nassetta, Hilton CEO.)¹⁵

The winners will be those who can transform themselves to respond quickly and creatively to the fundamental changes in consumer preferences. As always customers drive the bus, and the luxury coach is ready to leave Conspicuous Consumption-ville.

1 Diamond Rating® System, According to AAA NewRoom, 2009

2 Ibid

3 Gemma Greenwood, "How do you define a luxury hotel?" *arabianbusiness.com*, June 2007

4 Isadore Sharp, Founder, Chairman & CEO, Four Seasons Hotels & Resorts, *The Informed Traveler (The Five Star Alliance)*, May 2008

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The most successful lenders will be those who realise that the best path to principal recovery may not be the auction block, and who therefore expand the range of options available to defaulting owners and cash-strapped operators.



The smoking ban –
a catalyst for change
as Britain dines out

Deloitte research shows clearly that the price differential of drinking in the pub compared to drinking at home has widened considerably in the last decade ...

On 1 July 2007, the UK introduced a ban on smoking in enclosed public places. A Deloitte survey of 1,000 consumers shortly before the implementation of the ban found that 33% of consumers expected to eat out more often, given that they would no longer have to waft away smoke from neighbouring tables. Only 9% said they would probably eat out less. The view of the Licensed Retail team at Deloitte at the time was that the ban represented a real opportunity for pubs and restaurants to improve the quality and choice of their offerings and appeal to a customer base previously put off by smoky venues.

At the same time, other Deloitte research in the summer of 2007 looked at the experience in Ireland, which had introduced its smoking ban in March 2004. This concluded that although pub and restaurant revenue would probably drop in the short term, there would be a steady recovery over the next couple of years as the industry improved its non-smoking offering and new and returning customers enjoyed a smoke-free lunch, a quick drink with friends, or an evening out.

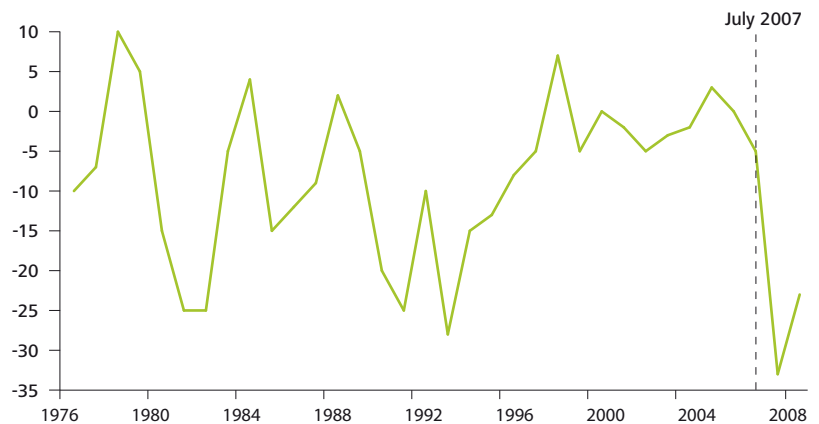
As it's now two years since the UK's pubs, bars and restaurants put away the ashtrays, we feel the time is ripe to reflect on what has happened in the intervening period and assess what the real impact has been so far. In this article we take a broad look across some of the statistics, which suggest that – although there have been hundreds of pub closures across the UK – pubs and restaurants that have improved their product offering have done much better than the dire predictions put forward in 2007.

Double the damage

In the period since the ban was introduced, the UK has suffered the worst economic slowdown in decades, and job losses, financial insecurity and falls in disposable income have muddied the analytical waters. Turmoil across the world's banking sector and the ongoing credit squeeze have damaged all businesses across the UK and dealt licensed retailers a double blow.

Figure 1 shows that in response to the recession, consumer confidence has fallen dramatically from around the time that the smoking ban was imposed. Consumer confidence in 2009 now mirrors the low levels seen in the recessions of the early 1980s and 1990s.

