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Over-Capacity in the Irish Hotel Industry and Required Elements of a Recovery Programme

Final Report

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Executive Summary

1. Tourism is a major industry in Ireland generating considerable value in terms of exports, employment and tax revenues. A total of 7,435,000 overseas visitors came to Ireland in 2008 and it is estimated that there were 8,339,000 domestic trips taken. It contributed €1.5 billion in taxes in 2008 of which €1.1 billion came from foreign visitors. Accommodation revenues account for almost 30% of the total and hotels supply 23% of all bednights spent by overseas visitors. However, the number of visitors to Ireland has fallen sharply in 2009 in line with other European countries.
2. The number of hotels and the number of available rooms rose rapidly in the period after 2003. Supply rose faster than overseas demand where growth was weak and although growth in the domestic market kept occupancy rates steady up to 2007, the slow-down since 2008 has shown that there is considerable excess capacity.
3. Hotel operators have attempted to address this situation through lower prices but inelastic demand for the sector in aggregate means that this results in lower revenues and margins as competitors react. This damaging process is given added impetus by the actions of hotels with no long term viability which are reducing prices to maintain cash flow.
4. In the years prior to 2008, decisions to invest in hotels increasingly came more from a wish to avail of associated capital allowances for tax purposes and were less related to the fundamentals of the industry. The allowances provided incentives to a range of decisionmakers to promote greater investment but none had compelling reason to be concerned about the potential impact of excess supply on the viability of existing businesses or the sector overall.
5. The situation is being made worse by the high cost base of the Irish economy. With the second highest electricity prices in the EU-14 and inflation in protected sectors of the economy still in double figures, operators are caught in a vicious trap of lower prices, higher costs and a sector that is being driven by decisionmakers whose short term objectives and interventions are detrimental to the industry.
6. The rapid growth in capacity has been accompanied by a huge growth in the indebtedness of hotels. There were 26,802 new rooms added to the register in the period 1999-2008, with an estimated total investment of €5.2 billion and debt of €4.1 billion. This debt relates primarily to new hotels and in particular to hotels developed after 2004.
7. In aggregate, the hotel sector has been insolvent since 2008 given the level of debt and asset values based on current profitability. The stock of *new* hotels has been seriously insolvent since 2005. The analysis shows that in every year since 2002, new hotels on average have been insolvent from the year of their construction. Insolvency is a characteristic, on average, of all major segments

- of the hotel industry but appears to be worst in higher grade hotels, medium size hotels and in hotels outside Dublin.
8. The insolvency problem is largely the result of excess capacity that has been created. Weakness of demand in recent years has served to turn a bad situation into a crisis. The situation is particularly bad in respect of hotels constructed in the period 2005 to 2008. These comprise 217 hotels with about 15,600 rooms.
 9. In a properly functioning industry, insolvency would be contained to the weakest businesses and the problem resolved as these exited the industry. However, the most insolvent hotels are remaining in business for a number of reasons. Among these is the need of hotels to remain open for seven years to allow investors to avail of capital allowances and to avoid the creation of a tax liability due to a clawback of allowances that have been claimed already; the reluctance of banks to realise losses and write off loans granted to hotels with no prospect of recovery because of the additional pressure this would place on the capital adequacy of their own balance sheets; and the reluctance to act in advance of the introduction of NAMA.
 10. The result of these factors is that the insolvency problem is being spread through the industry and is damaging the whole stock of hotels by pushing prices down to non-viable levels. This is leading to a contagion of insolvency as the burden of adjustment is transferred from banks to otherwise viable hotels. At the same time, the reluctance of banks to provide working capital is leading to liquidity problems that further undermine the businesses of solvent hotels.
 11. Unless demand can be expected to recover strongly, then action is required to remove the excess capacity to prevent this contagion from undermining the entire sector. Forecasts, even when an effective promotional initiative is built in, do not suggest that demand can grow sufficiently. Instead, reasonable expectations of recovery, assuming an effective programme of actions is implemented to promote the industry and improve competitiveness, suggest that the current situation, where demand for room-nights is about 50% of the available supply will only improve marginally to about 55% by 2013. This would not be sufficient to allow hotels to stabilise.
 12. This implies that in the absence of action to address the imbalance by removing capacity, the sector will undergo a major and chaotic shakeout over coming years. This process unlikely to result in an industry with the optimal mix of hotels in terms of grade, location and facilities necessary to underpin the growth of tourism in the medium to long term.
 13. Based on current capacity, it is estimated that between 12,300 and 15,300 hotel rooms need to be removed, if an appropriate balance is to be achieved that would allow the sector to recover to a stage where it can provide adequate returns and regain overall solvency. The higher end of this range recognises that there are considerable risks that demand could be weaker than expected in the next few years.

14. The conclusion is that instead a managed process of capacity reduction should be developed and implemented. One approach would be that the burden of adjustment would fall on the 15,600 rooms introduced since 2005 as many of these should not have been built given the emerging imbalance between supply and demand and the fact that the levels of associated debt make these the group with the highest degree of insolvency. Doing so would result in an industry with about 44,000 rooms in 700 hotels.
15. This strategy would hit hotels in the east of the country particularly hard and would also have a disproportionate impact on 4* and 5* hotels. Given that there are also high levels of debt associated with some older 5* hotels, it is questionable if this would be in the longer term interests of Irish tourism.
16. This work concludes that capacity must be reduced and indicates the magnitude of the adjustment that is required. However the process can only be implemented after an in-depth assessment of the needs of the tourism industry in terms of the optimal structure of its hotel stock has been undertaken. The conclusions point to a number of recommendations as set out below.

Removing Rooms from the Active Hotel Stock

17. The sector cannot rely on outside intervention to address the problems that have developed so, collectively, hotel operators must work to stabilise the industry. Demand growth will not be adequate to restore balance and stability to the sector. This means that the adjustment process will occur primarily on the supply side but this should be planned and co-ordinated and should not be allowed to be driven by actions of banks. ***It is recommended that the sector should prepare a strategy for the orderly elimination of approximately 15,000 rooms and that this process should begin before the 2010 peak season.***
18. The first requirement is that barriers to exit of insolvent hotels must be removed. ***It is recommended that a special provision be introduced in the Finance Act 2010 to allow relevant hotels to exit the industry without disadvantaging the initial investors in terms of availing of capital allowances. It is further recommended that an accompanying provision be introduced to the effect that capital allowances that have already been claimed in respect of any hotel should not be subject to any claw back by the Revenue should that hotel exit the industry within seven years.*** Removing this barrier would facilitate the exit of some hotels from the industry but would not necessarily promote the exit of any particular hotel. The costs to the Exchequer of removing this barrier to exit would be zero given the situation that has arisen. Hotel related capital allowances which remain to be claimed have an estimated value of €527 million to investors. Allowances already claimed which potentially could be clawed back by the Revenue have a value estimated at €1 billion. For as long as the current conditions relating to capital allowances are retained, there is a very strong incentive for these hotels to remain open in the industry even in situations where they have no prospect of recovery. Investors will claim and retain these allowances.

Therefore, allowing hotels to exit without consequences for investors in terms of the value of the tax allowances would have no financial implications for the exchequer compared with the situation where these remain open for the full seven years. However, the potential costs of retaining this barrier to exit are substantial for the hotel sector. ***It is also recommended that these provisions should apply similarly in respect of investors in hotels that close completely and those which are converted into alternative uses.***

19. It is imperative that a planned programme of closure must first identify the optimal future structure of the hotel sector in terms of location, grade, etc. ***It is recommended that a group be convened as soon as possible to begin this work including representatives of the hotel industry, tourism development agencies and the financial sector. It is recommended that the aim should be to agree a speedy and orderly decommissioning of supply in a manner that leaves the profile of substantially reduced supply appropriate to the long term demand for Irish tourism.***
20. There needs to be recognition and acknowledgement, by all stakeholders, especially financial institutions, that failure to foreclose on insolvent hotels is damaging to the long term interests of the hotel and tourism sectors. Should this recognition not be sufficiently forthcoming, ***it is recommended that the relevant financial regulatory authorities should consider the economic arguments with respect to insolvency and the consequences for the hotel sector at large of lack of foreclosure against fundamentally insolvent hotels. Based on this, they should ensure that banks fully recognise bad loans within the hotel sector and face any capital adequacy issues which might follow.*** In part, uncertainty as regards the transfer of loans from financial institutions to the proposed NAMA may account for a forestalling of action by the institutions against insolvent hotels. However, such vacillation is simply transferring the burden of adjustment from financial institutions to the hotel sector as a whole.
21. While there will be some degree of correlation between the level of insolvency of a hotel and its strategic importance to tourism, the optimal structure of the industry may mean that some insolvent hotels should stay open. ***It is recommended that detailed examination be made of the potential for establishing a Hotel Restructuring Fund. The objective of this fund would not be to preserve the existing stock of hotels but to arbitrate in situations where currently insolvent hotels are deemed to be important for the recovery of tourism against hotels which may be solvent currently but which have little or no strategic importance to the development of the Irish tourism product internationally. Such a fund could attract long term equity as well as participation by Irish financial institutions.*** A role could be to invest by way of long term equity in strategically important hotels whose reason for insolvency is excessive reliance on bank debt and cyclically depressed prices resulting from the current imbalance between demand and supply.
22. In the longer term, there is the potential either through NAMA or the actions of the banks that hotels with debt written off could be recycled back into the market at low capital cost. This would have long term implications for

existing operators. ***It is recommended that the industry examine how this possibility might be managed with a view to ensuring that such hotels re-enter the industry in a manner that does not threaten the stability of existing businesses. The best option in this regard may be to promote consolidation of hotel (groups) where there is sufficient management capacity in order to promote a reduction in average debt per room in operation***

23. Some opportunities may exist for hotels to be removed from the tourist accommodation sector and operate in sectors that do not threaten the stability of the sector. These might include care homes or language schools. ***It is recommended that a High Level Working Group be formed, including the IHF and representatives from the relevant Government Departments, to undertake the necessary research to assess the potential in this area, identify impediments to hotel conversion and co-ordinate with relevant agencies to maximise this potential. It is further recommended that the Department of Heritage, Environment and Local Government instruct local authorities to work with hotels in their areas to identify such opportunities and, in particular, to identify and remove such impediments in the planning systems as might be identified.***

Promoting Demand and Competitiveness

24. Liquidity is a serious concern for many otherwise viable hotels and there is a serious risk that strategically important hotels might be forced out of business before an effective adjustment programme can be developed. ***It is recommended that a Government Loan Guarantee Scheme, modelled on the UK Enterprise Finance Guarantee, should be introduced and provided to hotels with viable and proven business operations.***
25. While there are questions in relation to the long term performance of hotels in relation to attracting overseas visitors, there is no doubt that there has been a sharp downturn in recent years. New programmes to promote Irish tourism overseas are being developed and ***it is recommended that these demand promotion programmes should be supported.*** In particular, the focus should be on the British market with a particular concentration on specific parts of the market such as older age groups and the business segment. In addition, special incentives such as extending the free public transport scheme to all EU citizens while visiting Ireland should be supported.
26. As a vital element in the overall product, hotels need to be actively engaged in this process. ***It is recommended that the hotel sector co-ordinate its promotional activities within its industry and with the national agencies to promote Ireland and local regions as a destination for overseas visitors and grow the market that is available to the hotels.***
27. Improved competitiveness is essential to maximise the return from investment in promotion. The evidence shows that while there have been general falls in prices in 2009, inflation in the case of public services and regulated prices is still very high. ***It is recommended that direct action is taken to address this trend with a freeze on public service charges at 2008 levels.***

28. Hotels continue to face high rates bills that are unrelated to the actual business conditions, although there is emerging evidence that a review of rateable valuation in relation to hotels requires immediate review. ***It is recommended that this process under the Valuation Act 2001 should be prioritised in respect of hotels.***
29. It is important that all incentives are aligned to promote the reduction in the number of rooms on the market. In this respect, ***it is recommended that a formal mechanism be introduced immediately to validate the partial, or full, closure of hotels for all or part of the year and that this would be recognised in an appropriate adjustment to rates liabilities.*** For example, a hotel closing for 3 months would have a 25% reduction in rates or if hotel formally closed a certain percentage of its rooms then its liability would be reduced by a similar percentage.

Hotels' Pricing Strategy

30. Tourists' decisions to purchase are often only partly governed by rational thinking such as comprehensive comparison of the offerings that are available. Any element of confusion is a huge disincentive. ***It is recommended that the sector develop a single standardised format for pricing and that this is used exclusively in all promotional material.*** It is considered that, to conform with general international practice this should be on a cost per room per night basis, rather than the more usual practice of Irish hotels of a cost per person sharing basis. This of course does not affect the actual advertised room rate or disallow special offers or packages.
31. There is anecdotal evidence that prices offered on the international and domestic markets differ markedly with the perception that rooms are offered at relatively high prices abroad and the remainder placed at discounted prices on the domestic market. ***It is recommended that transparency should be introduced in this regard including comprehensive data sharing and co-operation between the hotels and inward travel operators.***
32. Aggressive price discounting does not work in terms of generating overall additional revenue. Reductions will soon be matched by competitors and the cycle undermines the finances of the industry without markedly growing the aggregate number of rooms that are sold. ***While recognising that intervention to limit price competition or to achieve collective price setting would be illegal under the Competition Acts, it is recommended that the IHF take the lead in ensuring that managers understand the implications of inelastic demand in the hotel sector and the potential for non-viable pricing, driven by the demand of banks to provide cashflow to destabilise the sector.***

Provide Consistent Data

33. Although there is a considerable amount of data produced on the tourism industry, there are some serious weaknesses in terms of its consistency. ***It is recommended that a detailed work programme should be developed and undertaken to address difficulties with the data and to provide a single comprehensive data source for the tourism sector to be used in developing policy and operational strategies and in assessing outcomes.***

1. Introduction

1.1 Background to the Report

The tourism sector has been one of the great success stories of the Irish economy over the past two decades. This period saw considerable and sustained growth, a situation which has changed dramatically over the past two years, major investment in key infrastructure and a move from a focus on low cost to quality as reflected in both the product offering and in policy.

A total of 7,435,000 overseas visitors came to Ireland in 2008, a fall of 4% from 2007 and slightly above the 2006 total¹. Of these, Britain accounted for 48%, Mainland Europe for 34% and North America for 13%. In addition, there were 591,000 visits by people from Northern Ireland and it is estimated that there were 8,339,000 domestic trips taken. Total foreign exchange earnings of tourism in 2008 are estimated at €4.8 billion, of which €0.7 billion represent fares to Irish carriers. Tourism, therefore, accounted for 3.2% of total Irish exports, but its impact on the economy is considerably greater due to much lower import content than many export oriented industries. Expenditure by domestic tourists is estimated to have been €1.5 billion giving total revenue for the industry of €6.3 billion. Overall, it is estimated that 74c out of every Euro spent in the sector in Ireland generated income in Ireland so that the sector contributed 2.6% of GDP in 2008. Tourism is a major source of tax revenue and it is estimated that tourism contributed €1.5 billion in taxes in 2008 of which €1.1 billion came from foreign visitors.

Unusually among the economic sectors that grew rapidly during the boom years and in particular the sectors that are traded internationally, tourism has a wide geographical distribution and employs personnel with a wide range of skills and often with atypical work structures. It has thus served to draw many into work that previously were not part of the labourforce. As many of the services that are bought by tourists are also bought by local residents it can be difficult to accurately estimate total employment. Consequently, various estimates of total employment in the sector are available depending on the precise definitions that are adopted. The CSO estimates that 119,600 people were employed in 'Accommodation and Food service activities' in the April to June period in 2009, a fall of 8.1% from 130,200 in the same period in 2007². This was 6.2% of total employment in this period in 2009. Research by Fáilte Ireland that employed a more comprehensive definition of the sector provided an estimate that 199,450 people were employed in the tourism industry in 2007³. This was down from 209,538 in 2005⁴. Of these, about one third were non-Irish. Areas outside Dublin accounted for 72% of employment and about 20% of the overall total related to people who were employed on a seasonal basis.

¹ Fáilte Ireland *Tourism Facts 2008*

² CSO *Quarterly National Household Survey, Quarter 2, 2009*

³ Fáilte Ireland (2008) *Tourism Employment and Training Survey 2007*, Updated

⁴ The 2005 estimate is taken from *Fáilte Ireland Tourism Development Strategy 2007-2013*

Along with transport infrastructure and attractions, the accommodation base is a core feature of the tourism industry. Bed & Board accounted for 28% of expenditure by overseas tourists in Ireland in 2008 with 'Other Food and Drink' accounting for a further 36%⁵. Overall, hotels accounted for about 23% of the total nights spent by overseas visitors in Ireland in 2008. As a result, the hotel sector is a major part of the Irish economy and its performance is a key element in the determining the performance of the overall tourism sector. This underlies policy to promote investment in the hotel sector to contribute to improving the overall standard of Irish tourism.

Data from the ILO referenced by the Tourism Policy Review Group indicated that tourism-related employment in Ireland in 2007 accounted for a greater proportion of total employment than in most EU countries and that employment in hotels and restaurants accounted for 6.2% of total employment in 2007. Hotels are certainly a major source of employment and the Fáilte Ireland survey estimated total employment in hotels in 2007 was just less than 72,000, up from 54,000 in 2005. Of these 50% were full time, with a further 29% being part time year round jobs. This breakdown varied considerably according to the location of the hotel with 91% of jobs in hotels in Dublin being year-round compared with just 61% in the South West.

Although tourism experienced a downturn in 2001-03, growth returned to the Irish industry thereafter before slowing again in 2008. This period marked an emphasis in Irish policy on upgrading the infrastructure of the industry and incentives were in place to promote investment in hotels. This resulted in a dramatic increase in the number of rooms available and, while occupancy rates remained at acceptable levels up to 2008, the growth of supply is now seen to have outstripped demand by a considerable margin. Furthermore, it is believed that many of the new hotels that have been constructed were put in place to avail of short term tax incentives but cannot be justified in terms of the fundamentals of the sector. Debt levels in the sector have also risen and it is believed that a meaningful number of hotels are in a financially precarious position. Against this background, room rates have been cut severely to promote cashflow. This has caused wider problems within the sector with the results that many hotels with viable business models, many of whom have traded profitably for years and play a strategically important role in terms of Ireland's tourism infrastructure, are being forced to compete at non-viable rates. The economic downturn which has hit demand, particularly in 2009, has changed this environment into a crisis situation for the sector.

The process of cutting room rates threatens the future of many otherwise viable hotels while doing little to address underlying problems. This report aims to quantify the situation as it currently stands in terms of the trends in supply and demand for hotel rooms, the solvency of the hotel industry, and the prospects for demand in the medium term. Having done so, it identifies recommendations to assist the sector in working through the crisis in a manner that results in a hotel sector that can play a strategically important role in driving the tourism industry back to growth and avoids the threatened chaotic shakeout of the sector that could result in insolvent hotels remaining open and undermining the viability of hotels with proven business models.

⁵ Fáilte Ireland *Tourism Facts 2008*

1.2 Structure of the Report

Section 2 examines the data on demand from international and domestic tourists in Ireland and projections for 2009. It also provides a brief overview of tourism policy at present. Section 3 examines trends in the supply and demand for hotel rooms. The work provides a detailed review of the growth of supply and the make-up of the current stock of hotel rooms. It examines overall demand and occupancy rates and the main markets. A key issue that is discussed at length is the source of the demand that meant that occupancy rates remained high even as supply grew rapidly up to 2007. This section provides the main data resource for the report.

Anecdotal evidence indicates that room rates have been falling in recent years and have been cut severely over the past year to probably unsustainable levels. Indeed, it is this issue, which arises as a result of what is perceived in the sector to be excessive and possibly 'unfair' competition from new hotels that have no long term viability and hotels that were purchased for their site development potential but are now being operated with the support of banks to provide cash-flow, which has triggered the need for this report. Section 4 examines the data on room pricing in Ireland in recent years. This is done in the context of findings from international research on the relationship between changes in room rates and hotel performance that, despite some questions regarding the trend in prices, enables conclusions to be drawn. This has implications for the strategies employed within the sector and the nature of the solutions that must be developed.

Section 5 contains a core part of the report. The growth of hotel room supply has been accompanied by a major increase in debt that reflects what has happened in many sectors of the Irish economy where there has been major investment in recent years. The research uses data on hotel debt and room supply to identify the levels of debt per room associated with the sector and with new hotels in particular. The role of capital allowances is examined and the incentive that has been provided by this measure as distinct from the prospects for returns based on the fundamentals of the hotels sector are analysed.

