

Regular research papers and articles providing sector specific insights and issues analysis – Hospitality sector.

May edition 2010 – Hospitality

Industry Intelligence Unit

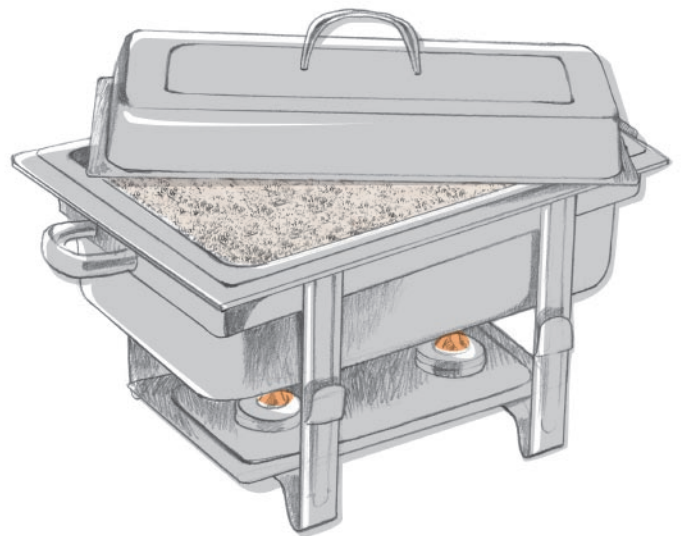
Grant Thornton's Industry Intelligence Unit (IIU) blends the latest information and analysis of specific industries drawn from publicly available sources (including the Australian Bureau of Statistics and the national press) with pragmatic, commercial and practical initiatives to improve stakeholder value.

Welcome to our first hospitality Industry Intelligence Unit (IIU) publication, which focuses on the pub/hotel sector of the industry.

The pub industry has had a tumultuous two years having undergone significant, well-publicised change. During this period we have witnessed the collapse of numerous high profile pub groups who fell victim to debt laden balance sheets. The festive season has now come and gone and with winter fast approaching many operators are contemplating the effects of a large hangover.

In this edition of our IIU publication we will specifically focus on:

- a snapshot of the pub sector
- micro analysis of pub profitability
- how to avoid becoming a casualty
- the year that was, and
- a case study of an inner city hotel.

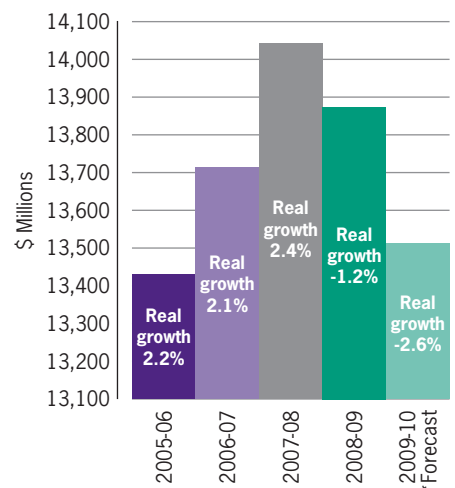


Snapshot of the sector

- The pub industry consists of hotels, bars and similar establishments, excluding licenced clubs. Industry revenue (2008/09) totalled \$13.8bn, which is expected to decrease in 2009/10 by 2.6% to \$13.5bn as a result of a reduction in household disposable income.
- The number of establishments (during the 2008/09 year) totalled 3,949. This figure is expected to decrease in 2009/10 to 3,866. Gaming is increasingly essential for survival with the majority of establishments (86%) now operating with gaming machines.
- It is expected that the decline in traditional pubs will continue with those venues that are customer focused and provide quality restaurant facilities likely to remain viable as competition continues to grow.
- A number of venues continue to struggle with heavy debt levels, due to a combination of significant yield compression over the last five years and capex programs undertaken to refurbish or cater for anti-smoking legislation.
- In 2009, IBISWorld indicated a relatively low level of concentration with the top four operators representing less than 15% of the market share. This element of the market is dominated by the two major retailers, Woolworths and Wesfarmers, as they continue expansion into pubs and retail liquor stores. The vast majority of the industry, however, consists of small owner operated businesses.
- The pub industry operates in a market where alcohol consumption is continuing to decline as a proportion of total household expenditure. Aside from household disposable income, alcohol related taxes, government regulations/laws, and societal attitudes towards alcohol consumption and gambling impact on pub profitability.
- After experiencing a sustained period of unprecedented growth and increase in values, the industry was severely hampered by the downturn in the Australian economy as a result of the global financial crisis during 2008 and 2009. This, combined with a number of other factors, led to a decrease in pub valuations across the board. The industry continues to feel the subsequent effects.