Figure 1. UK consumer confidence



Source: Nationwide

The timing of the recession therefore makes it extremely difficult to isolate and assess the true effect of any single factor. While some in the industry point to the smoking ban as the catalyst that closed 'the local', others attribute the loss of revenue in pubs and restaurants to the simple fact that people with less cash tend to go out less often. There is also a view that changing lifestyles are hastening the demise of the traditional British pub.

Few can doubt that pubs are having a very tough time. The British Beer & Pub Association (BBPA) estimates that more than 2,000 of them have shut in the past year. The rate of closure in summer 2009 is now estimated at around 50 per week by the BBPA, and one should not forget the plight of the individual landlords who form these statistics.

The smoking ban and the economic downturn came on top of a range of other challenges. Increases in the minimum wage, for instance, came at the same time as supermarkets intensified the competition by slashing the prices of alcoholic drinks, leading to home drinking and the concept of 'pre-loading' (consuming cheap alcohol from supermarkets before heading out for the evening). Deloitte research indicates that the price differential of drinking in the pub compared to drinking at home has widened considerably in the last decade, discouraging consumers from drinking outside the home.

The regulatory environment has also changed, with new licensing arrangements and increased duty on alcohol. Growing concerns about binge drinking have been exacerbated by the Government's re-defined guidelines on acceptably 'safe' amounts of alcohol, and there is now talk of legislation to record calorie counts on menus. To offset some of these factors, the government would point to amendments to licensing laws that now offer the possibility of 24 hour drinking, as well as the UK's temporary reduction in VAT to combat the effects of the recession. It is clear, however, that pubs and restaurants have had to work incredibly hard simply to maintain revenues at existing levels.

Some pubs that are led by a high quality food offering have seen large increases in the number of customers, particularly women and families who would normally have avoided pubs because of the smoke. These types of pub have benefited at the expense of smaller, wet-led establishments – the traditional British 'boozers' – where there was a high degree of correlation between customers who smoked, drank regularly and played the fruit machines.

In the restaurant sector, the impact of the smoking ban is less clear cut, largely because many restaurants already had 'no smoking' policies in place well before the new law was introduced. Certainly, many restaurants are seeing significant drops in footfall and turnover but this is more likely to be due to the economic gloom than the smoking ban. There is strong evidence that the 'fine dining' and 'premium casual dining/business lunch' venues have suffered as business expense accounts have come under closer scrutiny, with client entertainment budgets being cut and business sentiment turning away from lavish corporate entertaining. Diners are also 'trading down', with some people choosing cheaper menu options and cutting down on the number of courses eaten, or switching to more casual dining or fast food options.

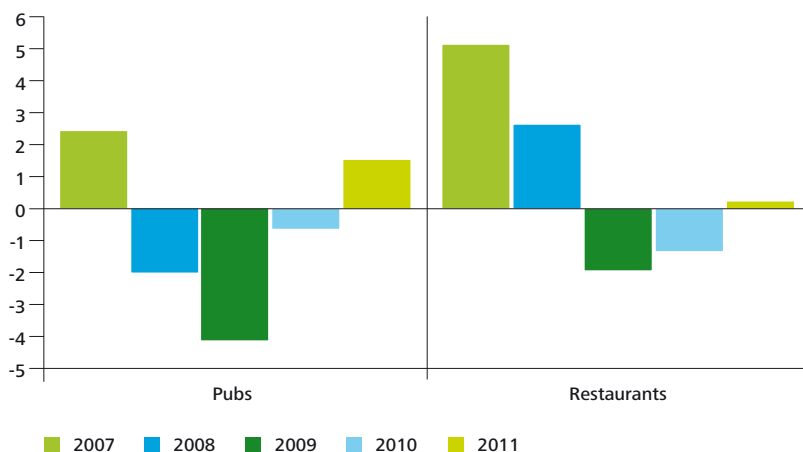
Overall, however, the eating out sector as a whole has proved remarkably robust, defying the dire predictions made by many analysts in late 2007.

To illustrate the impact on the industry, Figure 2 shows our analysis of the like-for-like sales growth for each of the quoted pubs and restaurants sectors, based on actual figures for 2007 and 2008 and broker note forecasts for 2009-2011.