Given that the hotel sector is experiencing excess supply, Section 6 draws together the findings of earlier sections and examines the prospects for demand to grow to address this overhang. The analysis is initially based on long term trends in the sector but the impact of the disruption to growth that has happened in the past two years is crucial for the conclusions reached. This section also quantifies the adjustment that is required to stabilise the sector and sets out requires to do so.

Finally, Section 7 summarises the conclusions of the report and identifies recommendations to address the serious problems in the sector. These go beyond the challenges of increasing international competition and competitiveness such as have been discussed in recent reports on the future of tourism in Ireland, although these are relevant issues, and require a much more radical approach if the hotel sector is to play a role of strength in supporting the recovery of the tourism industry.

2. Tourism Performance and Policy

2.1 Overseas Tourism to Ireland⁶

The main data source for the number and expenditure of tourists in Ireland is contained in the CSO's *Tourism and Travel* published on a quarterly and annual basis. Table 2.1 shows the development Irish tourism in terms of visitor numbers and expenditure since 1999. In this period, the number of out-of-state visitors increased by just over 25% while revenue, in current terms, grew by almost 66%. In real terms after adjustment for inflation according to the CPI, revenue grew by 25% in the 1999-2006 period but then declined in real terms so that overall growth for the period 1999-2008 was 16.3%. Average length of stay was 7.7 nights.

Table 2.1: Out of State Tourism Numbers and Expenditure

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Visitors (000s)	6,584	6,954	6,871	6,596	6,893	7,062	7,446	8,147	8,466	8,271
Expenditure (€m)	2,473	2,824	3,115	3,266	3,424	3,440	3,689	4,029	4,176	4,095
Bednights (000s)	~	46,167	45,275	44,338	46,845	46,605	49,453	55,617	55,628	59,390

Note: Expenditure excluded fare payments to carriers

Source: CSO *Tourism and Travel* (various years)

This table also shows the number of bednights generated by overseas visitors. No data were published for this measure for 1999, but the available data show that the number of bednights did not grow in the period 2000 to 2004. After 2004, total nights generated by overseas visitors grew by 27.5% to just under 60 million in 2008. From the point of view of the hotel sector two specific sectors of this market are important – the business and holidaymakers segments⁷. Together, these two segments accounted for just under 90% of all bednights in hotels according to the CSO data. Table 2.2 shows the number of visitors and expenditure for these markets along with the total number of nights (in thousands) generated by these visitors. Average length of stay for these two groups of visitors was 5.4 nights for business visitors and 7.3 nights for holiday visitors.

Table 2.2: Business and Holiday Visitors

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Business										
Visitors (000s)	994	1,085	985	906	854	926	967	1,100	1,211	1,334
Expenditure (€m)	438	486	460	445	402	424	457	473	554	594
Holiday										
Visitors (000s)	3,306	3,346	3,177	3,242	3,334	3,413	3,428	3,775	4,035	3,698
Expenditure (€m)	1,228	1,386	1,594	1,696	1,779	1,774	1,822	2,029	2,108	1,939
Total bednights	28,420	29,080	27,979	26,681	26,870	27,404	27,885	29,206	31,901	30,553

Note: The CSO did not publish estimates for the total number of bednights for 1999 or 2000. The data in this table for these years is a weighted estimate based on the number of visitors and the average length of stay. However, care should be taken in comparing the data on bednights for these two years with later years.

⁶ Visitors from Northern Ireland are included in overseas (Out of State) data

⁷ Holidaymakers are defined in the CSO data as visitors for holiday, leisure or recreation purposes.

The total number of overseas holiday and business visitors to Ireland grew by 17% in 1999 to 2008 while real revenue i.e. visitor expenditure adjusted according to the CPI, grew by 15% up to 2006 and then declined to show overall growth for the period of 6.8%. The total numbers of nights grew by 8.3% over the period, and by 11% if 1999 and 2000 are excluded.

2.2 Domestic Tourism Trends

The main source of data on domestic tourism is the CSO's Household Travel Survey the results of which have been published since 2000. Table 2.3 shows the number of domestic tourists and expenditure as measured by this survey.

Table 2.3: Domestic Tourism Numbers and Expenditure (2000-2008)

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Trips (000s)	5,478	6,307	6,452	6,657	7,001	7,173	7,310	7,942	8,339
Expenditure (€m)	707	880	849	971	1,037	1,165	1,375	1,551	1,546
Nights (000s)	20,703	23,207	22,222	23,616	24,189	24,607	24,203	26,328	26,195

Source: CSO Household Travel Survey (various dates)

In this period, the total number of domestic trips increased by 52% with total bednights rising more slowly by 26.5% as a result of a gradual reduction in the average number of nights away from home. Before allowance for inflation, expenditure rose by almost 120% and by over 62% when adjusted for inflation. Thus, there was a notable rising trend up to 2006 in real expenditure per person per night away from home that more than compensated for the falls in the average length of trips. A rise in terms of the value of this market that could be exploited by hotel and, while this trend did reverse slightly in 2008, the real value of expenditure per person per night away from home remains well above 2000 levels.

It would be expected that hotels' main markets would be concentrated among trips taken for business and holiday. Table 2.4 shows total bednights and expenditure for these two segments.

Table 2.4: Domestic Business and Holiday Tourism

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Nights (000s)	13,137	15,005	13,731	14,797	15,171	15,649	16,454	18,130	17,227
Expenditure (€m)	557	699	655	734	787	895	1,100	1,222	1,191

Source: CSO Household Travel Survey (various dates)

The total number of nights spent away from home by businesses and holiday tourists grew by 31% in this period which is considerably less than growth overall. However, expenditure grew fairly much in line with the overall rate for domestic tourism. This segment accounted for 65% of all nights with business nights accounting for only 7.5% of the total. These tourists accounted for 78% of expenditure by domestic tourists in this period.

Comparison with overseas tourism shows that domestic tourism in Ireland has been growing at about the same rate in terms of total nights but expenditure by domestic tourists has been growing much faster with a real increase of 62% compared with a

flat profile for overseas visitors. Among business and holiday visitors, domestic nights have grown faster than overseas and expenditure about 4 times as fast. This would indicate that the domestic market would have become relatively more important for hotels in this period.

2.3 Tourism in 2009

The World Tourism Barometer produced by the UNWTO shows that international tourism declined by 8.4% in January to April 2009 compared with a year earlier while tourism in Europe fell by 10.4%⁸. Ireland has been performing broadly in line with these trends.

As shown in Table 2.5, overseas tourist numbers to Ireland for the first 6 months of 2009 fell by 11.5% compared to 2008, which was itself a difficult year overall despite a 1% growth in visitor numbers in the first six months compared with 2007. Even more problematic is the fact that the falls are concentrated in the holiday and business segments which provide the main sources of demand for the hotel sector. Together, these markets fell by just over 19% in this period. As a result, even assuming that expenditure per person by these tourists on hotel rooms remains at its 2008 level, hotel revenue from room sales would fall by close to 20%. However, room rate discounting as discussed in Section 4.2 below means that this is an unlikely outcome.

Table 2.5: Overseas Tourism to Ireland, January to June, 2008 and 2009 (000s)

	Business	Holiday	VFR	Other	Total
2008	535	1,720	1,008	201	3,465
2009	455	1,371	994	245	3,066
Change	-80	-349	-14	44	-399
% change	-15.0	-20.3	-1.4	21.9	-11.5

Source: CSO

The most recent data from the CSO indicate that there were 4.9 million trips to Ireland in January to August 2009, a fall of 10.9% over a year earlier. August was down by 13% compared with 2008 but this varied considerably between the different markets. While the number of visitors from the UK fell by over 24%, visitors from other parts of Europe fell only 2.7% while the number of visitors from North America actually rose by 7%. However, visitors from Continental European markets tend to have a disproportionately smaller impact on hotel demand than the UK and North American market. Monthly figures may be subject to revision but it is clear that the key UK market is being affected by the strength of the Euro against sterling, although exchange rates do not seem to be adversely affecting the US market. Tourism Ireland are currently forecasting that the UK holiday market will fall by 16% this year.

CSO data on domestic tourism indicate that this market is weak but has performed better in terms of hotel demand. Total domestic trips increased by 2.3% and nights spent away from home by 3% in the first half of 2009 compared with the same period of 2008⁹. However, while the number of nights arising from holiday trips rose by 3%,

⁸ Tourism Ireland *Quarterly Situation and Outlook*, July 2009

⁹ CSO *Household Travel Survey, Q2 2009*, November 2009

the number of nights arising from business trips was down by 11%. Total expenditure by domestic tourists fell by 6% in this period to €571 million. Holiday travel expenditure fell by 15% with business travel expenditure falling by 20%. A not insubstantial part of the business market has been made up by demand from the public sector. With the cuts in expenditure expected in the upcoming budget, and similar for the next couple of years at least, there is going to be considerable ongoing weakness in this market even if international prospects improve.

The data show that total nights spent by domestic travellers in hotels fell marginally compared to 2008 meaning that it remained at a similar level to 2007. Given the weakness of the overall tourism industry this was a good performance in terms of the number of nights. However, the fall in overall expenditure suggests that this was the result of price discounts supporting the ability of hotels to sell rooms to the domestic market.

Preliminary results from the Fáilte Ireland Hotel Survey for 2009 also show the weakness of demand. These cover the period from January to July and are subject to revision. The results show room occupancy falling from 58% to 54% on average but bed occupancy remaining steady at 42%, partly because of a 2% fall in bed capacity in 2009. Overall, there has been a 3% rise in capacity but a 5% fall in room sales in January to July 2009 compared with the same period in 2008.

The survey shows that the British market is very weak with a 28% fall in bednight sales compared to 2008 but this should be interpreted with caution given the preliminary nature of the results. On the other hand, the European market, in particular, and the North American market appear to be performing much better suggesting that the strength of the Euro against the UK£ may be an important factor causing the weakness of demand from Britain.

The *Hotel Survey* results show that smaller, economy hotels in traditionally weaker regions outside the main centres have been hardest hit in terms of occupancy. This is very typical of the impact of slowdowns when rates are discounted: rather than growing the overall size of the available market to any great extent, price cuts mean that hotels effectively move downmarket thereby taking customers from hotels that are unable to offer as broad or as good a package in terms of quality. These hotels in turn repeat the process but hotels at the lower end of the market – smaller (probably with few facilities) 1* hotels in relatively weak tourism areas – are almost excluded from the market at any price. This race to the bottom risks undermining the quality of the product as well as threatening hotels that may be relatively weak in terms of the overall tourism product and their ability to attract business from outside the area, but which may perform important social roles in their local communities. As shown below, it also weakens the hotels that implement the price cutting strategies.

2.4 Tourism Policy Statements

The focus of Ireland's tourism policy has evolved in recent years from an earlier emphasis on expanding the sector in terms of numbers of visitors and jobs created to an increased emphasis on quality and the potential of the industry to address observed economic weaknesses and to maximise the value that is derived from the available

resources. This is driven by the fact that Ireland is a high cost destination that must deliver high quality if increased threats to the competitiveness of the product are to be addressed. The need to protect the environment, manage seasonal congestion, and realise the potential of tourism to address regional economic weaknesses support this evolution.

The policy direction for Irish tourism has been set by the Tourism Policy Review Group which initially reported in 2003.¹⁰ The 2003 review identified the optimal direction for the Irish tourism industry as an industry that is *'dynamic, innovative, sustainable and highly regarded'*. It set a target for the industry to double overseas revenue to €6 billion over the 10 year period to 2012 with €1 billion from domestic tourists. Regional targets were also identified and a target set for the number of visitors to the BMW region to grow at 7.5% per annum up to 2012 when this region would account for 34% of visitors, compared to 30% in 2002. The review concluded that if this is to be achieved, Irish tourism must realise that it is at a crossroads and that while the 1990s represented the decade of greatest success ever for the industry, the challenges for the future were different and that the strategy of the past would not suffice.

This Review concluded that Ireland needed to develop attractions of international standing. A key requirement was identified as the need to *'support the provision of essential tourism-related infrastructure in areas where the potential returns to private sector investors are below market rates'*. Guiding the Group's conclusion was the observation that leisure activities are a distinctive feature of the Irish tourism product and appropriate facilities are essential if value is to be extracted. Among the key market segments that were identified were:

- Conferences;
- Angling, Golf and sporting events;
- Cruising and other water-based activities; and
- Health Tourism.

It was clear that the hotel sector would have a key role to play in providing this infrastructure.

The review contained a list of recommended actions and the Tourism Action Plan Implementation Group (TAPIG) was established. This group reported that there has been good progress in respect of 63 of the 76 actions identified but that a number of important weaknesses – in particular, gaps in certain facilities and loss of price competitiveness – remained important¹¹. The Group observed that *'Ireland's tourism product has become tired and lacking in verve or bounce for many tourists'*. The problem was that while improvements were on-going, *'much of what has been achieved is taken as a given by ever more discerning tourists'*. It concluded that a 'more of the same' approach or an incremental upgrading of existing products, aimed at expanding capacity along existing lines, would be insufficient.

The Tourism Strategy Implementation Group (TSIG) was set up in 2006 to follow-up on the actions that remained outstanding and to identify recommendations for a

¹⁰ *New Horizons for Irish Tourism: An Agenda for Action* (2003) Report of the Tourism Policy Review Group

¹¹ Tourism Action Plan Implementation Group (2006) *Third and Final Progress Report*

mid-term review. Its report noted that sustained investment by the Government had delivered a big improvement in marketing, product development and training. However, some key elements of the product, such as the second terminal at Dublin Airport, had taken longer than expected to deliver. Importantly, the report pointed to ongoing declines in cost competitiveness and the potential for the changed economic conditions to reverse progress.

Given this mix of progress, some remaining weaknesses, the greatly changed economic environment and new challenges, the Tourism Renewal Group (TRG) was created to report with a framework for action up to 2013 i.e. the period of the current National Development Plan. Its report has now been published¹².

The report places considerable emphasis on the near term challenges and the need for actions to sustain the sector through the difficult period that is likely to persist for the next few years. At the same time it identified the need to continue to address the long term weaknesses and build on fundamental strengths. In terms of a short term survival strategy, the report recommends that

- The overall level of investment in marketing should be maintained;
- The air tax should be abolished;
- Co-operation between various suppliers should be improved while upgrading use of technology and skills;
- Spending on tourism-related investment should be prioritised;
- Costs must be controlled and access to working capital improved.

Beyond short term survival, the group also recommended a number of actions to aid recovery and growth. These emphasise the need to reaffirm the importance of the industry, sustain investment in marketing, skills and the product, improve access and transport within the country, and generally support enterprises.

There is little source for comfort for the hotel sector in this analysis of the tourism sector and outline for policy. First, the report emphasises that the environment has changed and that cost competitiveness is a serious problem in the sector. These problems are the result in part of the economic downturn but as the result of what the report terms ‘a challenging legacy’ of the period of rapid growth. Among these, it identifies the problems caused by easy access to capital and tax driven excess investment, high labour and other costs, a perceived loss of ‘Irishness’ in the frontline experience of visitors, and deep uncertainty about the future.

Second, the report sets out various scenarios for recovery given the challenges that have emerged. On the basis of a ‘realistic scenario’, the report sets a target for overseas tourists to stabilise at 2009 levels and return to growth by 2011 with modest growth of 3 to 4% per annum up to 2013. In relation to domestic tourists the report sets a target of a return to growth by 2011-12 with trips to reach 8.3 million by 2013. This is not a scenario for rapid recovery.

Third, beyond recognising that there has been ‘excess capital investment and some poorly appraised projects, especially in the hotel and resort sector, there is little recognition in the report of the crisis that exists in the hotel industry and no

¹² *Tourism Policy Review Report* (September 2009)

assessment of the extent to which demand promotion, even if accompanied by a generally improving economic environment and some measures to address the competitiveness issues that are identified, can address the over capacity and undermining of the viability of hotels that has occurred. The report does recommend that *'tourism businesses with strong track records and viable futures must be protected'*, but there is really no specific recommendation as to how this will be done. In other words, the report does not address the potential that some of the excess capacity as a result of the over investment may need to be removed from the sector. Neither does the report address the viability of hotels given the collapse in rates due to the excess supply. While obviously not party to the deliberations of the TRG, the consultants are somewhat surprised that the report recommends that the Government should provide *'incentives for refurbishment of accommodation'* (Recovery Action 4). The findings of this current report, as detailed below, would suggest that this is not a priority and that this type of policy approach has actually been instrumental in disrupting the hotel industry.

Tourism Ireland has identified the need to stabilise the British market as a key element of a recovery programme. The perception of Ireland as a tourism destination remains fairly positive in Britain but there are serious challenges arising both from within the Irish industry and from external developments. Among the latter is the growth of new destinations with easier and cheaper access. This raises the bar in terms of the competitive requirements of Irish tourism. However, the cost of visiting Ireland is a major impediment.

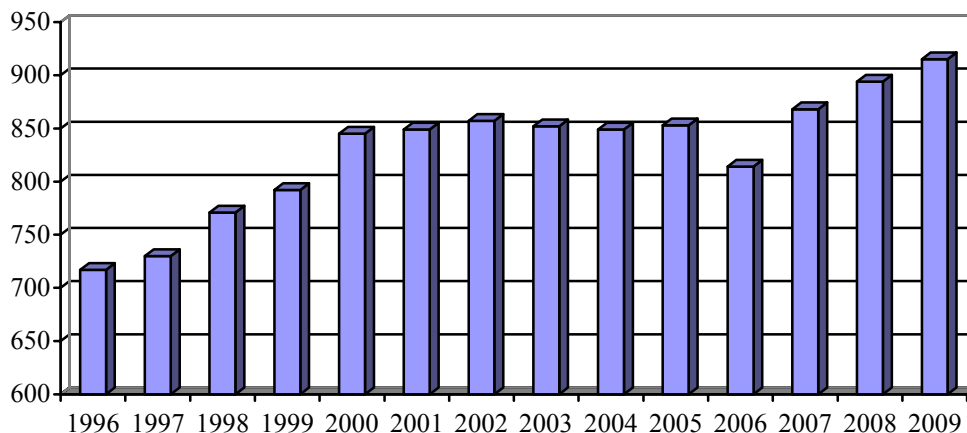
A new development programme for the British market is being prepared currently by *Tourism Ireland* and is due for publication before the end of 2009. However, the extent of the challenges should not be underestimated and there is no reason to conclude that these will diminish greatly in the short to medium term. Even with a prospective upturn in demand in the general British market, turning this into an increase in demand, particularly in the holiday segment, will be very difficult. Consequently, the recovery following the projected 16% fall in British holiday visitors in 2009 will be slow with annual growth in the region of 2.5% expected.

3. Supply and Demand in the Hotel Industry

3.1 Trends in Supply

The *Fáilte Ireland Hotels Register* is the statutory source of data on the number of hotels and hotel rooms in Ireland¹³. The number of registered hotels in Ireland in the period 1996-2009 is shown in Figure 3.1. In this period, the number increased by about 200 or 28%. This increase occurred mostly in two phases: a rise from 730 in 1997 to 845 in 2000 and then to 915 in 2009. It is this acceleration in the rate of growth of the number of hotels in recent years that has caused concern in the industry because, as shown below, while the rate of growth has actually been slower than what was experienced in the late 1990s, it has occurred during a period when demand for hotels has not been sustained.

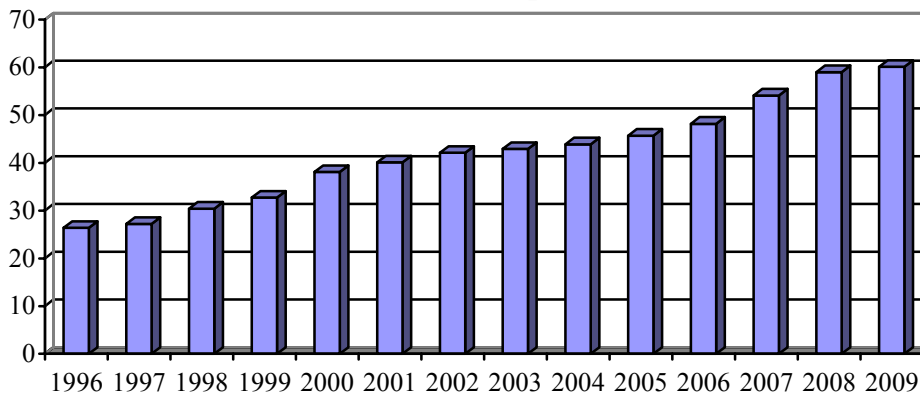
Figure 3.1: Number of Registered Hotels 1996-2009



The growth of the number of rooms is shown in Figure 3.2. The number of rooms grew from 21,000 in 680 hotels in 1989 to 26,400 in 717 hotels in 1996 (25.7% in 7 years). By 2001 it had reached 40,100 and grew to 45,700 in 2005. In the period 2005 to 2008 the number of rooms increased by 13,300 (29.1%) or just under 10% per year. The number of hotels grew by only 4.8% in this period, considerably slower than in the late 1990s, so the excess supply in room numbers has been caused by a trend towards larger hotels as well as the acceleration in the number of new hotels constructed.