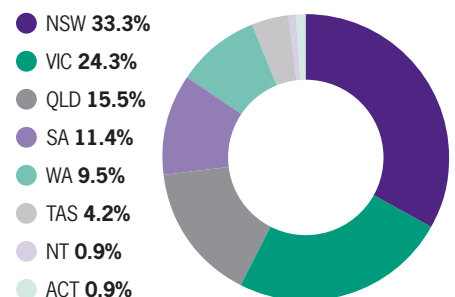
Industry revenue

Source: IBIS



Share of establishments by state 2010

Source: IBIS



Micro analysis

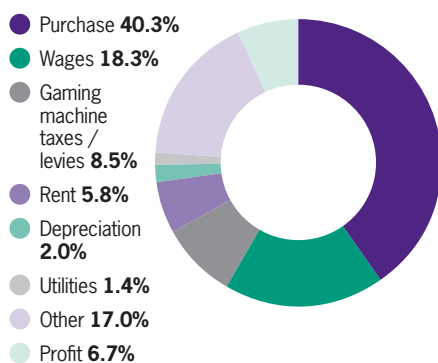
Cost structure

The cost structure detailed below is provided as a guideline only and will vary from operator to operator, between gaming and non-gaming venues, and freehold and leasehold premises.

Purchases and wage costs are typically the major expense items for operators, representing almost 60% of the cost structure. Holding costs of the venue will depend on the level of debt carried by a venue or the specific lease agreement.

Cost structure 2010

Source: IBIS



Profitability

Profits in the pub sector are relatively low. IBISWorld estimates an average industry margin on revenue for 2010 of 6.7%. This relatively low profit margin highlights the industry's dependence on a high volume of patrons and expenditure control.

Profitability is typically impacted by:

1. Internal factors

- the use and number of gaming machines in a venue (venues with gaming machines have a higher profitability)
- level of debt and associated interest costs for freehold venues and lease costs for leasehold venues
- ability to manage stock control
- ability of an operator to align wage costs with demand

2. External factors

- competition from substitutes, including cafes, restaurants and clubs
- changes in discretionary spending habits of consumers (IBISWorld forecasts a 2.6% decline in revenues from 2009)
- changes in consumers attitude to alcohol consumption
- government policy and regulation

Profitability is not expected to improve in 2010 and it is likely that the difficulties experienced in 2009 will continue through to the end of 2010.

How to avoid becoming a casualty

Here we provide five key areas of focus to enhance the profitability of a venue.

1. Customers

At the risk of stating the obvious, the most critical piece in the pub puzzle is patronage. The success of a venue is inherently linked to repeat business. To attract and retain loyal patrons a venue must provide a balanced offering that distinguishes it from its competitors.

To be able to do this the venue must have a clear direction and know its patrons. What is the venue's direction? Are they a family orientated venue that provides quality food and wines? Or a bar that is focused on the night trade,

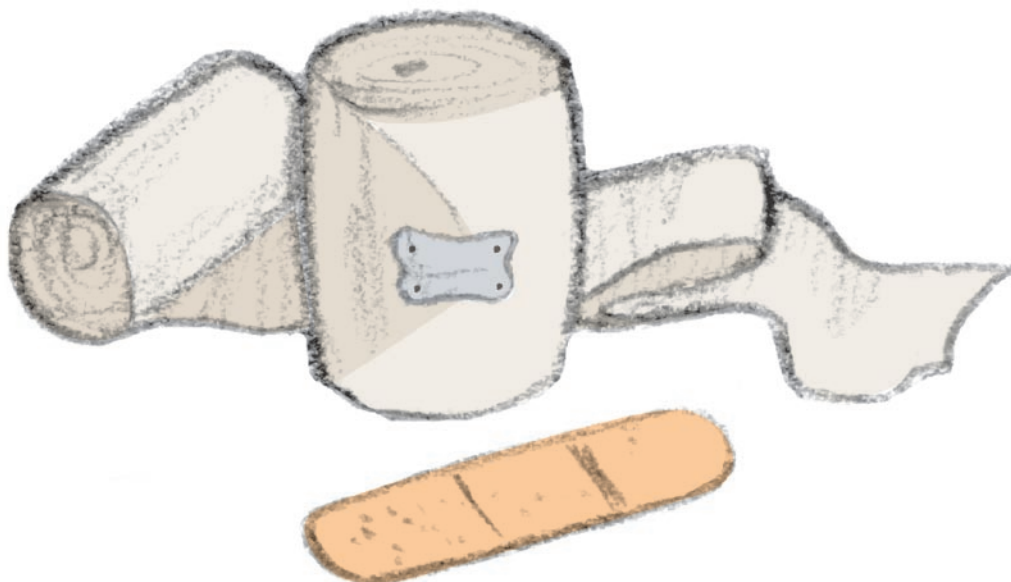
providing entertainment for young adults? Or a venue that is after the gaming dollar? Knowing this will allow a venue to maximise its position in the market and provide the correct ambience, facilities, food offering, entertainment and value to its patrons.