This shows a noticeable drop in 2009 like-for-like sales in the pubs sector relative to the restaurants sector, but with both sectors forecast to return to like-for-like sales growth by 2011. Within the pubs sector, however, there is a much larger degree of divergence across the sub-sectors than there is with the restaurants sector. Specifically, at the managed pubs end of the spectrum, the average 2009 fall in like-for-like sales has been only 1.9%, as compared to an average fall of 8% at the tenanted pubs end of the spectrum.

We see this as reflecting the underlying nature of the portfolios of pubs. The 'pure' managed pub operators, such as JD Wetherspoon plc and Mitchells and Butlers plc, at one end of the spectrum tend to have larger sites and more consistent food offerings, whereas the tenanted pubs at the other end of the spectrum are more likely to contain the smaller, wet-led sites. Interestingly, however, when one looks at broker forecasts of like-for-like sales growth in 2011, the predicted outcome is for 0.95% growth from the managed pubs but for 2.7% growth from the tenanted pubs. This is likely to be a result of the current closures of smaller wet-led pubs removing their statistics from the like-for-like comparisons.

Figure 2. Average actual/forecast like-for-like sales



Source: Deloitte analysis of actual 2007 and 2008 performance and broker note forecasts for 2009-2011 for quoted pub and restaurant operators

Winners and losers

Looking at the UK as a whole, there have undoubtedly been some clear winners and losers in the pubs sector. Beneficiaries are those pubs with a high quality food and beverage offering, a good location, well-developed outside facilities, and a strong catchment area with little local competition. The ban has accelerated the weeding out of establishments that had less opportunity to adapt to evolving consumer needs and were no longer economically viable, giving the best pub in the neighbourhood a better chance of survival by drawing custom from further afield.

Whilst many operators have reported resilient like-for-like sales, however, the truth is that, certainly for restaurant operators and the managed pubs operators, it is special offers that have been propping up business during difficult times. Consumers are much more aware of, and responsive to, promotional initiatives such as discounting, coupons and value offers ('two for one' meals, etc), with consequent margin erosion. Operators need to use such promotions wisely, to ensure that their initiatives genuinely increase sales rather than cannibalising profit margins on business that they would have had anyway. In the longer term, a key challenge for operators will be to wean consumers off these discount deals. The deals clearly help to buoy up trade whilst customers focus on 'value for money', but continuous discounting tends to undermine long term value creation from brand building.

Sector resilience in the face of changing consumer trends

There is comfort for operators in recent research suggesting that dining out and socialising are the two things people most like to spend their disposable income on.¹ They may well be near the top of the list of activities people cut back on when times are hard but they are the first to come back on the agenda when there is more disposable cash. Encouragingly, 30% of consumers still intend to eat out regularly and more than half the people interviewed still enjoy splashing out on a meal.² Eating out, therefore, is less discretionary than it has ever been.

The key challenge facing all businesses in the sector is how to adapt to changing lifestyles and shifts in consumer demand, how to appeal to a new generation of customers and how to bring the smoker back. This is particularly true of the pubs sector. Whilst the smoking ban and fierce competition from the large supermarket chains are cited most frequently as the top two reasons for this trend, some would argue that the ban has simply hastened the evolution of the British pub market. There was a year-on-year drop of more than 6% in beer sales in bars, pubs and restaurants in the first quarter of 2009 according to the BBPA's Quarterly Beer Barometer. Sales of beer in supermarkets and off-licences have fallen almost twice as much (11%) in the same period.

Both figures can be seen as an indication of a change in the culture of drinking, as well as a lack of disposable cash among pub 'regulars'. Research suggests that people who say they are not going to the pub because of the smoking ban are also staying away for economic reasons.³

People who claim that they drink at home because of the ban are most likely to be young (18-24) and from less affluent groups, while those who now choose to go out more are in the 25-44 age group and from the more affluent end of the social scale. They are also more likely to be women and to have children.

This same survey also confirms that the people now choosing to go to the pub because they can breathe more freely are outnumbering the smokers who opt to stay away.