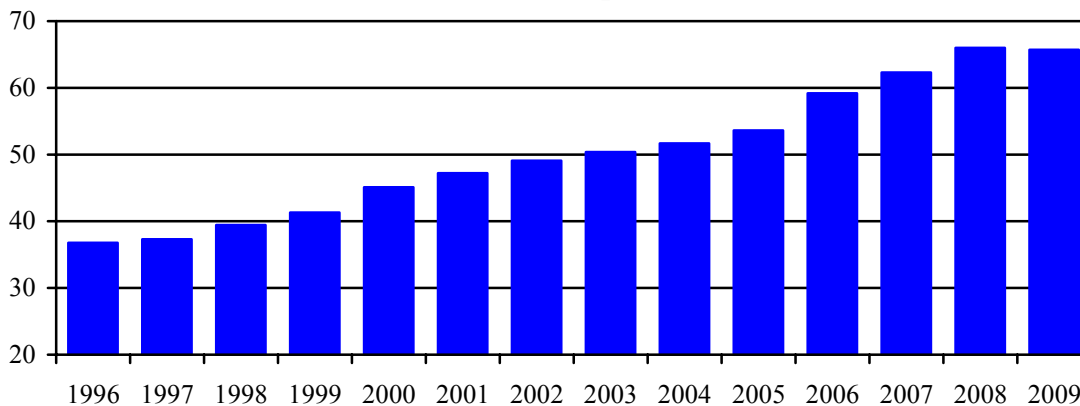
¹³ While hotels technically must be registered on the *Fáilte Ireland Hotels Register*, there have been occasional delays with hotels sometimes opening before registration. There were also some further delays in the late 1990s. While the data appear to suggest that the number of hotels fell in 2006, it is thought that this was due to some hotels failing to supply their returns to *Fáilte Ireland* on time in that year and no fall in the stock actually occurred

Figure 3.2: Registered Room Capacity (000s) 1996-2009



The data show that the number of rooms increased in every year since 1996, partly due to the increase in the average size of hotels. The average number of rooms per hotel rose from 31 in 1989 to 37 in 1996 and 50 in 2003. This accelerated after 2005 and, as shown in Figure 3.3, by 2008 it had reached 66 rooms per hotel.

Figure 3.3: Average Rooms per Hotel 1996-2009



An issue therefore is the size of hotels that have been constructed in recent years. Table 3.1 shows new hotels and rooms added during 2004 to 2008. Each new hotel in 2004-08 added about 72 rooms (this would equate to about 26,000 annual room nights) to the supply.

Table 3.1: New Hotels and Rooms (2004-09)

	Hotels	Rooms	Rooms per hotel
2004	42	3,070	73.1
2005	53	4,058	76.6
2006	112	8,485	75.8
2007	33	2,062	62.5
2008	19	1,033	54.4
Total	259	18,708	72.2

Source: Fáilte Ireland Hotel Register

3.2 *Categorisation of the Hotel Stock*

Table 3.2 segments the Irish hotel stock according to three descriptive variables: location, size and grade¹⁴. It shows the number of hotels, the number of rooms and 2008 occupancy rates for each segment. The data cover 915 hotels with 59,965 rooms and are more or less a full description of Irish hotels for these variables.

Dublin contains 160 hotels with 19,111 (31.9%) of rooms. In both the Western and Eastern regions, small 1* to 3* hotels accounted for about 50% of premises. Occupancy rates at 66% in Dublin were also higher than in other areas. Occupancy in the East outside Dublin at 52% was particularly low. Occupancy was low in the large cohort of small 1* to 3* hotels in the Western and Eastern regions but was lowest in 5* hotels in the South West.

This table shows that there is a good distribution of hotels in Ireland but there would appear to be fairly clear weaknesses on the basis of these data. Small, 1*, 2* and 3* hotels in the Eastern and Western regions had notably lower occupancy rates in 2008. These are not typical of new hotels opened in recent years which have tended to be larger and often 4*. Thus, without recognition of the importance of room rates in determining performance, the excess supply would appear to have impacted this sector hardest. While their small size means that these segments account for only a small proportion of the room stock, they account for about 50% of premises in these regions. The low occupancy in 5* hotels in the South West is also notable as these hotels are important in terms of the overall tourism product. However, there are small numbers of hotels in these segments.

¹⁴ This should give 32 categories but very small numbers of hotels in some categories means that some are aggregated.

Table 3.2: Hotel Categorisation

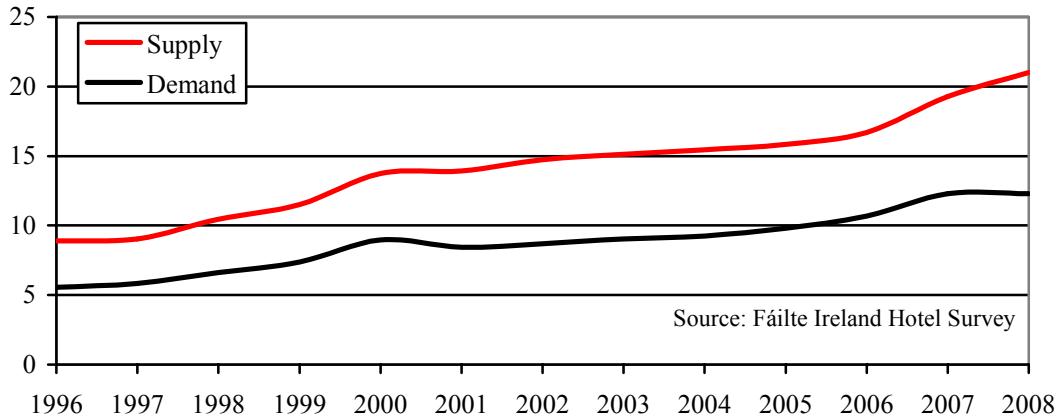
	No. of Premises	No. of Rooms	Occupancy Rates
DUBLIN			
Dublin, 1-49 rooms, 1*-3*	48	1,375	69%
Dublin, 1-49 rooms, 4*-5*	3	120	68%
Dublin, 50-99 rooms, 1*-3*	27	1,945	70%
Dublin, 50-99 rooms, 4*	4	313	60%
Dublin, 100+ rooms, 1*-3*	38	7,137	70%
Dublin, 100+ rooms, 4*	32	6,769	61%
Dublin, 100+ rooms 5*	8	1,452	70%
Total Dublin	160	19,111	
WESTERN: North West/West/Shannon			
Western Seaboard, 1-49 rooms, 1*-3*	176	3,962	49%
Western Seaboard, 1-49 rooms, 4*-5*	38	1,000	60%
Western Seaboard, 50-99 rooms, 1*-3*	52	3,711	56%
Western Seaboard, 50-99 rooms, 4*	32	2,375	60%
Western Seaboard, 50-99 rooms 5*	6	530	57%
Western Seaboard, 100+ rooms, 1*-3*	23	3,281	58%
Western Seaboard, 100+ rooms, 4*	20	2,995	59%
Total West	347	17,854	
EASTERN: East & Midlands/South East			
Midlands & East, 1-49 rooms, 1*-3*	120	2,485	44%
Midlands & East, 1-49 rooms, 4*-5*	21	469	55%
Midlands & East, 50-99 rooms, 1*-3*	35	2,621	51%
Midlands & East, 50-99 rooms, 4*	26	1,972	54%
Midlands & East, 50-99 rooms 5*	3	237	56%
Midlands & East, 100+ rooms, 1*-3*	9	1,059	46%
Midlands & East, 100+ rooms, 4*	25	3,238	53%
Midlands & East, 100+ rooms 5*	3	482	54%
Total East	242	12,563	
SOUTH WEST			
South West, 1-49 rooms, 1*-3*	69	1,685	56%
South West, 1-49 rooms, 4*-5*	16	448	59%
South West, 50-99 rooms, 1*-3*	19	1,334	60%
South West, 50-99 rooms, 4*	22	1,591	60%
South West, 50-99 rooms 5*	6	462	41%
South West, 100+ rooms, 1*-3*	15	2,191	60%
South West, 100+ rooms, 4*	15	2,169	60%
South West, 100+ rooms 5*	4	560	41%
Total South West	166	10,440	
TOTAL	915	59,968	

3.3 *Bednight Demand and Occupancy*

While the number of rooms in the hotel stock has risen strongly this decade, there was also a strong upward trend in demand for hotel rooms for much of this period. There

are two data sources on demand: the *Hotel Survey* conducted by Fáilte Ireland and data produced by the CSO based on its *Passenger Card Enquiry* survey and *Household Travel Survey*. The *Fáilte Ireland* survey is a sector survey of hotels with a response rate of close to 30% i.e. it surveys the suppliers of hotel rooms, whereas the CSO surveys hotel customers as the basis for its information. Figure 3.4 shows the demand and supply of hotel rooms in 1996-2008 according to the *Fáilte Ireland* data. This shows the rapid increase in capacity after 2005. However, there was also strong growth in demand up to 2007. Over this period, the number of rooms available grew by 136% while demand grew by 121%.

Figure 3.4: Demand & Supply of Rooms (millions) 1996-2008



As a result of this strong performance in demand, occupancy rates for rooms stayed within their long term range of about 60-65% up to 2007 before falling to 58% in 2008 (Figure 3.5). This is similar to the levels achieved in the earlier slowdown in 2001 to 2004 and represents a strong performance given the rise in capacity in 2005-08.

Figure 3.5: Occupancy Rates (%) 1996-2008

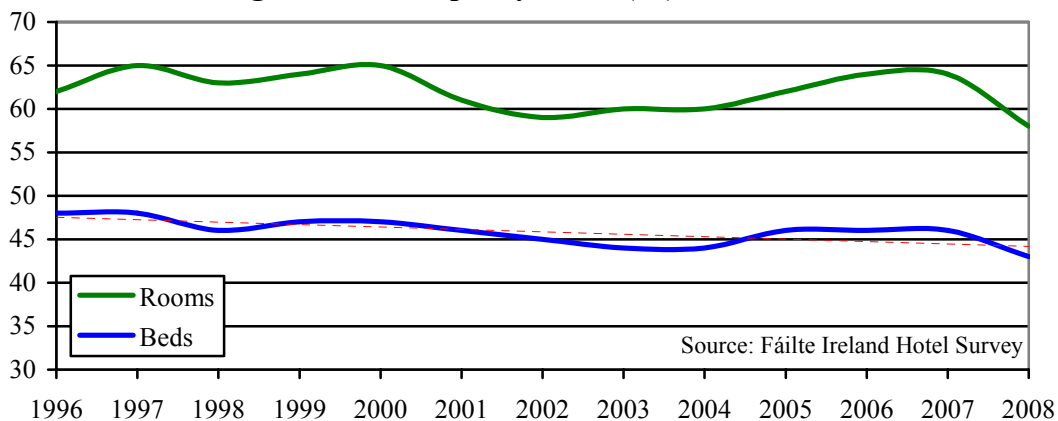
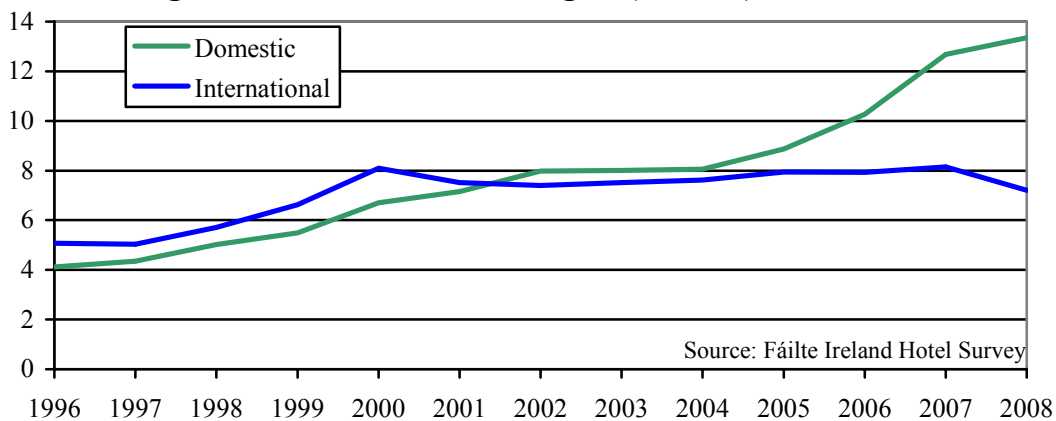


Figure 3.5 also shows occupancy rates for bednights. This is a useful measure of performance as the market for bednights can be further analysed according to various characteristics of hotel customers and because it can be used to assess the hotel sector's performance in terms of its market share. Occupancy rates for beds were at about 48% in the mid-1990s, but have since shown a small long term decline (dotted line) to 43% in 2008. This is because the number of beds sold per room sold has remained fairly constant in this period, while the number of beds per room has grown

slowly from 2.15 in 1996 to 2.3 in 2008. Thus, the sector’s supply characteristics are that the number of hotels has grown, the number of rooms per hotel has grown and the number of beds per room also has been growing.

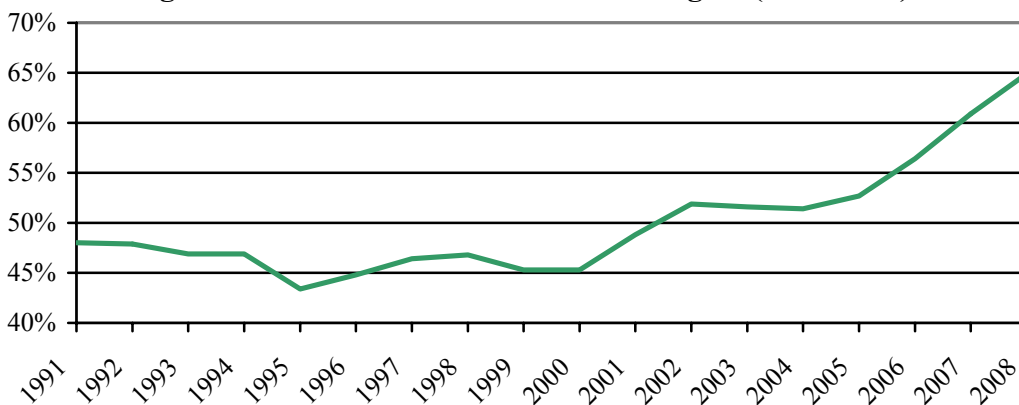
Further analysis of demand for bednights according to the Fáilte Ireland *Hotel Survey* shows an important feature illustrated in Figure 3.6. Bednights sold to out of state visitors rose strongly during the 1990s and peaked at just over 8 million in 2000. However, the survey’s results show that there has been no growth since then. In contrast, demand from Irish customers, which amounted to 6.7 million in 2000, has continued to grow and, despite a period of stagnation in 2002-04, the total number of bednights sold within Ireland had doubled by 2008.

Figure 3.6: Markets for Bed Nights (millions) 1996-2008



As a result of these trends, and as shown in Figure 3.7, demand for bednights from the domestic market rose from 45-50% in the period up to 2001 to 65% in 2008, with the trend accelerating after 2004.

Figure 3.7: Domestic Demand for Bed Nights (% of total)

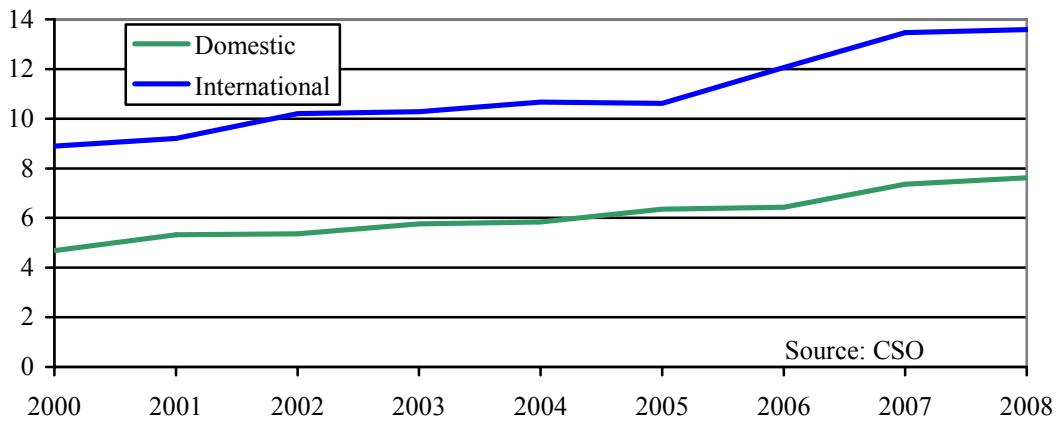


CSO Data on Hotel Bed Demand

The CSO has published data on demand for bednights since 2000 and the data contrast in important respects with the results obtained from the *Fáilte Ireland* data. The trends in demand according to the CSO data are shown in Figure 3.8. These data indicate that demand for bednights from overseas tourists rose by 53% in the period 2000-2008 (compared to a fall of 11% according to the *Fáilte Ireland* data) and

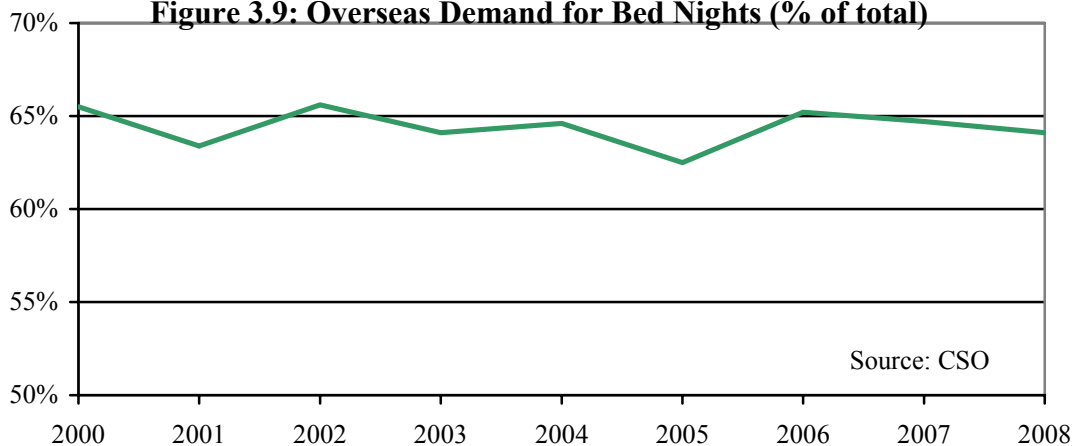
continued to rise in 2008. Demand from domestic tourists grew by 62% (compared to 99%) and again this market continued to grow in 2008. Overall, the CSO data indicate that demand grew by 56% in this period, ahead of the Fáilte Ireland estimate of 38%. While the CSO survey does not provide information on occupancy rates, this rate of growth would have been slightly ahead of the Fáilte Ireland figures for the growth in hotel rooms so that occupancy rates would have increased slightly over this period.

Figure 3.8: Markets for Bed Nights (millions) 2000-2008



Along with these differences in growth rates, the main difference is in the relative importance of the two sources of demand. According to the CSO data, the overseas market accounted for 64.4% of sales in 2008 and that this proportion has been fairly constant over the full period since 2000. This is shown in Figure 3.9.

Figure 3.9: Overseas Demand for Bed Nights (% of total)



The contrast with the *Fáilte Ireland* estimate for the share of domestic demand in the total, shown in Figure 3.8 above, is striking. The *Fáilte Ireland* data indicate that the overseas market accounted for just 35.1% of bednights sold in 2008, down from 54.7% in 2000.

Given the big differences in the results, it is perhaps surprising that the two data sources show very similar estimates for total demand for beds. In most years the totals are within a couple of percentage points of each other and the two estimates for total beds sold over the period 2000 to 2008 differ by less than 1%. This may well be a remarkable coincidence but may also be the result of various adjustments and

weighting used with the surveys analysis by the CSO. However, while the very different results shown for the relative importance of the domestic and overseas markets and the growth rates of both make analysis of trends difficult in terms of identifying how demand for hotels might be stimulated, it does mean that it is possible to be definite regarding the mis-match of supply and demand in the sector.