There is significant competition in the industry for patronage from direct competitors as well as external competitors including restaurants, cafes and casinos. A good operator will know their point of difference, develop a brand and establish a reputation in the market with its clientele. This can be achieved in a variety of ways, however, the simple initiatives are often the most effective: well trained staff (in uniform!), regular promotions and partnering with the local community are just a few of these.

2. Management

A successful venue will have quality, experienced hotel managers who not only have pub know-how but have the foresight to develop and adapt the business to a changing environment. Being able to change a keg and clean the beer lines is irrelevant if there are no customers to serve!

Quality managers will run the business as if it is their own and take ownership for the pub's direction. Savvy operators will incentivise managers based on a combination of financial and non-financial key performance indicators that are linked to the pub's direction. These may be performance based and linked to changes in revenue and/or profit or linked to other factors such as reductions in stock shrinkage.



3. Gaming/Entertainment

Gaming is a large component of most pubs' top line, however, venues must look to balance revenue streams and reduce dependency on gaming. The difference between a profitable pub and one that is, at best, breaking even can be its gaming strategy. A successful operator will develop a gaming strategy in line with its market position that will give thought to the:

- positioning/layout of the gaming area
- quantum/variety of gaming machines
- timing and cost of software and hardware upgrades
- continued assessment of technological advancements
- use of market research tools, and
- provision of other forms of entertainment such as TAB facilities, Keno, Foxtel and Sky Sports.

All of these areas are designed to provide patrons with continued variety and ensure that gaming facilities are used to their full potential.

Research by the Victorian Casino and Gaming Authority suggests that in Victoria, 75% of people who used gaming machines perceived it as a social outing rather than gambling. What is interesting is that more than half of players travelled less than five kilometers to play gaming machines. Knowing your local clientele is therefore vital for a successful gaming strategy.

4. Staff

The level of customer service provided from one venue to another plays a large part in patronage. A successful venue will have a highly trained and motivated workforce, who understands the direction of the venue. The pub workforce is typically highly mobile, youthful and largely casual (>60% of the workforce). Therefore, whilst achieving these characteristics amongst the workforce represents a constant challenge, it emphasises the need for quality management.

5. Expenditure

As a result of the relatively small profit margins, management's ability to control costs and get "bang for your buck" is

crucial. Most venues will have a limited budget on a month to month basis and therefore need to ensure they strike a balance between cost and benefit.

To assist in this process, a successful operator will develop budgets to manage cash flow on a weekly basis for key expenses such as purchases, payroll, repairs and maintenance, and marketing. Capital expenditure should be prioritised by necessity and, where possible (excluding major refurbishments), be funded from cash flow.

A successful operator will also invest in initiatives that will produce long term cost savings. This includes joint ventures to achieve buying power, regular stock-takes and staff training to minimise shrinkage, and implementing best practices to comply with regulatory matters to reduce fines, penalties, and insurance premiums.

Operating a successful pub is not an easy task. Gone are the good old days when selling a cold beer was enough. Competition is fierce and finding balance between offerings to suit your patronage is a constant challenge. Operators cannot control external factors and influences. They must therefore focus on the business, exploit their strengths, know their weaknesses and seize opportunities.



The year that was

Pub yields vary from state to state as a result of differences in licencing, gaming and other forms of legislation, which ultimately affect each pub's profitability. However, during the last decade, the pub industry has experienced unprecedented growth that has resulted in significant yield compression nationally.