This matches Deloitte's analysis of the impact of the ban in Ireland and in Scotland where, after an initial drop in customer numbers, business improved two years down the line. We believe that many operators have seen the ban as a chance to rework their offerings to appeal to this new wider group of clients, and pubs that have a good food offering and an attractive outdoor space have been able to keep both smokers and non-smokers happy. The smoking ban has thus accelerated the segmentation that was already underway in the marketplace. Smaller, wet-let and land-locked sites have suffered, as have a number of the smaller High Street chains and the majority of the recent pub closures have been sites of these two types.

The BBPA suggests that the way forward, in the short term, is to 'accentuate the positive' and to maximise the opportunities available. Certainly, sunny weekends and long, warm evenings always boost pub trade, and any venue with good outside facilities should have been able to benefit from summer celebrations. In addition, the strong Euro is encouraging many more people to spend their vacations at home rather than abroad, and this is good news for both pubs and restaurants, particularly those with accommodation.

And what of the future?

In the current economic climate, consumers are focused more on the 'value' of the offering than on the 'values' (i.e. health aspects, locality of ingredients etc) thus the great challenge of growing like-for-like revenues. In the longer term, however, operators will want to build a brand that stands for more than simply 'being cheap'. Price has to be competitive, but operators still need to have a good offering and manage their operations well. We also await with interest the potential introduction of a minimum pricing policy for alcohol likely, as with the smoking ban, to be implemented in Scotland first. Equality in prices between the on trade and off trade may help drive people back to the pub.

The additional challenges faced by all businesses in securing financing to develop their operations mean that those with a strong balance sheet are best placed to take advantage of the opportunities emerging from the recession. This is likely to mean more consolidation to achieve purchasing power benefits, as well as the development of multiple branded offerings to spread risk. The impact of the recession on the High Street means that it is now easier and cheaper for operators to get space there, to complement 'destination leisure' venues such as retail and leisure parks.

Although few things are recession-proof, we do know that people still want to eat and drink out regularly, to socialise and to celebrate. Those outlets that can offer a differentiated drinking and dining experience combined with real value for money will continue to show sustainable growth but, in the short term, it is likely that growth will be attributable to a combination of new site openings, the maturing of recently opened sites and the closure of underperforming sites.