The consultants are aware that there have been discussions between *Fáilte Ireland* and the CSO with a view to resolving this issue but that no solution has been identified. Clearly, given that there are quite different methodologies involved, it would not be expected that identical estimates would be produced but the difference are far greater than what could be accounted for by statistical error. The consultants are not in a position to say definitively which data source is the more accurate but can offer some observations of relevance to this report.

For a start, the CSO methodology being based on customers' recall, particularly in relation to domestic tourism where the period for recall is up to six months, appears *ex ante* to be less likely to produce accurate results than the *Fáilte Ireland* survey which is based on monthly data collection from hotels. In other words, it is a sectoral survey directly addressing the sector to which the data relate. The sample is also proportionately much higher than in the case of the CSO – reaching 250 to 300 out of about 900 hotels each month. As a result, while the somewhat higher statistical error that might accompany the CSO survey is not likely to explain the big divergence in results, the higher proportionate sample and stable weighting matrix used by *Fáilte Ireland* mean that its results are likely to be accurate. Furthermore, the CSO estimates involve the amalgamation of results from two distinct surveys. Apart from the methodology, the growth rates identified from the CSO survey for domestic tourism also appear somewhat at odds with the very high growth, particularly in expenditure, that was identified in respect of domestic tourism. This gives some reason to suspect that domestic demand may be under-represented by the CSO results. At the same time, the CSO data place the rate of growth of bednights in hotels by overseas visitors at 53% in the 2000 to 2008 period, compared with less than 29% growth in total overseas bednights and almost no growth in the number of bednights generated by overseas holiday and business visitors in this period, as shown in Section 2.1 above. This does not seem likely.

Consultations undertaken in preparing this report indicate that there are deep concerns among hotel operators regarding the accuracy of the CSO data, particularly in regard to the trend in overseas bednights. In summary, the data do not coincide with the experience of these operators and there is general acceptance that the *Fáilte Ireland* data are a better indication of what has been happening. On the basis of the considerations outlined above the consultants consider that the *Fáilte Ireland* data are the most appropriate basis for the analysis in this report.

Main Markets for Hotels

The *Fáilte Ireland* dataset contains information according to market segment. This is shown in Table 3.3. The UK market appears very important accounting for 42.9% of bednights sold to overseas visitors in 2008. The North American market is in decline in terms of both the total number of nights and its share of the total while the Europe & Other markets are growing in importance with 35% of the total sold overseas.

Table 3.3: Total Hotel Nights by Overseas Market (2000-2008, Fáilte Ireland data)

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Britain	2,929	2,984	3,030	2,842	2,856	2,817	2,975	3,120	2,753
% of total	39.6%	44.1%	46.1%	42.5%	42.1%	40.2%	41.7%	42.8%	42.9%
Other & Europe	1,832	1,715	1,759	2,039	2,129	2,347	2,174	2,352	2,247
% of total	24.8%	25.4%	26.8%	30.5%	31.4%	33.5%	30.5%	32.3%	35.0%
Nth America	2,627	2,064	1,779	1,801	1,795	1,845	1,978	1,818	1,424
% of total	35.6%	30.5%	27.1%	27.0%	26.5%	26.3%	27.8%	24.9%	22.2%

Source: Fáilte Ireland

The CSO also publishes data that show that the UK accounted for 35.4% of the total number of nights spent by overseas visitors in Ireland in 2000 to 2008 but that this proportion fell from 41.4% in 2000 to 28.7% in 2008. Nights spent by visitors from North America fell from 21.3% of the total in 2000 to 14.4% in 2008. Other European countries rose from 30.9% of the total in 2000 to 48.2% in 2008. Other areas accounted for about 8% of the total nights. The business and holiday segments accounted for 57% of all nights spent in Ireland by overseas visitors, declining from 61.8% of the total in 2000 to 51.4% in 2008. In terms of nights spent in hotels, about 24% of nights spent in Ireland by visitors from the UK were spent in hotels with the propensity for these visitors to stay in hotels rising over the period from 17.5% in 2000 to 28% in 2008. Visitors from North America are most likely to stay in hotels, about 35% do so. However, visitors from other European countries only spent 16% of nights in Ireland in hotels. Thus, the market with the highest growth rate in terms of nights spent in Ireland has the lowest propensity to stay in hotels.

Table 3.4 shows the total number of nights spent in hotels for each of these markets¹⁵. The growth of the Europe & Other markets means that this was the most important market for hotel bednights in 2008 with 56.5% of total overseas demand, up from 45% in 2000. Britain had 26.4% of the market¹⁶. The North American market has declined and accounted for only 17.2% of total overseas bednights sold in 2008.

Table 3.4: Total Hotel Nights by Overseas Market (2000-2008, CSO data)

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Britain	3,353	3,864	4,452	4,306	4,034	4,075	4,535	4,993	4,770
% of total	29.3%	31.4%	33.4%	31.5%	28.1%	29.3%	30.0%	28.8%	26.4%
Europe & Other	2,232	2,089	2,520	2,414	2,795	3,086	3,626	4,508	5,019
% of total	45.0%	45.8%	45.9%	45.9%	49.7%	49.2%	49.0%	51.8%	56.5%
Nth America	2,945	2,801	2,770	3,095	3,199	2,984	3,167	3,356	3,106
% of total	25.7%	22.8%	20.8%	22.6%	22.3%	21.5%	21.0%	19.4%	17.2%

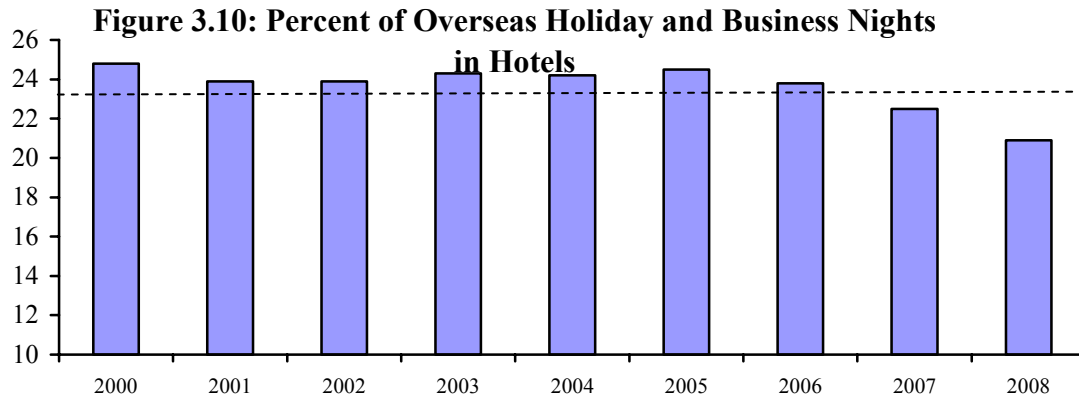
Source: CSO

Again, the differences between the two datasets for the total number of bednights make it difficult to draw conclusions regarding the relative importance of the UK and Other markets. In terms of trends, North America is certainly declining in importance while the UK is approximately retaining its share of the total.

¹⁵ The 'Others' market which contains all residual bednights sold in both datasets is included with Europe so as to reduce any distortion that might arise due to definition of regions.

¹⁶ Northern Ireland is not included in these data.

If the potential market is defined as the total number of nights spent by business and holiday visitors then the CSO data indicate that hotels gained 30.5% of this market in 2008. This is slightly above the 28.8% average for the period 2000-2008. However, the Fáilte Ireland data indicate a somewhat different performance with a much lower percentage of overseas bednights being spent in hotels. This is shown in Figure 3.10. Over the full period, hotel bednights amounted to 23.6% of the market as thus defined (shown as a dotted line). There is a clear fall-off in the share of this potential market that actually translated into sold bednights in the years 2006-08.



According to these data, in 2008, only 20.9% of the nights spent by overseas business and holiday visitors in Ireland were in hotels. This is 2.7 percentage points below the average. Had the average been achieved, there would have been an additional 0.8 million bednights bought in 2008. Given total capacity in 2008 of 48.2 million, this fall-off in demand was equivalent to lowering the bed occupancy rate by 2.8 percentage points i.e. bed occupancy was 42.6% in 2008, but would have been 45.4% if the average share of the market had been attained. This would have put occupancy in 2008 only marginally below the average for 2000-2007.

While differences in the data mean that it is difficult to draw definitive conclusions regarding the growth of international demand for bednights in Irish hotels over the past decade or the relative importance of domestic and overseas visitors, the consultants consider that the domestic market has become more important as the main source market for hotels and has been the main source of growth in demand for a number of years. This growth has now proven to be unsustainable. Britain is clearly a market of great importance but has not been performing strongly while North America is declining in importance. This report uses the *Fáilte Ireland* survey as the main source for data on the supply of hotel rooms and the consultants consider that this same source should be used for the demand analysis. As a result, the work proceeds on the basis that the results produced by the *Fáilte Ireland Hotel Survey* represent actual developments within the sector.

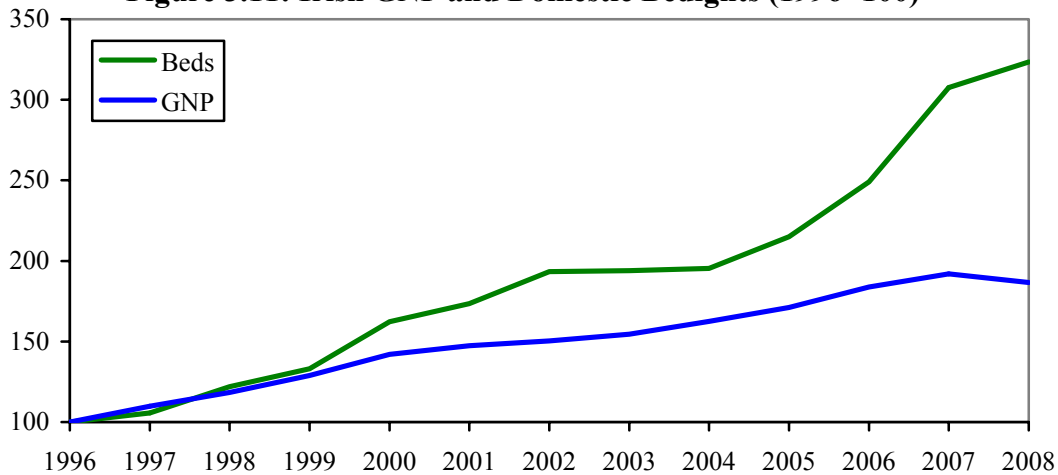
Implications of Reliance on Domestic Growth

The Fáilte Ireland data indicate a key difference between the 1990s and the period after 2003 when tourism started to recover from the slowdown in the early years of this decade. The supply of hotel rooms and bednights rose in both periods but while demand in the 1990s kept pace with supply due to strong international and domestic growth, demand growth in the period after 2000 has been totally reliant on the domestic market. For as long as the domestic market remained strong then occupancy

rates were maintained. However, the collapse of the Irish economy and domestic demand has shown these occupancy rates to be unsustainable.

As discussed further below, a reasonable assumption is that demand for hotel rooms would grow approximately one-for-one with economic growth i.e. for every 1% growth in GNP we might expect that demand for hotel bednights would also grow 1%. Figure 3.11 compares the growth in Irish GNP in constant prices and bednights bought in Ireland by Irish consumers for the period 1996-2008. The two series show a close fit in the 1990s and, despite more rapid growth in bednights in 2000 to 2002, they remain reasonably close up to 2004. However, in 2004-08, real GNP grew by 21% while domestic bednight demand grew by 67%, more than three times as fast. This has proven to be unsustainable and suggests that rooms were becoming more affordable not only because of rising incomes and spending power but because of lower prices.

Figure 3.11: Irish GNP and Domestic Bednights (1996=100)



The year-to-year changes in the number of bednights are quite volatile so a 2 year moving average was calculated and lagged by 1 year – the underlying assumption being that it will take a period of time before an increase in income translates into increased discretionary expenditure. This calculation resulting in quite a good fit to GNP up to about 2004 but the rate of growth of demand in 2004 to 2008 far exceeded the rate of growth of GNP. As a result, the period 2004 to 2008 saw only a slow recovery in demand from international visitors but stronger than might be expected growth from domestic visitors leading to buoyant overall demand. Furthermore, the trend rate of growth of the two series is divergent over this period – the rate of growth of GNP was slowing while the rate of growth of bednights was accelerating.

4. Pricing and Returns in the Hotel Sector

4.1 Review of International Research

The available data on the hotel sector provide the following information:

- Capacity increased over a relatively short period of time;
- Demand grew sufficiently before 2008 to keep occupancy levels close to their long run levels;
- Demand has fallen in 2008 and 2009;
- Room rates have been falling.

Analysing these developments using economic theory and results from international research provides some interesting insights. The concept of elasticity – defined as the response of a quantity variable to a change in some other determinant of market conditions – is useful in this analysis.

The Relationship between Room Rates and Demand for Rooms

The relationships between price and income elasticities and demand and supply in the hotel sector are discussed in detail in Appendix 2. Managers of commercial operations often have limited direct influence over the level of demand for their product or overall supply in their industry. Price changes, in this case room rates, provide a simple means to gain some influence over demand. Relatively small changes in either supply or demand that affect the desired balance, for example a target occupancy rate of 65%, may have a disproportionate impact on managers' pricing decisions as they try to sell their product. In effect, supply and demand do not directly determine price, but managers change prices in order to affect demand in response to perceptions of the existing balance of supply and demand. Elasticity measures the extent to which supply and demand for a particular product reacts to these price changes over a particular period of time. Demand will of course depend on other factors such as incomes and confidence and it is possible to derive elasticities in respect of variables other than price.

Research in the US estimated price elasticity of demand at -0.13 i.e. a 1% fall in average room rates would increase demand for rooms (the number of rooms sold) by only 0.13%¹⁷. The study also found that this elasticity depended to an extent on the hotel segment in question, with hotels at the extremes having a greater response. This was likely due to the fact that high grade hotels basically moved into a lower grade market segment by cutting their rates and could compete effectively in this segment in terms of attracting more customers. However, their cost base was geared towards the high end of the market so the strategy is risky. At the lower end of the market sales are sensitive to prices as low prices are the attraction and the hotels have little else with which to compete. This also means that the price elasticity of demand for hotels in the 2*, 3* and 4* categories may actually be even lower than indicated by the

¹⁷ Canina, L. and S. Carvell (2003) *Lodging Demand for Urban Hotels in Major Metropolitan Areas*. The research examined rates for 480 hotels in 22 US cities for the period 1989 to 2000.

average of -0.13. This finding of inelastic demand would appear to be supported by work undertaken in the UK which used the exchange rate – which will be a major determinant of prices for international visitors – in a model of demand for hotels in London¹⁸. The results found a price elasticity of -0.18 for London hotels.

Research shows that the income elasticity of demand for hotel rooms is about 1, although some research has placed it higher. For example, there has been a long run 1:1 relationship between GDP growth and hotel room demand in the US implying a long run income elasticity of demand of 1¹⁹. Similarly, the London hotel study cited above found an income elasticity of demand of 0.96.

This finding that demand for hotels is negative but price inelastic is important since it means that cutting prices will increase occupancy (the number of rooms sold) but will reduce overall revenue. As marginal costs are not zero, this means that there is a squeeze on margins with lower revenue and higher costs to service the higher number of guests.

These estimates make it clear that the response of hotel demand to changes in incomes will be much greater than the response to changes in prices and that price reductions to address lower cyclical demand will result in lower average revenue per room. In effect, a 1% reduction in price would be expected to increase demand in the sector by only 0.15% whereas a 1% fall in incomes would cause a 1% fall in demand. However, hotel demand in the US during the current recession has fallen by about 4 times the rate of decline in incomes. This has prompted debate as to whether the recovery will be similarly fast – the so-called V-shaped recession – or that the extent to which the current recession has undermined consumer behaviour means that the long term relationship will reassert as recovery begins but with permanently lower level of demand – the L-shaped recovery.

Economic theory concludes that the price elasticity of demand for an individual hotel will be greater than for the hotel sector in general as there are many alternatives to any particular hotel but few alternatives to hotels in aggregate. As a result, hoteliers cut prices to protect their occupancy rates because of the knowledge that others will do so. However, lower prices do not increase total demand for hotel rooms sufficiently so, overall, the revenue that is earned by the sector will fall. The result is that the sector ends up competing for a market where there are fewer customers – due to the fall in demand – and lower prices.

The question therefore is whether it makes sense for hotels to protect occupancy by cutting rates in a market downturn or even in response to a longer term excess supply? A major US series of research projects indicates that price discounting is not a good strategy in the face of reduced demand. To date, reports have been published covering the period up to and including the slowdown in 2001-02, the recovery period up to 2006 and 2007-08²⁰. This work looked at pricing strategy for between 11,000 and 16,400 hotels each year in the period 2001 to 2007, giving a total of over 67,000

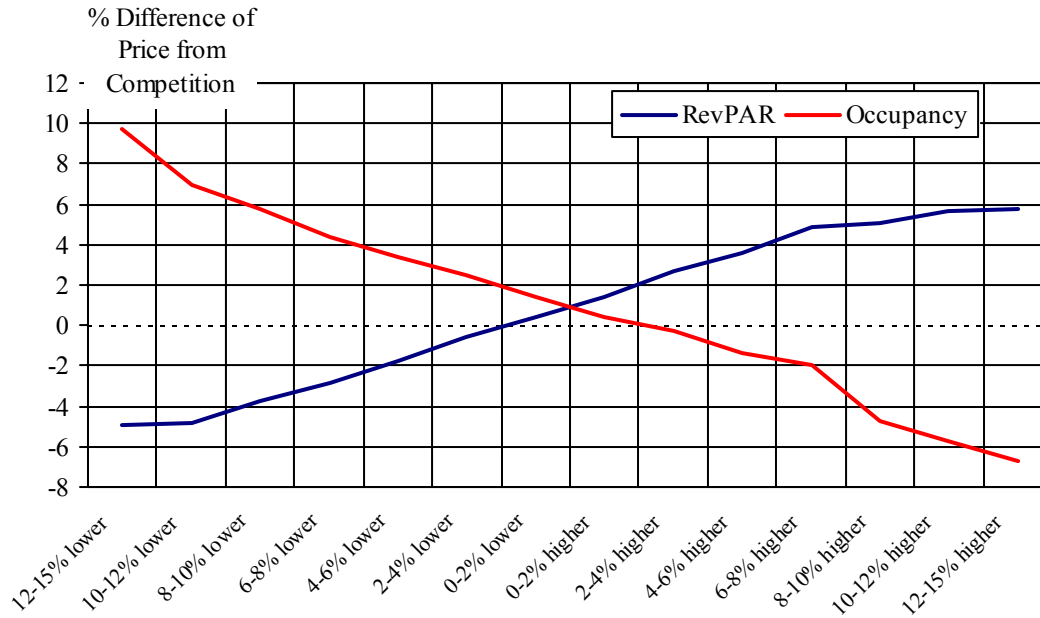
¹⁸ Greater London Authority (2006) *Hotel Demand Study*

¹⁹ *The Relationship Between GDP and Hotel Room Demand*. Global Hospitality Group, July 2009

²⁰ Enz, C., L. Canina and M. Lomanno (2009) *Competitive Hotel Pricing in Uncertain Times*. Cornell Hospitality Report, Vol. 9 (10). This updated earlier published work by the same authors in 2004 and 2007.

observations. The results of the study are captured by Figure 4.1. The vertical axis shows pricing strategy in terms of each hotel's room prices relative to its competition in a defined area. This ranges from 8% below the average room prices of the competition to 12% above the average price. The horizontal axis shows the impact of this strategy on revenue per available room (RevPAR) and occupancy.

Figure 4.1: Mean RevPAR and Occupancy % Differences



This analysis provides a very clear conclusion. As prices fall below competitors, occupancy rises. For example, setting prices 4% below competitors increased occupancy by more than 8% above where it would otherwise have been. However, this increase in occupancy was insufficient to protect the overall value of room sales so that RevPAR would be about 8% below where it would be if prices were set at the average. This result held, with fairly small variations in values, across all hotel grades and in years of strong demand, such as 2004-06, and during weakness as in 2001-02 and 2007-08. In fact the best results for individual hotels were obtained by keeping room rates 2 to 4% above those in direct competitors, and attracting customers through better promotion or 'free' extras, thereby avoiding price competition.