As detailed in the graph (below right), during the past two years the industry has witnessed a softening in yields across the board. This softening is largely attributable to:

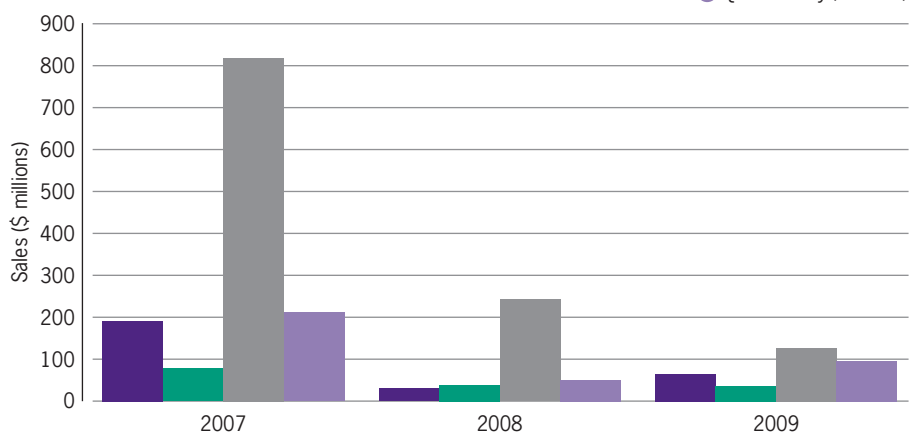
- the increased cost of debt
- lack of available credit, and
- the wider economic implications of the global financial crisis on profitability of venues.

As a consequence, there has been a dramatic reduction in general sales activity within the industry. This has made it difficult for vendors and buyers alike to understand where yields lie, resulting in a disparity between vendors' and purchasers' expectations.

Based on discussions with CBRE Hotels, whilst the outlook in general is a little more optimistic, the risk of increasing interest rates and the end of government stimulus will continue to place pressure on yields during the next 12 months.

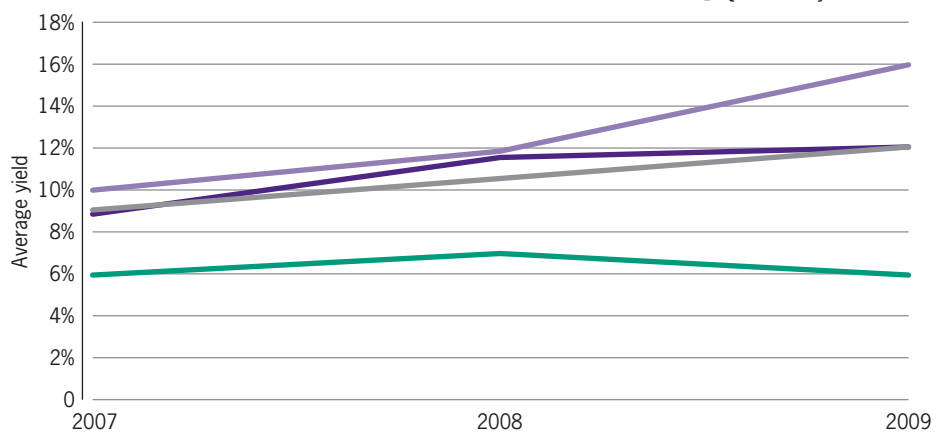
Comparison of pub sales (freehold)

Source: CBRE – indicative figures based on their research/database



Comparison of average pub yields (freehold)

Source: CBRE – indicative figures based on their research/database



A case study of an inner city hotel

We now focus on a case study of an inner city hotel which successfully implemented turnaround strategies to return the business to its former glory days.

The venue was a privately owned hotel located in an inner city suburb of Sydney. The establishment had been in existence for decades and leased by the current owners for the past ten years.

During that time the operators had enjoyed the glory gaming days. However, they had neglected to invest in any capital expenditure or repairs and maintenance. As a consequence the venue was significantly run down, it was struggling to service its debts, losses were being supported by director loans and the business was on the verge of closure. At a loss, the owners engaged an external adviser who immediately conducted a strategic review of the venue and identified the following key issues:

- The hotel was severely undercapitalised
- It lacked sufficient working capital
- The owners had no clear direction
- The owners had failed to adapt to changes in the industry and consumer preferences

As a result, the following strategies were immediately implemented:

- Sourcing and engagement of a “hands on” manager who treated the hotel as his own
- Implementation of rigorous cash management systems (cash handling, float management and banking

procedures)