¹ 'Theatre of eating out' report, Mintel, April 2009

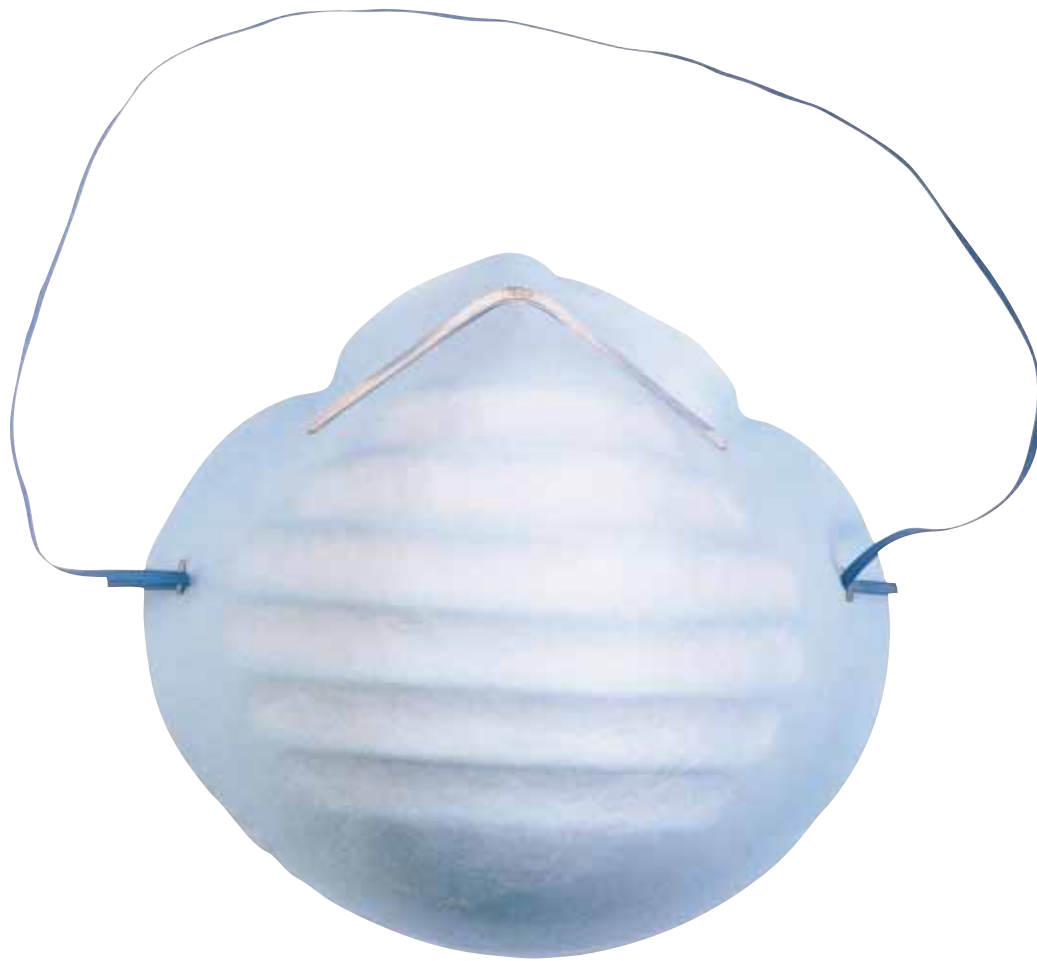
² Ibid

³ 'Pub visiting' report Mintel, September 2008

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Pandemics: Business unusual?



“Swine Flu: 100,000 new cases reported”
... “Flu outbreak means lost summer for
Mexican tourism” ... “Airlines stop swine flu
victims flying” ... “Tourism industry could
be big loser as nations warn against travel
to U.S.”¹

With headlines like these, the tourism, hospitality and leisure industry needs to ask if it is prepared and ready for more of the same in the future. Have lessons been learnt from previous epidemics and what measures can the industry take to manage the implications of business *not as usual*?

Pandemics have occurred intermittently over the past century. In 1918-19 "Spanish flu" claimed 50 million lives, in 1957-58 "Asian flu" claimed 2 million, and in 1968-69 "Hong Kong flu" killed 1 million people. Recently the world has been plagued by more frequent, though fortunately so far less lethal, epidemics starting in 2003 with SARS, followed by the avian flu (H5N1) virus in Asia, and now swine flu.

Since emerging in Mexico in late April, the new influenza A virus, subtype H1N1 (commonly known as swine flu) has spread internationally with unprecedented speed. In previous cases, flu viruses have needed more than six months to travel as widely as the new strain spread in its first six weeks. On 24 July, the World Health Organisation (WHO) announced that the number of human cases of swine flu was still increasing substantially in many countries and the organisation would no longer publish global tables of confirmed cases due to resource constraints. The outbreak has reached the highest phase six, that of global pandemic.

Travel and business impact

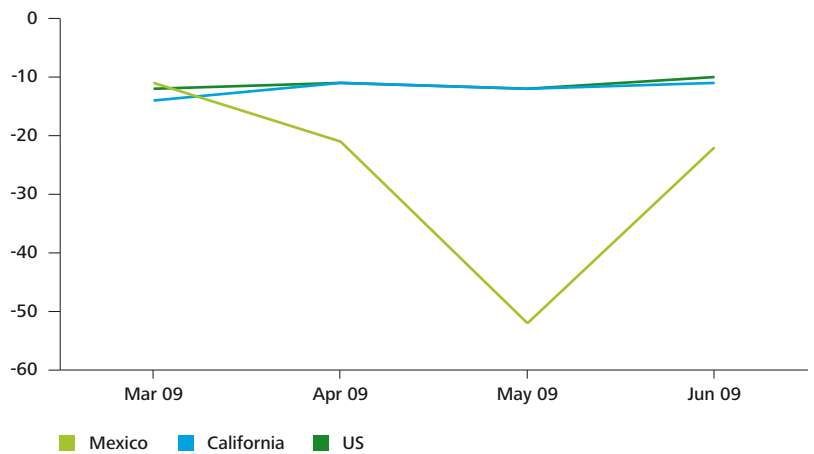
Swine flu had an immediate impact on the travel and hospitality industry. When news of the virus broke, investors wiped US\$5 billion off the value of leading US airlines within 10 minutes of the announcement of a public health emergency, with those carriers most heavily exposed to Mexico racking up double-digit losses.²