These results indicate that even at the level of individual hotels the price elasticity of demand remains inelastic so cutting prices will not increase revenues. At the same time higher occupancy increases operating costs. Furthermore, cutting rates risks undermining the brand and image of the hotel by moving the hotel towards a market for which it was not originally designed. It also creates an expectation in relation to hotel rates so that there may be resistance to increased prices when demand returns. The study concluded that:

... [A] policy of matching competitors' rate cuts puts your hotel at the mercy of the most foolish or most desperate competitor. You gain no competitive advantage by lowering your prices because your competitors know almost immediately about your strategy and can instantly match it. In short, not only can you not count on stronger revenue from lower prices, but once prices are reduced, it can be difficult to raise them. (p. 14)

This final point applies in all cases even in an attempt to reverse a previous price cut. Put simply, competitors will know when a hotel tries to raise prices and will not increase their price so there will be a big impact on demand. As a result, the price elasticity of demand for a particular hotel is elastic for prices above the prevailing price but inelastic for lower price levels.

4.2 Experience in Ireland in Recent Years

What has been happening in Ireland?

The analysis above showed that the period 2004 to 2008 saw only a slow recovery in demand in Irish hotels from international visitors but stronger than might be expected growth from domestic visitors leading to buoyant overall demand. However, this has come at a cost. Table 4.1 shows average hotel room rates in current prices and at constant 2000 prices. In current prices, average rates rose slowly in the recovery period from 2004 to 2007. This actually mirrors the trend in overseas demand shown earlier. However, the most striking feature from this table is that when these rates are adjusted for inflation according to the Consumer Price Index (CPI) the data show a considerable fall in the value of room rates. In real (inflation adjusted) terms, the average room rate fell by 25% in the period 2000-08.

Table 4.1: Average Hotel Room Rates (2000-08)

	Average Room Rate		Rate in Constant prices	
	€	Index	€	Index
2000	87.19	100.0	87.19	100.0
2001	88.64	101.7	84.58	97.0
2002	88.35	101.3	80.54	92.4
2003	90.99	104.4	80.17	91.9
2004	92.59	106.2	79.82	91.5
2005	95.22	109.2	80.15	91.9
2006	97.58	111.9	79.01	90.6
2007	97.69	112.0	75.44	86.5
2008	88.25	101.2	65.47	75.1

Source: Room rates from HBC Hotel Survey; CSO Consumer Price Index

It seems clear that hotels were following a strategy of maintaining occupancy through price reductions aimed at the domestic market. This promoted demand in this market and kept occupancy high. However, this strategy was being employed during a period when international tourism was growing and domestic demand was strong. As these trends have changed in 2008 and 2009 the ‘success’ of this strategy has been reversed.

Cutting room rates to maintain occupancy is commonly done by hotels but the international research discussed above suggests that it is a high risk strategy. This is clearly illustrated by Table 4.2. This table shows revenue per available room in the hotel sector (RevPAR). This is calculated by multiplying the average room rate from Table 4.1 by occupancy for each year.

Table 4.2: Revenue per Available Room (2000-08)

	RevPAR		Constant prices	
	€	Index	€	Index
2000	57.02	100.0	57.02	100.0
2001	53.72	94.2	51.26	89.9
2002	52.13	91.4	47.52	83.3
2003	54.41	95.4	47.94	84.1
2004	55.37	97.1	47.73	83.7
2005	58.85	103.2	49.53	86.9
2006	62.45	109.5	50.57	88.7
2007	62.23	109.1	48.05	84.3
2008	51.63	90.5	38.30	67.2

The conclusion from this table is unequivocal. Lower prices, while maintaining occupancy rates, resulted in falls in average revenue per available room in hotels. When allowance is made for inflation, RevPAR fell by about a third in the period 2000 to 2008. This is the result of cutting prices to attract domestic visitors because of weak demand from international visitors. Operators may rationalise price reductions on the basis that, because of excess supply, other hotels will cut prices and take away the market so this is just competition. What this table shows is that hotels by engaging in this race to the bottom undermine their business by reducing average revenue per room. This is a typical result for a sector characterised by inelastic demand. The impact on the hotels viability is then made worse by the fact that higher occupancy rates result in higher costs than would be the case with lower occupancy and higher prices. Therefore margins are squeezed even further.

However, once again, data from the CSO show a somewhat different picture. In summary, detailed sectoral price data indicate that room rates actually rose strongly in the period up to 2007 before plateauing and then falling rapidly from mid-2008.

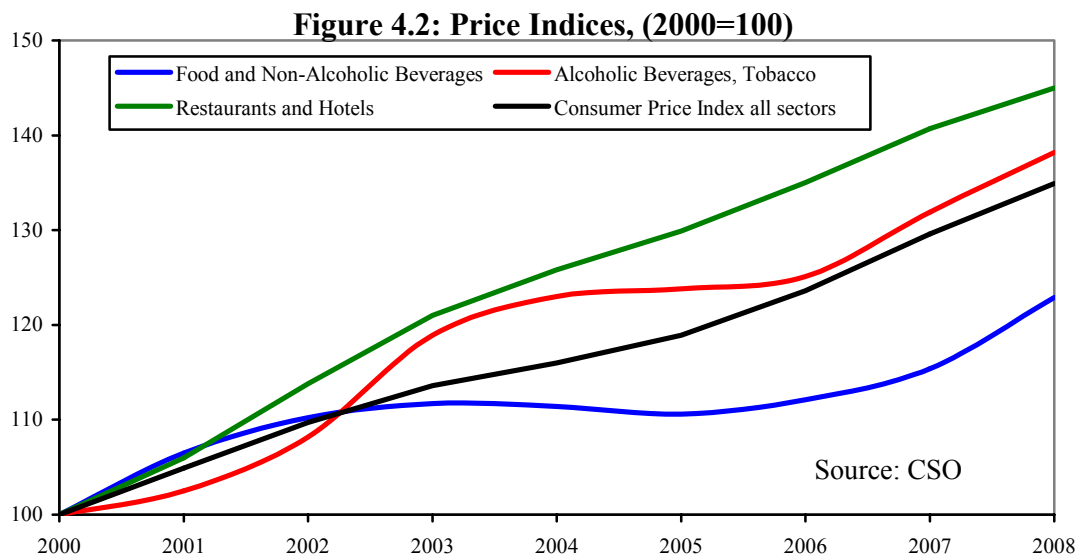
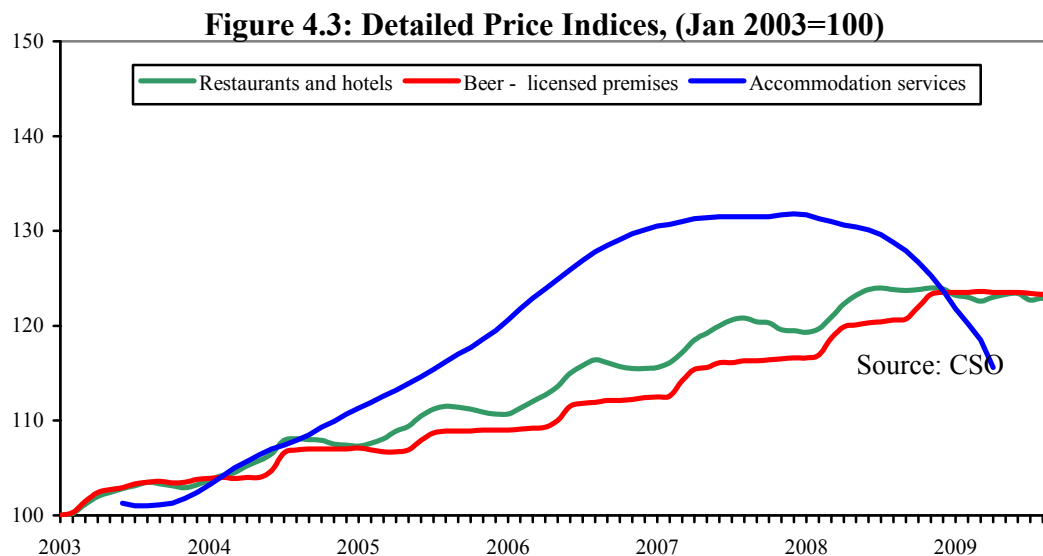


Figure 4.2 shows annual price indices for Restaurants and Hotels, Alcohol and Tobacco, Food and non-Alcoholic Drinks, and the overall CPI since 2000. The price of alcoholic drinks rose somewhat faster than the CPI while price inflation for food

was considerably lower. However, price increases in hotels and restaurants were considerably higher than the CPI overall increasing by 45% in 2000-2008 compared to general inflation of 35% in this period.

The Restaurants and Hotels sector contains a number of fairly disparate sub-sectors and so it is necessary to further disaggregate the data. The CSO have published monthly data since January 2003 for various sub-sectors that allow for price changes in Accommodation to be separately analysed. Figure 4.3 shows price indices for Accommodation for the period 2003-2009. The CSO data are monthly and since accommodation rates have a strong annual seasonal element, the figure shows a 12-month moving average of the CSO data. The figure also includes monthly indices for Restaurants and Hotels – the monthly version of the annual data in the previous figure – and for Beer in licensed premises to reflect price rises in alcoholic drinks.



There is a very clear conclusion from this figure. High price rises in the Hotel sector up to 2007 were driven primarily by the level of price increases in accommodation services, not by high price rises in drinks. In fact, for most of the period, the index for drinks inflation is below that for the hotel sector overall. Since 2008 the situation has reversed dramatically. Drinks prices have levelled off while accommodation rates have fallen very quickly so that prices are now back to about their levels in 2004. These data indicate that the loss of competitiveness was driven not by external factors such as rapid drinks price increases but by internal cost factors that were reflected in higher accommodation costs.

Once again it is necessary to make a judgement in relation to the actual trend given the differences in the conclusions indicated by these data sources. The data on average room rates from the HBC survey indicates that room rates rose only slowly in the period 2000 to 2007, well behind the rate of inflation, and then fell. If 2003 is taken as the base year, i.e. to coincide with the period for which the CSO detailed data are available, then prices were almost flat up to 2007 before falling indicating that accommodation prices were not undermining competitiveness. The CSO data suggest the opposite with accommodation price increases running well ahead of general inflation and price increases in the sector overall.

Irrespective of the data source used, it is clear that the price of accommodation i.e. room rates, has fallen very severely since about the middle of 2008. While increasing construction and labour costs would lead to an expectation that there would be price increases in accommodation, consultations with the sector suggest that external factors such as increases in drinks' prices were more important. In addition, it would be expected that the rapid increase in the supply of accommodation in hotels with occupancy rates that were not higher than trend, would tend to place downward pressure on the sector as it competed for business. Furthermore, the HBC data result from a detailed sector-based survey that looks at the prices for which rooms were actually sold. It is certainly the case that sustained investment has upgraded the hotel stock and the HBC survey segments hotels to reflect this. As the proportion of rooms in the higher classification rises, average prices based on a simple of unweighted average could rise although the price paid for a room in a particular grade may not have risen. It is not clear how this is accounted for in the CSO data which relates to all types of accommodation.

It is also likely that the methodology employed by the CSO may have failed to accurately track developments in relation to room rates up to 2008. The data refer to standard published rates and probably do not take account of special offers, the implied rates when rooms are sold as parts of packages, discounts that may be available for bulk buyers and intermediaries, in particular online distribution sites. Consequently, and based on consultations with industry operators, the consultants conclude that prices were considerably weaker prior to 2008 than implied by the CSO data. Therefore, although, the CSO provides the official price data, much more research would be needed to uncover the accurate trend in accommodation prices, and there are good reasons to accept that price pressure has been a feature of the sector for a number of years even if it has not resulted in prices quite as weak as suggested by the HBC data. However, irrespective of this difficulty, it is clear that rates have been falling very rapidly since 2008.

One further issue that arises is the suggestion that arose in the consultations that quite different hotel rates often apply to international visitors when compared with the domestic market. As a result, many of the special rates that have been available to Irish residents have not been available on international markets. This means that prices for international visitors have been higher and a different price trend might be applicable. If the Fáilte Ireland data on the nationality of hotel guests are accurate then this would only have a fairly small impact on the overall trend as domestic tourists account for 65% of bednights. However, international tourists account for about 35% of hotel bednights according to the CSO data. The consultants have been unable to obtain any hard data in relation to any difference in the average prices of rooms sold on the Irish market as distinct from overseas visitors. It appears likely that there is a difference but there are no quantitative data to support this proposition.

Despite this weak price trend for accommodation, there is evidence that Ireland has been losing competitiveness in terms of its tourism offering and it is to be expected with accommodation accounted for almost 30% of total expenditure that trends in this item would play a role in this development. Fáilte Ireland data show that costs are a major item in terms of negative visitor attitudes to Ireland²¹. Cost of living in Ireland

²¹ Fáilte Ireland *Visitor Attitudes Survey 2008*

was by far the highest ranked negative item with 22% of all holiday visitors spontaneously identifying this as a disadvantage that distinguished Ireland from other destinations. This varies little across the various markets. Only the poor road infrastructure, which 11% of visitors noted, was seen as a major disadvantage. Furthermore, 17% of international visitors identified a lack of good all round value for money as an issue with which they were dissatisfied following their trip to Ireland. This has risen slowly over the years. However, only 4% expressed dissatisfaction with the quality of the accommodation that was available. The issue therefore would appear to be cost rather than quality. However, the dissatisfaction appears to apply to Ireland in general rather than specifically to the cost of accommodation.

Pricing in 2009

The hotel sector is facing a very challenging market due to the economic slowdown in 2009. According to the available data, Irish hotel prices have fallen by 26% compared with 2008²². This is the steepest fall of all major European countries. European prices fell on average by 16% in 2009 compared with 2008, although prices in Norway and Austria fell by 24% and 23% in the same period. Globally, prices are estimated to have fallen by 17% in 2009. With an average price of €80 paid per room in 2009, compared with €108 in 2008, Ireland is the cheapest Western European country. The price fall was particularly pronounced in Dublin where prices fell by 27% which was also the steepest fall in Europe and placed Dublin below Galway and Cork in terms of room prices.

These results are broadly supported by other recent research²³. Covering Cork, Limerick, Waterford and Galway, this shows room rates down by 18.5% on average for the year with RevPAR falling by 25.5% as a result of lower occupancy. Average occupancy in hotels in these cities has fallen to 61% in 2009 from 66% in 2008.

There has been only a marginal increase in the capacity of the hotel sector in 2009 so that the weakness of rates in 2009 is primarily related to the under-performance of demand. If it is assumed that the propensity of overseas holiday and business visitors to buy hotel rooms in 2009 is unchanged from 2008 then these developments would translate into a fall in room revenue from the overseas market of 40% in January to June 2009 compared with 2008.

4.3 Strategic Directions

Faced with a situation of excess supply, the evidence indicates that hotel operators cut prices to maintain occupancy and thereby undermined margins, depleted cash and introduced a threat to their long-term viability. It is easy to understand why individual hotel operators react to market weakness by cutting room rates even if it is known that demand for hotel rooms is inelastic. The price elasticity of demand estimated in the literature reviewed above is for the hotel sector as a whole or for a broad segment or geographical area. This gives the clear conclusion that as room rates in the sector fall, the value of total sales falls even if occupancy is maintained.

²² Hotels.com Hotel Price Index reported in *Travel Daily News* on September 23rd 2009

²³ City Occupancy Summary (September 2009) www.cityoccupancy.com

At the same time, costs are higher than they would be if rates were maintained and occupancy was lower. Margins are therefore lowered across the sector. However, at the level of individual managers in hotels, it would be a common perception that lowering room rates will enable a hotel to protect its market share and lead to a better financial outcome. This is possibly true: individual hotels may face an elastic demand curve within their particular market segment or geographical area. Since pricing decisions are made at the level of individual hotels, the incentive is to cut prices even though this would result in competitors reacting and lower revenues and margins for the sector. ***This is what economists describe as a market failure: individuals making decisions that are in their own interests produce a result that is sub-optimal, and possibly very damaging, for everyone.***

The implication of identifying a market failure is that it is possible to envisage a better outcome in aggregate and possibly for all. The obvious answer in this case is that prices should be higher. However, there are two barriers to proposing this outcome. The first is that the elasticity of demand could be asymmetrical, at least in the short run. In other words, although the level of demand has not responded sufficiently to the fall in prices to maintain revenues, a rise in prices could have an adverse market reaction such that the fall in demand in response to a rise in prices would be quite large i.e. an elastic response. This would mean that revenues would fall even more in response to a rise in room rates even if this was co-ordinated across the sector. Given the current global economic weakness and increasing availability of new holiday locations, this is a very real prospect at present. The second problem is that it would probably be impossible to co-ordinate a rise in rates. Each hotel would still have an incentive to under-cut its immediate competitors that would immediately undermine such a strategy. In addition, there would likely be problems in undertaking such a strategy and remaining in compliance with the Competition Acts. As a result, while the objective is obvious, achieving it would be very difficult.

Usually, the answer to a market failure is a co-ordinated response, but this response will not be successful if it attempts to directly determine prices. The underlying problem is that demand and supply are out of balance and rates have fallen as providers and customers have responded to market forces. Changing this means changing these market forces. This means increasing demand, other than through further price falls, reducing supply, or a combination of both. The emphasis must be on both sides of the market. Concentrating on promoting demand only is unlikely to be successful given the scale of the imbalance and current market weakness. Placing the emphasis on reducing supply without an intensive demand promotion strategy risks the adverse elastic response discussed above as prices rise. Section 6 below assesses this approach by qualifying the potential for demand to grow and the required supply adjustment that would be needed to restore balance.

5. Financing Expansion: Trends in Hotel Indebtedness

5.1 Hotel Debt and Valuation

The increase in capacity in 2004-08 was also accompanied by refurbishment, upgrading and changes in the ownership of existing hotels. This has resulted in a large build-up of debt in the industry and has caused a serious increase in the debt to asset value ratio. This section examines the current level of debt in the sector.

Valuation Methodology

Three approaches to hotel valuation can be identified. The most basic is to value hotels according to the cost of construction or replacement. This approach may be useful for an investor wishing to enter the industry in deciding whether to build or buy an existing hotel. However, while this may be useful for providing indicative values for new hotels it ignores relevant information such as trends in the industry and, as a hotel ages it becomes increasingly difficult to accurately quantify any loss in value. A second approach is known as sales comparison. This is useful in indicating the broad range of appropriate prices based on prior sales and price trends in the sector, particularly where hotel specific data are not available. However, given the unique nature of many hotels, it is not generally considered sufficient to provide accurate valuations. A third approach known as income capitalisation assumes that the value of a hotel is the present value of future income flows. Although there are specific data requirements and it is necessary to ensure that the period for which data are available is not distorted by some non-typical event, this approach has been gradually adopted as the preferred approach throughout the world²⁴.

Different variations of this general approach have been derived but the simplest is to take current profits and divide by a capitalisation rate based on an investor's perceived desired return or yield. The decision on this desired rate is clearly important and will reflect a number of factors in the economy such as the cost of capital, risk, expected inflation, etc. In addition, the estimated value will be very responsive to cyclical or short term changes in tourism demand²⁵. This means that values can change considerably from year to year as industry demand changes irrespective of changes in property values in the wider economy.

The hotel room values in this section use the income capitalisation approach. As current years' income is used, the room values that are subsequently derived are volatile. Since 2008 profit levels are used in a number of cases, and were particularly low compared with earlier years, it might be argued that the results are thereby distorted. However, the subsequent analysis shows that projections for 2009 and beyond do not indicate that an improvement is imminent. Instead, it is likely that the situation has deteriorated considerably. The estimated value in each case is based on a 7% yield requirement applied to the estimate for profit before tax taken from the

²⁴ Rushmore, S and E. Baum (2001) *Hotels and Motels: Valuations and Market Studies*. Chicago: The Appraisal Institute

²⁵ Mahony, M. (2007) 'The Influence of Domestic Fiscal Incentives and Internationalisation on Hotel Valuation'. *The Property Valuer*, Summer pp 18-23

Horwath Bastow Charleton Hotel Survey. It could be argued that this is on the low side given the nature of the risks in the hotel sector. Increasing the required yield would result in lower value being estimated for hotel assets in the following sections. This would further emphasise the extent of the problems but would not in any way affect the conclusions. The per-room value is derived using the number of rooms in each year according to the *Fáilte Ireland Hotel Register*. Almost all the conclusions in relation to solvency are based on industry averages. As in any industry, the actual situation in any business will be distributed around this average. The analysis segments the industry as far as possible given the data that are available but no conclusion can be interpreted as referring to any specific hotel.