- Implementation of simple daily reporting procedures that provided accountability, transparency and credibility to the figures without resulting in burdensome administration
- Securing a reputable food operator under a lease agreement and designing a simple menu (recession proof at a margin) to meet the locals’ needs at reasonable prices
- Providing entertainment on a weekly basis
- Developing a relatively inexpensive marketing budget and program focused on the local area, including advertisements in the local paper, letter box drops and specifically designed value deals and sponsorship of local sporting teams
- Developing weekly budgets for both staff costs and purchases to meet demand and manage cash flow
- Conducting essential repairs and maintenance aimed at improving the presentation of the pub and reducing OH&S risks
- Developing a medium term gaming strategy that could be self funded from gaming revenues
- Reviewing all regulations and ensuring hotel compliance

The net result of the strategic review was a dramatic turnaround in trading over a 12 month period, including:

- an increase in total revenue of 40%
- maintenance of gaming revenue with limited software/hardware upgrades
- generation of sufficient cash flow to service interest payments on borrowings
- self funded capital expenditure of \$70k
- repayment of a significant proportion of the directors’ working capital loans
- introduction of integrity to the trading figures
- improved staff morale.

Prior to engaging the external advisor, the owners had failed to adapt their business model and had no clear direction for the venue. As a result, the pub was unable to match the competition and its business declined. The failure to respond to this part of its lifecycle created a spiraling effect between the financial performance and the condition of the hotel.

The owners’ eventual acceptance that they required help led to the much needed strategic review. By focusing on the business fundamentals and applying specific strategies aligned with the local market, the pub was able to regain its direction and market position. As a consequence, the hotel was able to return to profitability relatively quickly.

Industry Intelligence Unit

About Grant Thornton

Grant Thornton Australia is a member firm of Grant Thornton International - one of the world's leading organisations of independently owned and managed accounting and consulting firms.

Grant Thornton member firms share a commitment to provide high quality services to all our clients and provide services which include assurance, taxation, reorganisation / reconstruction, corporate advisory, wealth investment management, risk management, and specialist business advice.

What is the Industry Intelligence Unit?

The IIU is unique in its objective of providing stakeholders with information, understanding and analysis of the issues faced within specific industries and sub-industries. The IIU also seeks to provide pragmatic, commercial, practical measures and initiatives to improve stakeholder value.

Industry focus

The IIU utilises the industry experience and expertise of Grant Thornton partners and staff across Australia. The IIU is predominantly focused on the following industries and their related sub industries:

- Property
- Retail
- Aged Care
- Automotive
- Hospitality
- Financial Services

Disclaimer

Material contained in this document is a summary only and is based on information believed to be reliable and received from sources within the market. It is not the intention of Grant Thornton that this document be used as the primary source of readers' information but as an adjunct to their own resources and training.

No representation is given, warranty made or responsibility taken as to the accuracy, timeliness or completeness of any information or recommendation contained in this publication and Grant Thornton will not be held liable to the reader in contract or tort (including negligence) or otherwise for any loss or damage arising as a result of the reader relying on any such information or recommendation (except in so far as any statutory liability cannot be excluded).

This presentation has been prepared for general information and not having regard to any particular person's investment objectives, financial situation or needs.

Accordingly, no recommendations (express or implied) or other information should be acted upon without obtaining specific advice from an authorised representative.

Please note past performance may not be indicative of future performance.

If you want to know more, please **contact us...**

Adelaide

Dale Ryan
T 08 8372 6666
F 08 8372 6677
E info@gttsa.com.au

Brisbane

Graham Killer
Michael McCann
T 07 3222 0200
F 07 3222 0444
E info.qld@grantthornton.com.au

Melbourne

Matthew Byrnes
Andrew Hewitt
Greg Keith
Nick Mellos
T 03 8663 6000
F 03 8663 6333
E info@grantthorntonvic.com.au

Perth

Matthew Donnelly
Tony Douglas-Brown
T 08 9480 2000
F 08 9322 7787
E info@gtwa.com.au

Sydney

Paul Billingham
Said Jahani
Michael Owen
Trevor Pogroske
T 02 8297 2400
F 02 9299 4533
E info.nsw@grantthornton.com.au



www.grantthornton.com.au

Grant Thornton Australia Limited is a member firm within Grant Thornton International Ltd. Grant Thornton International Ltd and the member firms are not a worldwide partnership. Grant Thornton Australia Limited, together with its subsidiaries and related entities, delivers its services independently in Australia. Liability limited by a scheme approved under Professional Standards Legislation.