Hotel room occupancy figures for Mexico show the potentially devastating impact of the virus. On 24 April occupancy was at 58.8%. By 10 May occupancy had dropped to its lowest point of 14.6%. Overall, Mexico reported a 52.4% drop in occupancy during May 2009 compared to the previous year. Those organisations who are exposed to the epicentre of an outbreak feel the impact quickly, as noted by Gabriel Escarrer Jaume, Vice Chairman and CEO of Sol Meliá Hotel Group:

"As always, when one country is suffering, others take advantage to improve their own situation, and the swine flu has been no exception. While Mexico was losing their place as a tourist destination, neighbouring countries were benefiting."

With Mexico being the source of the outbreak, the immediate drop in hotel occupancy was to be expected. The implications of the outbreak were not yet known and people feared the worst. When California and the rest of the United States became the next most affected regions, correlating decreases in their occupancies might have been expected. However, decreases of only 12% were seen, perhaps due to mortality rates not being as high as feared.

Figure 1. % Change in occupancy from previous year



Source: STR Global

During the Severe Acute Respiratory Syndrome (SARS) crisis of 2003 the WHO issued regular information bulletins and travel advice. It is important to note that at no time did the WHO issue any travel restrictions, although it did advise people to consider postponing all but essential travel.

Again during the current crisis no restrictions on movement have been recommended by the WHO. Even if curbs on international travel could delay the arrival of a pandemic by weeks or months it would not prevent its spread indefinitely. Restrictions would have a crippling effect on the global economy at a time when many organisations are already under financial duress.

Hard to predict

With the progress of the pandemic now seemingly inevitable the business community is looking to government for advice on how to react and plan ahead. Advances in viral immunology, global surveillance and modelling techniques are making planning somewhat easier than in the past.

Despite these improvements it remains impossible to accurately predict the impact surrounding the pandemic, due to continued lack of understanding of the health implications of the virus, both in terms of the actual incidence of illness (clinical attack rates) and mortality rates.

Guidance from the United Kingdom Department of Health states that the clinical attack rate should become more evident as person-to-person transmission develops, but response plans should recognise the possibility of a clinical attack rate of up to 50% in a single-wave pandemic. Businesses have been advised to consider the likely levels of absence from work in each scenario.³ British Airways has considered scenarios of 10%, 20% and 30%, while Marriott has considered a 30% – 40% absenteeism figure.⁴

In the United States, both federal, state, and local governments and the private sector are refining their planning, preparation and coordination on an ongoing basis, taking into account how flu threats change over time. In particular, the US Center for Disease Control and Prevention (CDC) has deployed 25% of supplies in the Strategic National Stockpile (SNS) to all states in U.S. territories. This included antiviral drugs, personal protective equipment, and respiratory protection devices.

Preparation not panic

Within the travel and hospitality industry, organisations leading the field have been reviewing their working practices and business continuity plans. Lessons appear to have been learned from the “media hysteria” experienced during the previous SARS and avian flu epidemics. This time around the watchword is preparation and proportionate response rather than panic. Nevertheless, the power of the media over people’s behaviour should not be underestimated.

Senior Director of Business Continuity at Marriott Hotels, Dr Penny Turnbull, explained that Marriott started planning for infectious diseases in 2005 at a time when avian flu was of concern. A task force at senior executive level wrote the corporate pandemic preparedness and response plan, which was then rolled out and has been kept updated since. This meant they were ready to implement their plans as swine flu unfolded.