Debt & Value per Hotel Room

Figure 5.1 shows the estimated debt and value per room in the Irish hotel stock for each year in the period 1999-2008. Debt per room is calculated by dividing the Hotel Sector Debt estimate published in the Central Bank *Quarterly Bulletin* by the number of rooms in the hotel stock.

Figure 5.1: Estimated Debt and Value per Room, 1999-2008

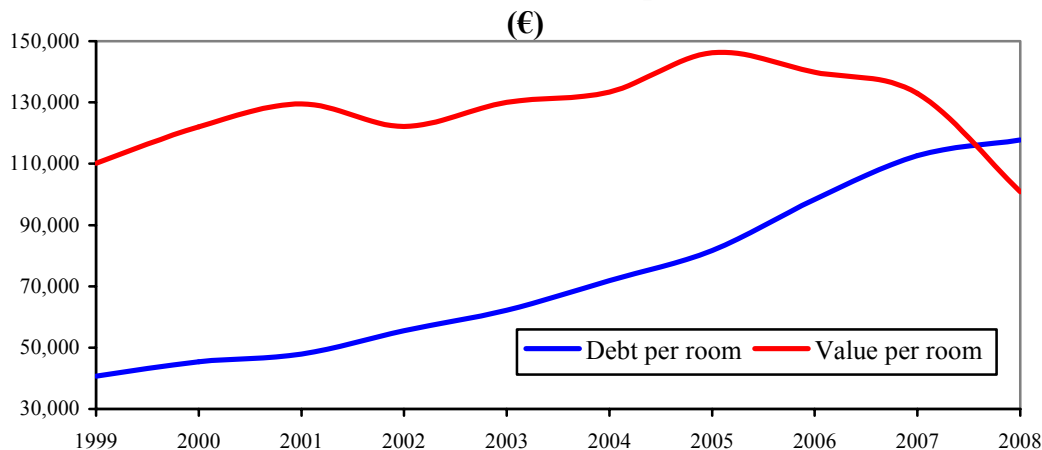
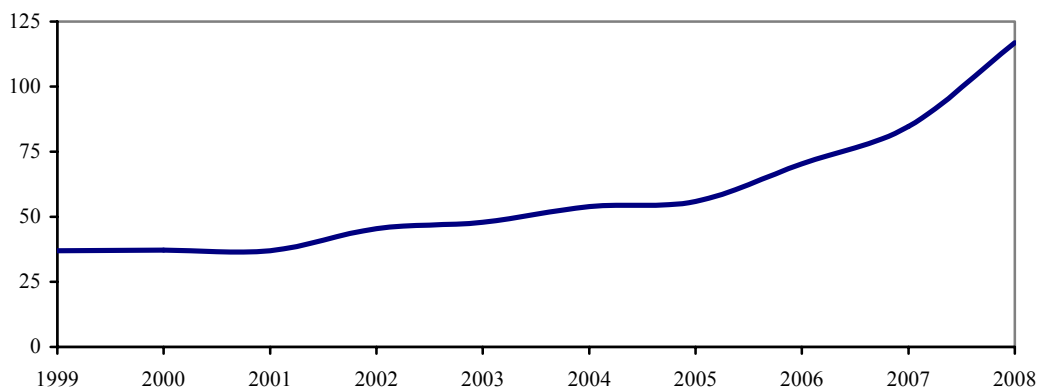


Figure 5.1 shows that debt levels began to rise sharply after 2001 and then accelerated further from 2005 reaching just under €118,000 per room in 2008. Meanwhile, valuations based on 7% yield rose slowly to peak at €146,000 in 2005 and then declined. This decline accelerated as prices were cut in response to weakening demand in 2007/08 and stood at €100,800 in 2008.

The result of these developments is a negative net asset value of just over €17,000 per existing hotel room in 2008 and a debt to room value of 117% as shown in Figure 5.2. This gives a total excess of debt over room assets for the hotel sector of €1,035 million in 2008²⁶. Given the ongoing and intensifying difficulties being experienced by the sector, it is considered that this deficit will have increased in 2009.

²⁶ This would amount to about 42% of total revenue from rooms given the revenue per available room estimate in Table 4.1 above.

Figure 5.2: Debt as % of Room Values, All Rooms in Hotel Stock, 1999-2008

5.2 Debt Associated with New Hotels

To gain insights into the dynamics of debt accumulation in the hotel sector requires that the total debt incurred is disaggregated to identify the years when it was incurred and the types of hotels with which it was associated. A meaningful analysis along these lines is possible based on the cost of the investment that is required per room according to different grades of hotels using the *Fáilte Ireland* Register's numbers for hotel rooms per year. This approach uses an estimate of the investment per room and assumes an 80% debt ratio across the board. The estimated cost of investment per hotel room is shown in Table 5.1. No estimate for 5* rooms is included in this table as the actual investment in 5* hotels constructed in this period varied considerably. Estimates were built into the calculations to derive the total figures in subsequent tables.

Table 5.1: Estimated Cost per Hotel Room by Classification

	1*	2*	3*	4*
1999	70,000	80,000	110,000	160,000
2000	80,000	90,000	120,000	170,000
2001	90,000	100,000	130,000	180,000
2002	100,000	110,000	140,000	190,000
2003	110,000	120,000	150,000	200,000
2004	120,000	130,000	160,000	210,000
2005	130,000	140,000	170,000	220,000
2006	140,000	150,000	180,000	230,000
2007	150,000	160,000	190,000	240,000
2008	160,000	170,000	200,000	250,000

Source: Horwath Bastow Charleton.

The total number of hotel rooms constructed each year in each classification is shown in Table 5.2.

Table 5.2: Number of New Hotel Rooms by Year and Grade

	1*	2*	3*	4*	5*	Total
1999	20	77	1,568	802	271	2,738
2000	15	216	1,094	954	0	2,279
2001	10	543	173	611	359	1,696
2002	0	82	0	442	145	669
2003	0	35	280	397	0	712
2004	0	119	1,524	1,290	137	3,070
2005	38	12	1,244	2,596	168	4,058
2006	53	347	2,215	5,282	588	8,485
2007	10	10	585	1,148	309	2,062
2008	0	58	318	523	134	1,033
Total	146	1,499	9,001	14,045	2,111	26,802
% of total	0.5%	5.6%	33.6%	52.4%	7.9%	

Note: A small number of rooms - 30 in total - that were not classified in the register are included as 3*
 Source: Fáilte Ireland Hotel Register

This table shows that 4* hotels comprise by far the greatest number of rooms that were constructed in this period. Along with 3* hotels, these comprise 86% of total new rooms. This is mainly the result of the new hotels registered in 2005 and 2006 when 14,151 rooms in the 3* and 4* grades were first entered onto the register.

Multiplying the cells in these two tables provides an estimate of the total investment in hotels in this period. This is shown in Table 5.3. Total investment was almost €5.2 billion of which it is estimated €3 billion was in 4* hotels. Hotels first registered in the period 2004-06 accounted for over €3.2 billion or 63% of this.

Table 5.3: Investment in Hotels (1999-2008, €million)

	Total
1999	365.27
2000	314.10
2001	270.24
2002	127.80
2003	125.60
2004	565.83
2005	834.58
2006	1,837.67
2007	479.38
2008	244.41
Total	5,164.88

It is considered that it is reasonable to assume that 80% of the investment was funded through debt in all cases²⁷. The resulting debt profile, in the year of construction, so derived is shown in Table 5.4 and indicates total borrowings of over €4 billion.

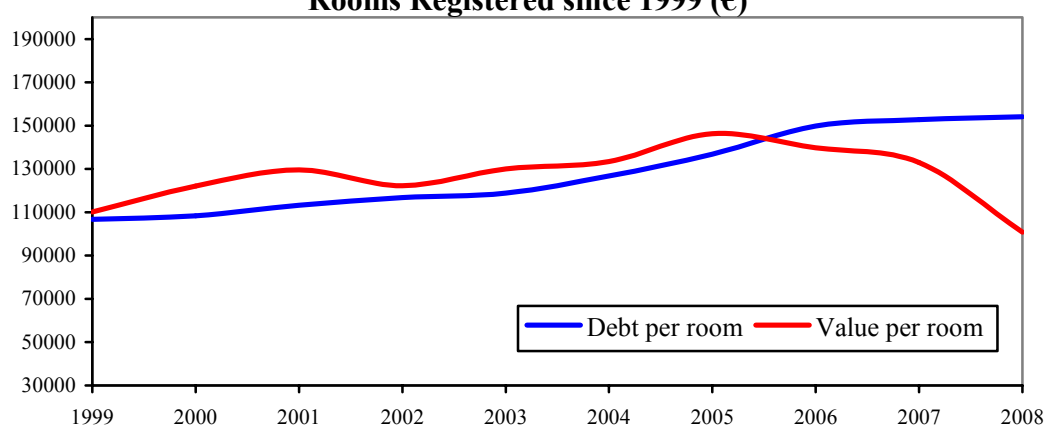
²⁷ See the discussion on the operations of accelerated capital allowances in Section 5.3 below.

Table 5.4: Estimated Hotel Debt in Year of Registration (1999-2008, €million)²⁸

	1*	2*	3*	4* & 5*	Total
1999	1.12	4.93	137.98	148.19	292.22
2000	0.96	15.55	105.02	129.74	251.28
2001	0.72	43.44	17.99	154.04	216.19
2002	0.00	7.22	0.00	95.02	102.24
2003	0.00	3.36	33.60	63.52	100.48
2004	0.00	12.38	195.07	245.22	452.66
2005	3.95	1.34	169.18	493.19	667.66
2006	5.94	41.64	318.96	1,103.6	1,470.14
2007	1.20	1.28	88.92	292.11	383.50
2008	0.00	7.89	50.88	136.76	195.53
Total	13.89	139.02	1,117.6	2,861.4	4,131.9

From this it is possible to calculate the accumulated debt since 1999 per room added since that date. This is shown in Figure 5.3. In effect, this is Figure 5.1 redrawn but including only rooms added since 1999 and the associated debt. As would be expected, comparison with Figure 5.1 shows that debt was a higher proportion of estimated new room values in all years with the debt to value ratio above 1 since 2005. Debt reached 153% of values in 2008. However, it is clear that the debt to value ratio was close to 1 for most of the period from 1999 up to the crossover after 2005 indicating that there was little room for any fall in room values as a result of a weak market. It appears probable that investors in hotels believed that yields for hotel investment would be closely aligned to those obtained from commercial property. However, the latter class is often let under long leases with stable and increasing rents. In contrast, the cyclical nature of the hotel sector means that a substantial premium should have been priced into the desired yields. This was not the case.

Figure 5.3: Debt and Value of Cumulative Stock of New Rooms Registered since 1999 (€)



Debt is not a constant and may gradually be paid off under normal conditions. However, consultations with operators and professional advisors indicate that the repayment of debt in respect of hotels over the past decade has been minimal with most loans provided on an interest only basis. This means that the debt associated with the rooms added since 1999 would stand in 2008 at €4.13 billion. However, as

²⁸ The estimates in respect of 4* and 5* hotel debt are aggregated to ensure confidentiality.

shown in Table 5.5, the fall in values in 2008 to €100,800 per room means that, on average, rooms first registered in every year since 1999 would still have had a debt to value ratio greater than 1 in 2008. For example, a room registered in 2002 with an interest only loan would have a debt to value ratio of 1.52 in 2008.

Table 5.5: Debt to Value Ratios of New Rooms Constructed since 1999 based on 2008 Valuations

	Debt per room	Debt to value ratio
1999	106,726	1.06
2000	110,259	1.09
2001	127,472	1.26
2002	152,825	1.52
2003	141,124	1.40
2004	147,448	1.46
2005	164,530	1.63
2006	173,263	1.72
2007	185,986	1.85
2008	189,282	1.88

The calculation shows that the fall in room values using the income capitalisation approach means that rooms constructed in each and every year since 1999 are now insolvent.

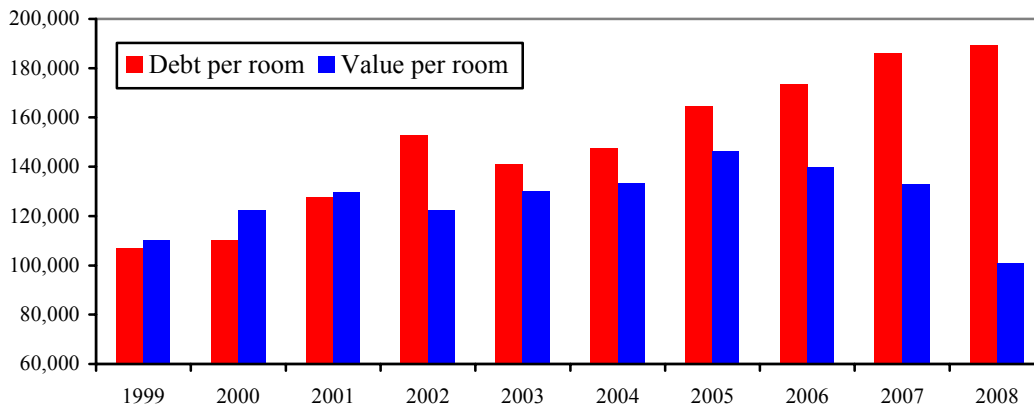
While this analysis provides important insights regarding the situation as it currently stands, it is retrospective in the sense that investors in any year prior to 2008 would not have been able to predict the room valuations that would exist in 2008 and would not have taken into account the situation in respect of hotels already in the stock. However, it is possible to analyse the data on an annual basis i.e. taking into account only the hotels entered on the register in any particular year in calculating the debt to value ratio.

Debt and Value in the Year of the Investment

To get an idea of the situation facing investors at the time at which the investment was made, the debt per room for new hotel rooms added was calculated for each year and compared with the room valuation based on returns in that year²⁹. This is shown in Figure 5.4. This calculation shows that, for every year after 2001, on the basis of room values derived from profitability in each year, new rooms had associated debt at the time of the investment that exceeded their values. This existed well before the period of rapid expansion from 2004 and the slowdown from 2008. The debt to room value ratio is also accelerating having stood at 1.24 in 2006 and rose to 1.88 in 2008.

²⁹ This approach uses only rooms and debt in each year rather than all accumulated debt and rooms as in the previous figure. This can be interpreted as the debt to value ratio that would have faced investors when making the decision to invest before taking accelerated tax allowances into account.

Figure 5.4: Estimated Debt and Value in Year of Construction of New Rooms, 1999-2008 (€)



This is a remarkable outcome because it means that investment in new rooms could not have been justified on the basis of a debt to value calculation since 2001 i.e. the level of debt associated with investing in hotels exceeded the asset created valued according to a desired yield of 7% in every year after 2001. If cost to value is used then the situation is even more extreme. Put another way, investment in hotel rooms destroyed value in every year since 2001. Thus, for new rooms, negative equity is not a recent phenomenon that can be explained by the recent downturn in demand or by the room rate discounting that has characterised the sector in recent years. Rather it has been a feature of the industry going right back to the downturn in international tourism following 2001. Of course, this is an overall average for all new rooms in any year and it is possible that some hotels may not have shared these features. However, the chart shows that the extent of the negative equity was expanding only slowly up to 2005 after which it accelerated rapidly. Given the weakness of demand in 2009 and ongoing price reductions in the sector it is likely that the room debt to value ratio is currently close to 2 for hotels constructed in recent years. This would mean that, on the balance of probability, all new hotels since about 2005 never experienced a solvent position where room values exceeded debt and that the downturn since 2008 has greatly exacerbated this situation.

The conclusion therefore is that insolvency in the sector is a consequence of rooms added to the register since 2002. The fall in values in 2008 means that these rooms are insolvent but, furthermore, that the insolvency is not simply a function of this fall in values as the analysis also shows that rooms constructed since 2002 were insolvent in the year in which they were first registered. The number of rooms involved amounts to 20,089 i.e. the number of rooms first registered in 2002-2008.

The analysis indicates however, that insolvency in the stock of new rooms really intensified from 2005 onwards. The calculations indicate that this latter cohort is in a more serious situation than rooms developed earlier. For example, Table 5.4 above shows that the overall level of debt, and Table 5.5 shows that the debt to value ratio, both jump noticeably for rooms introduced from 2005 onwards. The data show that a total of 15,638 rooms were introduced to the register in 2005 to 2008.

However, a note of caution is in order. These results are based on an underlying assumption that profit margin estimates that underlie valuations, which are based on all hotel rooms, are accurate in respect of *new* hotel rooms. There are a number of

reasons why this might not be so. For example, new rooms may experience disadvantages in terms of reputation, managerial experience or location – an existing hotel might be on the main street whereas a new hotel might be on a town's edge – that would mean that they could have lower profits. More importantly however, the characteristics of the new hotels might differ from the existing stock. This is likely to be most important in respect of classification but regional location and size may also be important. As shown in the HBC Hotel Survey, profits per room vary according to the grade, location and size of the hotel³⁰. The analysis in Section 5.4 below examines this issue.

5.3 *Role of Capital Allowances in Hotel Investment*

This analysis shows that returns have not been sufficient to justify the investment that has taken place irrespective of whether the analysis done using the complete stock of hotels or limited to new hotels. Importantly, the previous section also showed that in every year since 2001 the fundamentals of the industry meant that, at the time of the investment new hotels were effectively insolvent given the estimated debt associated with construction and the valuations that could be placed on rooms at that time. Thus, investment was categorically not driven by the fundamentals of the hotel industry or by the available returns from operations, even before the impact of excess supply or the weakness of demand in the current downturn on prices is taken into account. In other words, these investments never made sense from the point of view of operating hotels and would have been insolvent if market conditions had stayed as they were at the time of the investment. Given this conclusion, the hypothesis is that the investment was totally driven by external factors, for example, regulatory requirements such as the necessity to include commercial operations in return for residential planning permission and tax incentives.

Capital allowances for hotels were originally introduced in the mid-1960s. In 1965 there were 712 hotels in Ireland with a total of 17,292 rooms, giving an average size of 24 bedrooms. Of these hotels, only 3,652 had bathrooms ensuite. The capital allowances incentivised the creation of national hotel groups in the late 1960s, early 1970s, such as Ryan's, Flannerys, Costello's and Doyle's.

Accelerated tax allowances had been available for investment in hotels since the Finance Act 1994 which provided for accelerated allowances over 7 years rather than the earlier 10 years. Chapter 1, Part 9 of the Taxes Consolidation Act (TCA) 1997 provided for accelerated capital allowances for hotels. This special provision for hotels was terminated in Budget 2003 with investment in hotels from end 2002 to be treated under the general industrial buildings allowance of 4% over 25 years. However, the Finance Act 2003 included transitional arrangements for hotels that allowed for the continued availability of 100% write off over 7 years provided certain

³⁰ See exhibits 2.2, 3.2 and 4.2 of the 2009 HBC Hotel Survey. These show in turn that room profitability varies according to the region, grade and size of hotel in question. It is likely, however, that the main underlying factor is grade and that this is correlated with size and region giving the impression that these latter variables are important. For example, 5* hotels tend to be larger and concentrated in Dublin. If 5* hotels have higher profits per room then the survey results would appear to indicate that larger hotels and hotels in Dublin have higher profits. However, such correlations are unlikely to account for all the differences.

conditions were met. This arrangement was further extended in Finance Acts 2004 and 2005. The conditions related to the timely obtaining of planning permission or equivalent and Fáilte Ireland certification.

Initially, the seven-year rate of write-off was available only in respect of expenditure incurred by the end of July 2006. However, Finance Act 2006 effectively extended the transitional period for accelerated capital allowances for hotels by introducing a phase-out period with 100% of expenditure allowed provided it occurred during 2006, 75% allowed for expenditure during 2007 and 50% for expenditure during 2008. Additional conditions were attached, including registration with Fáilte Ireland.

The tax allowance scheme allowed hotels to access both equity and debt finance easier than would be the case otherwise. Furthermore, it enabled developers to work with international franchisee hotel operators who are primarily interested in operating or leasing rather than developing or owning properties³¹. However, while there is reason to conclude that incentives to promote investment in the hotel sector were useful to address weakness in the product offering in the 1990, on the basis that that socially desirable levels of tourism investment would not arise because of a poor risk return profile relative to investment opportunities in other sectors of the economy, by 2005 the IHF had concluded that the system required reform. Noting the importance of tourism in the Irish economy and the ambitious targets that had been set against a very competitive marketplace and ongoing weaknesses in the sector, the IHF argued that they should be restricted to three areas of investment³²:

- Investment to increase the size of small hotels;
- Investment by existing hotels in additional facilities; and
- Investment in upgrading and refurbishment.

Investment in these areas, it was argued, would address the observed weakness in the sector and would be in line with the direction of policy as laid out at the time. However, the retention of a largely unmodified scheme has meant that incentives remained focussed on expanding the sector in terms of room numbers beyond what could be supported by foreseeable growth in demand.

An Example of the Impact of Allowances

A stylised example indicates the strength of the incentives that were created by the allowances. In this example, a developer in 2004 is looking for planning permission for a mixed use development involving shops and some residential development. It was common that the planning authority would request that a hotel would also be developed on the site³³. Faced with this, the developer would allocate some land at zero cost and perceive this as a cost associated with obtaining the required planning consent. Assume the hotel has 50 to 60 rooms with a construction cost of €10 million. Indeed, the developer has an incentive to maximise the cost incurred in the hotel, for

³¹ Mahony, M. (2007) 'The Influence of Domestic Fiscal Incentives and Internationalisation on Hotel Valuation'. *The Property Valuer*, Summer pp 18-23

³² Irish Hotels Federation (2005) *Tax reliefs on Hotel Developments: Submission to the Department of Finance* (March)

³³ The contrast between this approach and the process in respect of retail development under the Retail Planning Guidelines, where new developments must effectively demonstrate a 'need' for new outlets, is notable.

example by including all access infrastructure, so as to maximise the value of allowances.

The developer contacts high net worth individuals who expect that they will have big tax liabilities over the next seven years. These fund the €10 million in return for sharing in the tax allowances. In effect, given that the allowances will be worth €4.2 million, the investors provide funds directly to the developer to the value of €2.1 million. The remaining €7.9 million is then borrowed from a bank on an interest only basis, in the investors' names but with non-recourse to other assets, to fund the hotel. Once built, the hotel is leased to a hotel operator, often an international chain, and the lease income is used to pay the interest on the bank loan. At the end of the seven years the hotel and the loans are transferred back to the developer or sold. Unless property prices fall sharply, the sale will raise sufficient funds to pay the loan and provide a profit to the developer.

There are quite a range of incentives involved from the point of view of many actors in this process:

- The developer gets planning permission and the prospect of a good profit in seven years;
- The investors get the difference in the net present value of the tax allowances over seven years instead of 25 years, less the payment to the developer;
- The planning authority ensures that what it has determined to be good integrated development occurs, local employment is provided, tourism is promoted, it gets revenues from levies associated with the development, and a rates base is created;
- The tourism development agencies see the accommodation base being strengthened;
- The exchequer can look forward to new taxes and since the social discount rate is lower than the private discount rate that the investors will attach to the allowances, the cost to the exchequer of providing the allowances, in present values, is less than the value perceived by the investors;
- The banks get to provide a loan to high net worth individuals secured on a property with a loan to value ratio of 79%;
- Hotel operators who usually do not want the trouble of developing or owning hotels get an opportunity to enter a booming economy as a result of the new hotel for lease;
- Residents in the local area get a new facility that can be used by residents as well as visitors.

This is a fairly powerful list of reasons why all decision-makers involved would favour such development. Most importantly, no one on this list will expect to experience a downside that might result from excess capacity being created that could undermine the viability of other hotels in the wider area, even if this was perceived to be a possibility.

However, the factor missing from this analysis is any consideration of whether the fundamentals of the hotel industry justify the investment. In this way, the result of the allowances was that the decision to invest in hotel development become distanced from objective consideration of the prospects of a return from trading, and even more distanced from what might be in the interests of the industry.

Given that the allowances were increasing the supply of rooms it is a basic requirement if balance is to be maintained that this new infrastructure would contribute to growing the demand for rooms. However, this was not the case. A survey of hotels in 2005 found that 60% of hotels in the survey had utilised the incentive over the previous five years³⁴. Most respondents to the survey considered that the scheme had improved the accommodation base in the country but less than 40% believed that it had attracted additional overseas visitors to Ireland.

The inevitable implication of these results was that the new hotels were competing with the existing hotels for a customer base that was growing more slowly than the stock of rooms. It was also inevitable that this would result in price discounting that would adversely affect turnover, profits and hotel valuations in the future. In effect, the value of the allowances must eventually exceed the value created in the sector. In other words, the investors availing of the allowances were effectively removing value from the sector.

It is possible to provide an indicative estimate of the value of capital allowances that are outstanding at the end of 2009 in respect of new hotels entered on the register in the period 2004-08³⁵. Assume that all new hotels that have been constructed since 2004 qualify for accelerated allowances. An investment made in 2004 will have 10% of its allowances left for 2010, this will be 25% in the case of an investment in 2005, and so on. On the basis of the data in Table 5.3 above, and allowing for the phase-out period in 2007 and 2008, the total eligible investment in 2004-08 was €3.72 billion. Total remaining allowances in respect of this investment amount to €1,284 million. At the 41% marginal tax rate, these are worth €527 million to investors in terms of the potential tax saving.

However, the requirements to avail of allowances contain a provision that allowances that have been claimed already for any hotel that does not remain open for seven years can be clawed back by the Revenue. This means that the total value of allowances in respect of hotels opened in the period 2004-08 is a relevant consideration. Using a similar approach to the previous paragraph, it is estimated that allowances with a value of €998 in terms of their tax saving have already been claimed. Thus, the total value of tax allowance related to hotels that have not been open 7 years at end 2009 would be just over €1.5 billion.

5.4 Debt and Value by Industry Segment

As noted above, the conclusions relate to new hotels in total but the sector is actually composed of a number of segments where markets and conditions can vary considerably. Profit estimates are available for different segments – grade, size and location – of the hotel stock are available³⁶. This information was used to identify room values for new hotels registered since 1999 in each of these segments. It is

³⁴ Indecon Survey of Hotels in Ireland conducted on behalf of the Department of Finance in 2005, as reported in Mahony (2007)

³⁵ All the allowances associated with an investment made earlier will have been used by end 2009 (6 years @ 15% and 1 year @ 10%).

³⁶ These data from the HBC survey broadly comply with the segmentation used to categorise the supply of hotels in Section 3.2.

assumed that profit estimates which were calculated for the whole hotel stock are appropriate in respect of the subset of hotels opened since 1999.

The debt incurred was segmented according the cost per room estimates used above. This is straightforward in respect of the segmentation according to grade but certain assumptions were used to segment by size and location. It was assumed that rooms in small hotels cost in line with 3* rooms, rooms in medium size hotels cost the same as 4* rooms, and rooms in large hotels cost the average of 4* and 5* rooms³⁷. Regarding location, it was assumed that hotels in Dublin in each classification cost 20% more to construct than the average for rooms in that classification, while hotels in other parts of the country cost 15% less than the average³⁸.

For each segment, the debt in each year was calculated according to the number of rooms registered in that year. Table 5.6 shows the number of rooms in each segment, the value of debt per room in each segment, and the value per room in that segment in 2008 assuming a required yield of 7% per annum.

Table 5.6: Debt to Value Ratios in 2008 for New Rooms by Hotel Segment

	Rooms	Debt per room	Value per room	Debt to value ratio
Grade				
1-3*	10,646	92,152	78,949	1.17
4*	14,045	145,005	111,336	1.30
5*	2,111	170,493	97,394	1.75
Hotel Size				
Small	4,878	110,666	96,267	1.15
Medium	7,336	119,305	76,474	1.56
Large	14,588	137,448	115,996	1.18
Location				
Dublin	9,079	146,631	134,171	1.09
East	7,877	113,792	94,514	1.20
West	6,420	107,220	76,900	1.39
Cork/Kerry	3,426	110,818	88,014	1.26

Of the total debt outstanding for new hotels in 2008, 30% is associated with mid-price and economy hotels (1-3*), 60% with First Class (4*) hotels and 10% with luxury (5*) hotels. Due to the assumptions above in relation to the cost of constructing of hotel rooms by the size and location of the hotel, the estimates for room costs by size and location should be treated as indicative. Even allowing for any error that may be introduced as a result of these assumptions, the clear conclusion from this table is that hotel rooms constructed since 1999 have, on average, a debt to value ratio above 1, irrespective of the grade, location or size of hotel. The highest ratios arise in 5* hotels, medium sized hotels and hotels in the West. Small and 1* to 3* hotels, and hotels in Dublin, have the lowest ratios along.

³⁷ This is done only to facilitate the estimates in this hotel and does not imply that this is an accurate reflection of the actual grade of rooms in hotels of these various sizes.

³⁸ These assumptions act as a starting point for this analysis; the consultants will revise in the light of any information that can be provided.

5.5 Summary of Hotel Debt

This analysis based on the cost of investment in new rooms allows some light to be thrown on the make-up of the Central Bank data for debt in the hotel sector. Table 5.7 shows this calculation. This shows that debt associated with investments undertaken prior to 1999 amounts to €1,510 million or 21% of the total. The estimate for new rooms is taken from the analysis in this report and amounts to 57.7% of the total. New hotel openings raised the required standard in the sector with the result that existing hotels invested in facilities such as leisure centres, spas, and function and conference facilities funded mainly by debt. High profile transactions involving *Gresham Hotels*, *Great Southern Hotels*, *Jury's Inns*, *Bewleys*, *the Burlington*, *the Berkeley Court* and *Jury's Ballsbridge* were also very likely funded by debt. Furthermore, some of the debt raised from Irish banks was used for hotel developments abroad.

Table 5.7: Hotel Sector Debt in 2008: Allocation by Use

	Debt Outstanding in 2008 (€m)	% of total
Existing prior to 1999	1,510	21.1
New rooms since 1999	4,132	57.7
Refurbishment, Upgrading, Transactions & Overseas	1,521	21.2
Total	7,163	100.0

The total for refurbishment, upgrading, transactions and overseas use in Table 5.7 is a residual, being the difference between the total debt existing prior to 1999 and new hotels since 1999, and the overall total debt figure taken from Central Bank data, and is not based on any other analysis in this document. It relates mostly to 34,410 hotel rooms i.e. those that existed prior to 1999, although it is certainly possible that some rooms first registered since 1999 may have undergone refurbishment or had further investment in this period. At €1,521 million, it is estimated that this accounts for 21.2% of total debt in the sector.

5.6 Impact of Insolvency on the Industry

This analysis shows the extent of the insolvency problem in the sector. Table 5.8 summarises the main points. About 26,802 new rooms were constructed in the period 1999-2008 with associated debt of €4.13 billion. While the downturn in 2008 is an important factor in terms of the level of insolvency in the sector, the fact is that on the basis of the expected return in the year in which the investment was made, hotels on average in every year since 2002 were insolvent from the time of the investment. Thus, the investment was destroying wealth. Furthermore, the low level of returns in 2008 means that hotels constructed in every year since 1999 are, on average, insolvent. This leads to two questions. First, why was the investment undertaken at all? Second, why are hotels that are insolvent continuing to operate?

The answer to the first is straightforward. As shown in Section 5.3 above, the capital allowances provided financial incentives to undertake the investment. The fact that

the fundamentals of the sector did not justify the investment was not a major consideration in terms of the returns. Furthermore, the potential for excess capacity to undermine the sector is a classic market failure – the potential downside would be borne by the whole sector including the existing hotels while the upside would accrue to the investor in new stock. Excess investment is the inevitable result of such a situation, particularly when further promoted by planning considerations and the easy availability of debt.

Table 5.8: Summary of Debt and Value in New Rooms

	New Rooms	Total Debt Incurred	Debt to value ratio in first year	Debt to value ratio in 2008
1999	2,738	292.22	0.97	1.06
2000	2,279	251.28	0.90	1.09
2001	1,696	216.19	0.98	1.26
2002	669	102.24	1.25	1.52
2003	712	100.48	1.09	1.40
2004	3,070	452.66	1.11	1.46
2005	4,058	667.66	1.12	1.63
2006	8,485	1,470.14	1.24	1.72
2007	2,062	383.50	1.42	1.85
2008	1,033	195.53	1.88	1.88
Total	26,802	4,131.9		

The answer to the second question lies in a number of factors. First is the distortion created from the need to remain in business as a hotel so that investors can retain and avail of the tax allowances. In short, under the rules governing the incentives, even if the hotel is losing money, the loss to the investor in terms of tax allowances would probably be much greater if the hotel closed. This is because for every year the hotel stays open, within the first 6 years, the tax allowances will be worth 6.15% of its construction cost (15% multiplied by the marginal tax rate of 41%). In the 7th year the allowances are worth 4.1% of construction costs (10% by 41%). Provided operating losses do not exceed this amount, there is a clear incentive to remain in business. Therefore, the profit motive for remaining in business is greatly weakened.

The second reason arises from the banks' reluctance to incur write downs at a time when their capital adequacy is in question. In the current financial situation, banks are anxious to avoid having to write off bad loans as would happen if a hotel closed and the bank was required to recognise the insolvency. By definition the bank would not recover all the money and potentially only a limited fraction. The resulting write down would strain capital adequacy at a time when there are serious questions regarding its adequacy. The data in Table 5.5 can be used to provide an estimate of the potential write-down. The highest levels of insolvency relate to the 217 hotels with 15,638 rooms that were constructed during 2005-08. The total outstanding debt would be €2,450 million at end 2008. Applying the debt to value ratios in Table 2.5, to net out the proportion of the debt that would be realised in a liquidation, the write-down required in respect of the loans associated with these hotels would be €965 million, assuming no debt repayment has occurred. This is possibly a low estimate in practice given that the banks might engage in a fire sale of hotel properties by selling blocks of hotels at low values to speed up the liquidation.

Finally, there is considerable uncertainty currently regarding the operations of the proposed NAMA. It is likely that loans in respect of certain hotel developments will be eligible to be transferred to NAMA when it becomes operational. The banks clearly have an incentive to postpone any decision in respect of insolvent hotels until after any such transfers are made. It is not known how many loans involving hotels will be transferred to NAMA. While there are likely to be some loans – in particular high profile transactions that did not involve new construction but are associated with land and development loans – it is not known how much of the debt that is associated with hotels will be deemed to be loans to operational entities as distinct to loans for development. In this situation, there is an incentive for banks not to act since to do so could adversely affect the value of security held in respect of loans intended to be transferred to NAMA.

A crucial point is that none of these influences have anything to do with the fundamentals of the hotel industry. In each case, the decisionmakers are making a rational calculation on the basis of their own private interests. However, the decision is having major implications for the sector and for operators who have potentially viable businesses.

The continuation in business of hotels with no long term viability, many of which have never had viable business plans and whose main objective is to realise some cashflow by cutting rates is affecting profitability throughout the sector. As a result, insolvency is becoming contagious in a period when businesses are under pressure due to the weakness of demand. The burden of excess capacity is not being borne by new entrants that have caused the problem or banks which have financed bad investments, as would be the case in a properly functioning market that would force failed entrant out. Rather the burden of adjustment, in effect is being transferred by banks away from themselves to the hotel sector as a whole, thus threatening the viability of hotels which are fundamentally competitive. .

In effect, the difficulties being experienced throughout the sector, and the well publicised difficulties in the banking sector, mean that hotels with relatively low levels of debt are experiencing difficulties in accessing working capital. The problem is that banks have possibly less incentive to keep them open than is the case for hotels with high levels of debt. A poorly managed shakeout of the sector could therefore result in solvent businesses being forced out of business due to liquidity of cashflow problems while the banks keep insolvent businesses afloat to avoid the need to realise bad debt and the resulting write-offs.

In summary, the strategy of postponing the closure of that part of the hotel stock that has no prospect of long term viability is not optimal unless a strong recovery of demand is to be expected. The next section assesses the potential for this development to resolve the situation.

6. Outlook and Scenarios for Demand and Supply

6.1 Recent Forecasts for Tourism Demand

The most recent forecasts from the United Nations World Travel Organization (UNWTO) indicate that a recovery is underway and that the number of international tourists will grow in 2010³⁹. The figures show that international arrivals dipped 4% in July this year, compared to a year-on-year change of 7% in June and 10% in May, suggesting that the trend in traveller numbers has turned up. In the first seven months of the year 500 million travellers crossed borders, down 7.4% from 540 million in the same period of 2008. Tourism in Europe is down 8% but an improvement in the data for July, which was down 4% as compared to a fall of 11% in May and 7% in June when compared with 2008, indicates that demand might be picking up. The UNWTO is still finalising its forecasts for 2010, but it is expected that it will be better than the 4-6% drop in international tourist numbers that is now expected this year.

Domestic tourism is expected to have done comparatively better in the main countries. However, the WTO expect that this will not be sufficient to compensate for the losses in international markets. As in previous downturns, tourism earnings are expected to suffer somewhat more than arrivals as consumers tend to trade down, stay closer to home and travel for shorter periods of time.

Against this background, the *Tourism Policy Review Report* outlined various scenarios for recovery in Irish tourism. Its 'realistic scenario' is based on mid-range assumptions for the global economy and tourism growth and what it describes as an 'effective' response by the public and private sectors to the downturn and the challenges it identifies for the sector. From this it can be concluded that this realistic scenario assumes that its policy and other recommendations are implemented and are effective. It also assumes that there is no deterioration in air access to Ireland, a variable that is beyond the control of the Government or the sector. This scenario sees overseas tourists stabilising at 2009 levels and returning to growth by 2011 with modest growth of 3 to 4% per annum up to 2013. This would mean that overseas visitor arrivals would reach 7.5 million by 2013. Revenues from overseas tourists would fall in 2009 and 2010 but show modest growth in 2011-13. Overall, Ireland maintains its market share by strengthening its position in Europe and reversing the decline in Britain. In relation to domestic tourists the report sets a target of a return to growth by 2011-12 with trips to reach 8.3 million by 2013.

The best case scenario sees overseas visitor numbers of 8 million in the peak year of 2007 being reached again in 2013 with steady growth in domestic tourism and revenues. However, the worst case scenario which would result from below trend global economic growth, volatile oil prices and exchange rates and a failure to tackle competitiveness issues in Ireland, sees overseas visitor numbers and domestic trips both continuing to fall to 6 million in 2013. Holiday trips would be particularly hard hit. Revenues fall faster in real terms and Ireland loses market share under this scenario.

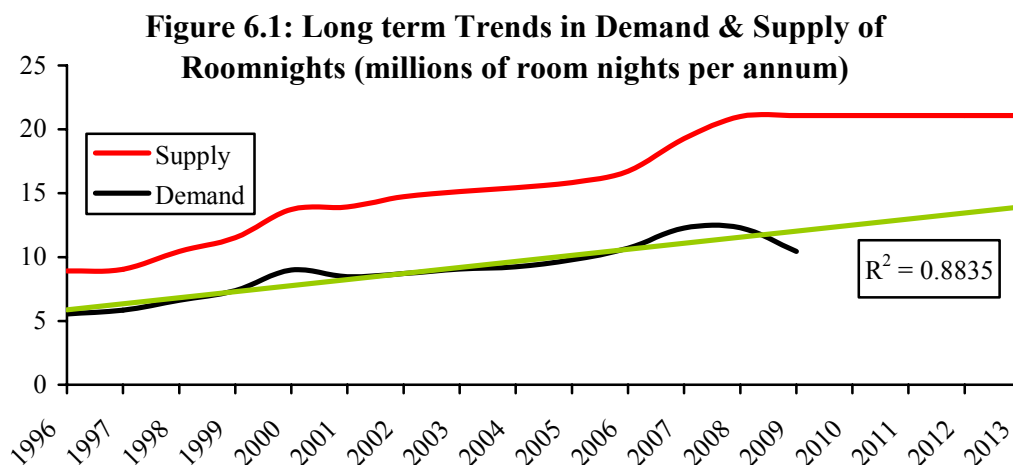
³⁹ UNWTO Press Release 'Increasing Confidence in 2010 Recovery for the Tourism Sector' Oct 02

These scenarios have been developed following appropriate consideration of the issues and the consultants so not intend to review this exercise. However, it is clear that the realistic scenario depends on a number of factors improving, not all of which are under the control of policy makers. Initiatives in areas such as improving competitiveness and promotion are clearly required, but even if implemented this outlook is far from a forecast that the market for hotels is going to regain anything like what it was prior to 2008. Indeed, 2009 would appear to be a more accurate representation for the next couple of years with 2008 conditions thereafter. Furthermore, there is considerable opportunity for the downside and it is noted that while the realistic scenario identifies 7.5 million overseas visitors in 2013 as a target, the potential under the worst case is 6 million compared to an upside of 8 million under the base case. In addition, the Tourism Review Group (TRG) was clear, in line with the WTO above, that revenues are likely to fall by more than tourism numbers.