One of their biggest challenges was that health planning varies from country to country, which impacts how their plans are implemented on the ground. In writing their pandemic plan, they took into account the “six phase” WHO plan, but consolidated this into three key stages, being the pre-pandemic, ramp-up period and pandemic at WHO level 6 phase.

The WHO guidelines have also been followed by British Airways and Sol Meliá Hotels. Each has adapted their response to follow WHO best practice, and consider alignment with local official best practice is critical.

British Airways had established a centralised Business Resilience Group and the company held a two week corporate simulation exercise in 2007 that was based on the avian flu. In line with the accepted thinking at the time, they felt this was the area of risk. They revisited and updated their plans and are monitoring the swine flu situation on an ongoing basis through a dedicated steering group of key managers. This group addresses issues such as WHO and United Kingdom government advice, overseas states’ requirements for arriving passengers, and people policies.⁵

A widely held view is that the swine flu has not met these companies’ “worst case” scenarios, and they have been able to scale back some of their plans. They remain vigilant however, as a potential second wave in the winter could have a more severe impact on their people and their business.

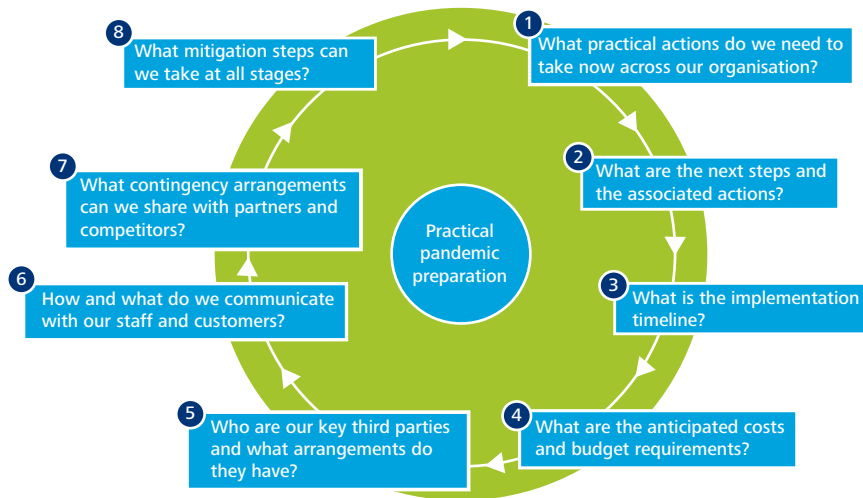
Challenge of absenteeism

One of the key challenges for business planning is a high level of staff absenteeism and the impact this will have on the continuity of business critical activities across the supply chain. Experts have also pointed out that, in contrast to normal seasonal flu, the infection rate from H1N1 is higher in healthy individuals who represent the greatest part of the labour force.

According to the British Airways Business Resilience Manager, Brian Duxon, the organisation realised early on that in a worst case scenario it would be left with no passengers or staff. Their most important decisions were around deciding which functions were essential and how resources could be reassigned. As to be expected, their flight and cabin crew are the most critical, and would require the highest level of support.

The aviation industry also needs to consider capacity in ground staff such as air traffic controllers, as they cannot simply be replaced, and may be bound by working time directives. The concern over staff absenteeism has prompted other organisations to review their communications and travel policies, ensuring that in the absence of several corporate members the organisation can retain a strategic making capability.

Figure 2. Practical pandemic response



Source: Deloitte

The highest impact is likely to be the loss of staff members caring for sick children or elderly family members, with absenteeism compounded by possible school closures. Employees and customers (i.e. commuters and holiday makers) may also choose to remain at home rather than travel. On top of this, remote working is impractical for many tourism and hospitality organisations which require their staff to be present on-site.

Cross-training employees is an important component of ensuring continuity. At Marriott, Dr Turnbull says this follows their "Spirit to Serve" philosophy, where associates are cross-trained and so involve themselves where necessary to keep business going as normal. The other key element is to know what wider skills their associates have, so that they can transfer to other areas of the business.

Other leading industry organisations are promoting the use of 'social distancing' techniques in office environments, which eliminate close contact and proximity between staff in the workplace, thereby reducing the likelihood of transmission of influenza from one staff member to another. Several other organisations requiring on-site access plan on compartmentalising their offices into zones, enabling them to quarantine staff displaying flu symptoms.

Further challenges

Businesses need to think about the welfare of their staff and many organisations are assuming some basic level of healthcare. But this also raises many ethical and moral questions. Organisations with offices in developing countries, where standards of healthcare may be lower, will have to address questions of how to prioritise the welfare of their entire overseas workforce.

Companies need to consider not only their staff absenteeism but the affect on critical suppliers – what plans have suppliers put in place and what is their level of commitment to maintaining critical supplies? In addition, in a time of economic recession the impact of a pandemic may tip suppliers already in financial distress into administration – what contingency plans are in place should a critical supplier fail?

The diagram in Figure 2 highlights some of the key questions that tourism and hospitality organisations need to ask themselves in preparation for a pandemic. Practical actions could mean reallocating people to deal with high levels of staff absenteeism and ensure the continuity of business critical operations. Equally it could mean taking steps to identify alternate sources of revenue, such as the transportation of medical equipment, or the provision of beds for hospitalisation.

Deloitte's Resilience & Business Continuity team are advising organisations on a range of environmental issues that threaten to disrupt business operations, including global pandemics, at operational and corporate level. The team are working with organisations developing business continuity processes for the first time, right through to organisations with established and more mature business continuity processes. The team is also working with these organisations to test – or 'exercise' – the effectiveness of their plans and give assurances over their preparedness.

Cross-training employees is an important component of ensuring continuity.



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Proportionate response

Organisations have been taking steps to slow the spread of, and respond to, the influenza outbreak. In some countries, particularly those Asia Pacific countries that were affected by SARS, airlines and local authorities are screening inbound passengers using thermal imaging technology to detect symptoms of the virus and minimise its spread.

Operators across the industry have tightened up their cleaning regime and are promoting good personal hygiene, which can be achieved cheaply and effectively, for example, by providing staff with flu masks and clinical gels.

For operators such as Sol Meliá Hotels, the priority has been to disseminate information provided by global health organisations to hotel guests and associates, using tools such as workshops, monitoring boards, posters and electronic information mails.

Marriott consider it vital to educate their associates, from encouraging them to stay at home if they are ill, to running a “Healthy Habits” campaign, and ensuring their intranet is up to date.

Travel and hospitality companies may also need to build contingencies into their corporate communication and travel policies, to avoid the loss of strategic decision making capability resulting from several corporate members falling unwell.

Overall though, the message to date has been about being prepared for the worst case, but taking proportionate response as events unfold.

Here to stay

Lessons have clearly been learnt from SARS and avian flu. Speaking to some key players in the industry, preparations have been made and business continuity processes are in place. Their effectiveness is yet to be tested in more extreme scenarios, but so far they appear to be holding up.

Unfortunately, modern patterns of travel cause these outbreaks to spread far quicker than ever before. Our industry therefore finds itself being both a “carrier”, and deeply impacted each time a pandemic breaks out. If pandemics are to be a regrettable but unavoidable fixture in today’s globalised world, travel and hospitality companies need to be in the vanguard of the planning and preparation effort to deal with this threat.

So, the travel industry is now confronted by another threat, one whose form and potential impact is unknown but which appears to be recurring with unnerving frequency. Business resilience management is becoming the buzzword in an industry which is expected to cope with a number of challenges – from natural disasters to terrorist attacks, epidemics and now pandemics. Survival is critically dependent on managing those risks proactively. The future is, business unusual ...

1 Sky News (23 July 2009), Reuters (10 June 2009), CNN (20 July 2009), Daily News (27 April 2009)

2 Travel, tourism stocks in turmoil on swine flu, Reuters, 27 April 2009

3 Cabinet Office memorandum, Business Advisory Network for Flu. Swine flu planning assumptions. 16 July 2009

4 Sourced from British Airways Business Resilience Manager and Marriott Business Continuity Director

5 Sourced from British Airways Business Resilience Manager

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