The TRG observes that the first requirement in terms of the key British market is that numbers are first stabilised. *Tourism Ireland* is developing a new strategy in relation to this market and while Ireland has managed to retain a positive perception among British customers, the cost of visiting Ireland is a serious challenge. The trend in this respect remains negative given the ongoing weakness of sterling and further strengthening of the Euro against sterling cannot be ruled out. Even assuming that this trend does not further erode competitiveness in this market, Tourism Ireland forecasts indicate that growth in the holiday segment is unlikely to exceed 2.5% in 2010 and subsequent years, following a fall of 16% in 2009. Thus, one of the most important markets from the point of view of hotels is likely to substantially underperform the recovery projection set out in the TRG report.

6.2 Hotel Capacity and Outlook

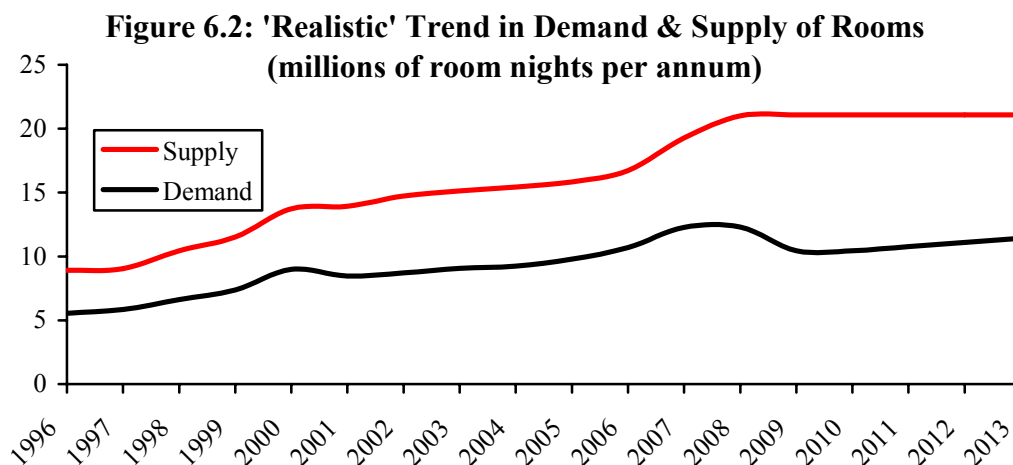
Against this background it is useful to compare the supply and demand for hotel rooms looking forward. First, it is worth looking at long term trends in demand and supply. This is shown in Figure 6.1. The green line represents the trend in demand for hotel rooms based on data for the period 1996 to 2009 incorporating a fall of 15% in room demand in 2009. It is also assumed that no new rooms are added after 2009.



If this were an accurate representation of prospects then occupancy rates, while declining in 2008 and 2009, would soon recover to the extent that they would exceed

60% from 2011 and would reach the 2005 level by 2013. Thus, while the excessive investment in capacity would have caused problems the crisis would have been temporary and the industry would have had the potential to begin to recover within a couple of years.

However, the analysis in the previous section makes it clear that this is most unlikely to happen. Assume that room demand moves in line with overall visitor numbers as outlined in the TRG realistic scenario. Recall that this assumes that measures are put in place to address the challenges and to promote the sector. The results of this scenario, in terms of the supply and demand for rooms are shown in Figure 6.2.



Under this scenario, room occupancy falls below 50% in 2009 and 2010 and recovers slowly thereafter. However, it achieves only 54% in 2013 less than the 58.5% experienced in 2008 and well behind the rate of 64% in 2006-07. The gap in terms of excess capacity is shown in Table 6.1.

Table 6.1: Excess Capacity of Roomnights with 'Realistic' Scenario (000s p a)

	2007	2008	2009	2010	2011	2012	2013
Supply	19,273	21,019	21,074	21,074	21,074	21,074	21,074
Demand	12,284	12,294	10,450	10,450	10,763	11,086	11,419
Difference	6,989	8,725	10,624	10,624	10,311	9,988	9,655
Difference %	36.3	41.5	50.4	50.4	48.9	47.4	45.8

Under this scenario, the demand for roomnights stabilises 10.45 million in 2009-10 and then grows to 11.4 million in 2013. This would still represent a fall of 7% relative to the 2007 level. The excess capacity, which stood at just under 7 million in 2007 rises to 10.6 million in 2009-10, just over 50% of the total, and then falls slowly.

There are a number of other important issues for consideration when interpreting this scenario. First, the outcome depends on an effective programme of interventions to address competitiveness and support marketing. Thus, this is already built into this outcome. Second, it is assumed that hotel demand moves in line with overall tourism numbers. Irish hotels have been very dependent on domestic visitors and this market could fall more than tourism overall. Furthermore, the evidence in 2009 is that the holiday and business sector are hardest hit. Third, while this analysis refers to room

numbers, it is likely that revenue will fall even more. In addition, the occupancy rates achieved in 2008 and 2009 were based on heavily discounted room rates that make many hotels non-viable. As a result, even with a small recovery in occupancy in 2011 there is no certainty that hotels will have returned to viability. Finally, there are risks that the TRG realistic scenario will not be achieved. In the worst case scenario, numbers continue to fall to only 75% of the 2007 level by 2013. This would require a 4% per annum fall in numbers in the period 2011-13. Should this occur, then occupancy rates would fall to only 44% by 2013. However, while this level of demand cannot be discounted, this level of occupancy in itself cannot be considered to represent a future likely outcome as many hotels would have been forced to close by this stage.

The conclusion therefore is that the projected level of recovery for Irish tourism and hotel room demand will not be sufficient to maintain the viability of a large cohort of existing hotels. This is the case even if effective actions are taken as outlined in the TRG report.

This projection provides a very dark outlook for hotels. Expected levels of growth in demand will not solve the problems so it is necessary to ask what adjustments in terms of capacity could provide an impetus for recovery. There are clearly two related problems: there are too many hotel rooms relative to demand and rates have already fallen to a level that is leading to a spread of insolvency. This means that it is not adequate to think in terms of simply stabilising the sector at current levels. Instead, adjustment must be adequate to create a situation where hotel operators perceive that there are opportunities to improve returns to viable levels. This would ideally be achieved through reduced costs and this should have a role to play in any successful strategy. However, the extent of the fall that has occurred in room rates mean that reducing costs alone will not restore profitability. The result is that the sector must be restructured in a manner that allow the steep falls seen in 2008 and 2009 to be reversed. While higher rates would depress demand somewhat, the analysis in Section 4.1 above concludes that, taken as a whole, higher room rates with lower occupancy would improve margins and the value of room sales.

To illustrate what this means in terms of a supply adjustment, it is assumed that a supply gap, (i.e. the gap between demand and supply of roomnights as a percentage of total supply), 2 percentage points lower than that which existed in 2007 would create a situation where returns could recover⁴⁰. In addition, a target is set that supply will be reduced so that prices can return back to 2007 levels. The available evidence indicates that there has been about a 30% fall in rates. The elasticity values discussed in Section 4.1 suggest that addressing this would depress demand by about 5%. However, there is evidence that elasticities can rise in a situation where there is market turbulence and, given the trend in rates in recent years, a price reversal such as this would meet resistance in the market. To accommodate this, it is assumed that the impact of price increases on demand is double the normal elasticity so that demand is 10% less than what it would otherwise be. Table 6.2 illustrates the outcome under these assumptions.

⁴⁰ The gap of 7 million bednights that existed in 2007 resulted in either a levelling or slowing falling average rooms rate in Ireland depending on the date source.

The targeted supply is equivalent to the gap that existed in 2007 plus 2% of the 2007 capacity. Adding this to the demand projection provides the supply target. The excess capacity is therefore the difference between this target and current capacity. This is expressed in bednights and is translated into hotel rooms on the assumption that hotels are open on average 360 nights of the year⁴¹.

Table 6.2: Supply Adjustment Required for Recovery (000s nights per annum)

	2010	2011	2012	2013
Demand	9,405	9,687	9,978	10,277
Targeted gap	7,221	7,221	7,221	7,221
Supply target	16,626	16,908	17,198	17,498
Excess capacity (000s nights)	4,448	4,166	3,876	3,576
Excess capacity (rooms)	12,357	11,573	10,766	9,934

The calculation shows that under these growth assumptions than there would need to be a reduction in supply of 12,357 rooms to provide an environment for the sector to recover. Occupancy in 2013 would be almost 59% as in 2008.

However, this assumes that growth will be along the lines of the TRG realistic projection. Its worst case projection is a possibility and has a major impact on these results. Should this scenario come to pass, then the initial requirement that 12,357 rooms need to be removed in 2010 soon proves to be inadequate. By 2012 the required adjustment has risen to over 14,400 and to 15,368 in 2013.

This analysis provides an indication of the supply adjustment that is required for the sector to stabilise. Depending on the strength of the recovery in demand, it is necessary for between 12,350 and 15,350 rooms to be removed from the current stock.

6.3 Capacity Scenario with Insolvent Rooms Removed

The implication of the conclusion of the previous section, that forecast demand growth, even with the effective implementation of the recovery programme identified by the *Tourism Review Group*, will not be sufficient to remove the excess capacity that exists in the hotel stock, means that hotels that are currently insolvent will not recover. Furthermore, the insolvency, which was initially a feature of hotels with high debt and a weak business case to start, will spread to other hotels in the industry that would survive the current downturn in an industry with balance between supply and demand. To avoid this, it is necessary that the excess capacity be removed. However, the analysis so far does not address the issue of which rooms should be removed. Logically, these should be those hotels where the prospects for overcoming insolvency are least good.

While the analysis in Section 5 above showed that all parts of the hotel stock first entered onto the register since 1999 have solvency issues on average given the fall in

⁴¹ This is approximately the amount implied by the relationship between the Fáilte Ireland *Hotel Survey* estimates for roomnight supply and the actual supply of hotel rooms according to the Hotel Register.

asset value implied by the low returns achieved in 2008 and currently, it was also clear that the extent to which the level of debt exceeds room values is meaningfully greater for hotels first registered in 2005 and later years. These amounted to 15,638 rooms in 217 hotels. Therefore, removing these hotels from the stock would have the greatest impact on a per room basis, on average, on the degree of insolvency in the sector. This would not fully resolve the problem since the analysis showed that hotels first registered in all years since 2002 have a solvency problem but it would provide an opportunity to work through the problem for two main reasons⁴². First, by removing this level of supply, the market would be much tighter with a good chance that, for any given level of demand, operators would see and avail of opportunities to raise room rates. This would support profits and therefore raise room values. Second, while the recovery will be slow, tourism will begin to pick up and so there will a demand driven recovery in profits for any given level of room supply that will, in time, assist in resolving the residual solvency issues.

Table 3.2 above categorised the supply of rooms according to four regions, three grades of hotels and three sizes of hotel. This analysis has been re-worked but with all hotels that were first registered since 2005 removed from the stock. The results are shown in Table 6.3 below. The stock removed amounts to about 24% of hotels and 26% of rooms. Geographically, Dublin would account for one-third of the rooms to be removed while the Eastern and the Western Regions – as defined by *Fáilte Ireland* – account for 27% each. However, the South West, which includes Limerick in this definition, would account for only 12.5% of rooms removed. The proportionate impact on the South West would also be relatively low. While Dublin and the West would lose 27% and 24% of their rooms respectively, only 19% of rooms in the South West would be removed. In contrast, this scenario sees that over one-third of rooms in the East outside Dublin would be removed from the stock.

In total, the removal of these rooms would result in a stock of 698 hotels with 44,330 rooms. The demand projection used in Figure 6.2 above would equate to just over 29,000 rooms in 2010. This would give an occupancy rate of 65%, just above what was achieved in 2006. It is considered that this would be adequate to allow prices margins to begin to stabilise or recover.

⁴² It may seem strange at first to be describing a situation whereby insolvent businesses continue to trade with the prospect that they may work themselves out of this situation. However, it is important to recall the basis on which insolvency is being defined in this report. It is not an analysis of hotels existing balance sheets – it is almost certainly the case that many of the hotels opened in recent years value their fixed assets in terms of their cost of construction and thereby do not show an insolvent position. However, the developments of recent years in terms of property values, plus the downturn in the tourism sector, mean that this approach is really not meaningful to this analysis. The associated implication of the approach used here, as discussed in Section 5 above, is that insolvency can be discharged as trading conditions improve either due to an upturn in demand or a reduction in capacity.

Table 6.3: Hotel Stock Following Removal of Rooms Registered since 2005

	Stock Removed		% of rooms	Stock Remaining	
	Hotels	Rooms	removed	Hotels	Rooms
DUBLIN					
1-49 rooms, 1*-3*	9	224	16.3	39	1,151
1-49 rooms, 4*-5*	1	30	25.0	2	90
50-99 rooms, 1*-3*	3	276	14.2	24	1,669
50-99 rooms, 4*	1	88	28.1	3	225
100+ rooms, 1*-3*	9	1,567	22.0	29	5,570
100+ rooms, 4*	13	2,773	41.0	19	3,996
100+ rooms 5*	1	265	18.3	7	1,187
Total Dublin	37	5,223	27.3	123	13,888
WESTERN: North West/West/Shannon					
1-49 rooms, 1*-3*	40	844	21.3	136	3,118
1-49 rooms, 4*-5*	15	398	39.8	23	602
50-99 rooms, 1*-3*	6	410	11.0	46	3,301
50-99 rooms, 4*	10	828	34.9	22	1,547
50-99 rooms 5*	3	287	54.2	3	243
100+ rooms, 1*-3*	2	324	9.9	21	2,957
100+ rooms, 4*	8	1,168	39.0	12	1,827
Total West	84	4,259	23.9	263	13,595
EASTERN: East & Midlands/South East					
1-49 rooms, 1*-3*	26	493	19.8	94	1,992
1-49 rooms, 4*-5*	9	350	74.6	12	119
50-99 rooms, 1*-3*	6	425	16.2	29	2,196
50-99 rooms, 4*	11	822	41.7	15	1,150
50-99 rooms 5*	2	168	70.9	1	69
100+ rooms, 1*-3*	1	100	9.4	8	959
100+ rooms, 4*	12	1,642	50.7	13	1,596
100+ rooms 5*	1	200	41.5	2	282
Total East	68	4,200	33.4	174	8,363
SOUTH WEST					
1-49 rooms, 1*-3*	10	227	13.5	59	1,458
1-49 rooms, 4*-5*	3	67	15.0	13	381
50-99 rooms, 1*-3*	0	0	0.0	19	1,334
50-99 rooms, 4*	6	452	28.4	16	1,139
50-99 rooms 5*	0	0	0.0	6	462
100+ rooms, 1*-3*	0	0	0.0	15	2,191
100+ rooms, 4*	7	970	44.7	8	1,199
100+ rooms 5*	2	240	42.9	2	320
Total South West	28	1,956	18.7	138	8,484
TOTAL	217	15,638	26.1	698	44,330

The impact of this process in terms of hotel size and grade is shown in Table 6.4. This shows that 23% and 22% respectively of small and medium sized hotels would be removed. However, just less than 30% of rooms in large hotels would be removed. This likely reflects the larger average size of new hotels in the period, when compared with the total stock, which was noted in Section 3 above.

Table 6.4: Summary of Hotel Stock under this Scenario

	Stock removed		% of rooms removed	Stock Remaining	
	Hotels	Rooms		Hotels	Rooms
Small Hotels	113	2,633	22.8	378	8,911
Medium Size Hotels	48	3,756	22.0	184	13,335
Large Hotels	56	9,249	29.5	136	22,084
1-3* Hotels	112	4,890	14.9	519	27,896
4-5* Hotels	105	10,748	39.5	179	16,434

A major issue that emerges from this table is the disproportionate impact of removing these hotels on the stock of 4* and 5* hotels. The table shows that just under 40% of the total stock of 4* and 5* rooms would be removed, compared with less than 15% of the stock of 1* to 3* rooms. This reflects an important issue: the big investment in hotel construction during the boom was not just a replication of what was already there in terms of the characteristics of the hotel stock but resulted in an upgrading of the total stock. However, the corollary is that debt and insolvency is concentrated in these hotels.

This is an important issue but it probably underestimates the potential impact of removing from the stock the hotels with the greatest levels of insolvency. The data in Table 6.3 for 4* and 5* hotels, and particularly in relation to the 5* grade, shows that the proportions of the existing stock of these rooms that would be removed in all areas outside Dublin is very high, being above 50% in some cases. This is not the case in Dublin where the impact on this grade appears to be low. However, this misrepresents the true picture in Dublin. It is known that many of the largest high grade hotels in Dublin have high associated debt due to change of ownership during the boom but are not included in this analysis because they have been on the *Fáilte Ireland Register* for many years. However, the logic underlying this scenario is that the hotels with the greatest insolvency are removed and many of these hotels would fall into this category. As a result, the impact on the stock of 5* hotels would actually be much greater than suggested here and it is likely that well over 50% of these hotels would be removed from the stock.

This fact points to two vital questions that would need to be answered before any programme to remove capacity along these lines could be implemented.

First, would the remaining stock of hotels, which would by definition be older, of lower grade and somewhat smaller than the current stock, be optimally structured to promote the recovery and development of Irish tourism over the longer term? In addition, the relative rebalancing of the stock towards the South West requires consideration in this respect.

Second, within the various categories, would the low debt hotels that remain be superior in terms of their product offering to the hotels that are removed? In this respect, it should be noted that a substantial proportion of the total debt, as shown in Table 5.7 above, is associated with the refurbishment of older hotels. Some of these would be insolvent but lack of data prevents these being included in the analysis.

Thus, the residual stock of hotels is those that have not greatly invested and is concentrated in the lower grades.

There seems good reason at least to set out the proposition that the answer to both these questions may be negative: removal of hotels on the basis of those solely with the greatest insolvency would not result in a superior stock of hotels in terms of their physical attributes, although it would make the sector as a whole solvent and would provide the opportunity for some hotels that are currently insolvent to trade out of this situation. Such physical attributes would include location, grade, facilities, management, etc.

This has important implications. In summary, if demand cannot be prompted to recover then supply needs to be removed. A do-nothing approach essentially means that the market would be left to make this happen over time, by causing the insolvency that exists in parts of the sector to expand thereby ultimately forcing hotels to close and by deterioration in the fabric of facilities. This is what is happening in 2009. Alternatively, in order to avoid this contagion, the hotels with the greatest levels of insolvency can be removed allowing the remainder to trade in a stronger market. However, the problem is that either approach may result in a race to the bottom either as hotels cut costs, quality and prices, or as quality facilities are removed to achieve balance between supply and demand. Neither approach would guarantee that the hotels that survive are those that are best placed to promote the development of the Irish tourism industry. As a result, a third approach is required to recognise the need to remove insolvent operations but also to achieve a hotel sector that is well structured to meet the needs of a recovering tourism industry. This means that while a planned programme to reduce capacity is required, it must be one that sets as its first imperative the identification of the structure of the hotel stock that is optimal in terms of the development of Irish tourism.

6.4 *Operating Costs, Insolvency and Liquidity*

Although accommodation costs have fallen, Irish tourism in general has lost competitiveness and Ireland is seen as expensive. The data discussed above suggest that this outcome is likely to be result of trends in costs other than accommodation. This is not surprising and there is plenty of evidence that Ireland has become a high cost country in which to do business.

Ireland's competitiveness weakness have been starkly illustrated in recent reports. The *National Competitiveness Council (NCC)* has stressed that while the global economic downturn can correctly be identified as a major factor that has contributed to the weakness in exports, the need to improve competitiveness in order to maximise performance during this weakness and position Ireland for the recovery is the correct area on which to focus⁴³. As well as restoring stability to the public finances the NCC, pointed to the need to ensure that '*the state uses its funds and influence to ensure that banks are lending to viable businesses*'. This loss of competitiveness is not a recent phenomenon and the NCC found that Ireland experienced a 30% loss in

⁴³ National Competitiveness Council *Getting Fit Again: The Short Term Priorities to Restore Competitiveness*. June 2009

its trade weighted international price competitiveness from 2000 to June 2009⁴⁴. While wage levels are high, non-pay costs such as energy and communications are most out of line.

Restoring cost competitiveness is identified as a fundamental requirement for recovery since the NCC concluded that price levels in Ireland are significantly higher than in many competitor countries. Specifically the NCC identified the need to adjust wages to competitive levels, the need for lower energy costs and an urgent requirement to tackle costs in areas of the economy that are dominated by public services and regulated prices. While prices have been falling across the economy over the past year or so, the NCC found that inflation in public services and administered prices is still running at 13.2% in 2009.

Energy costs are one area where Ireland is significantly out of line with competitor countries. Electricity costs for business and industry are the second highest in the EU-14 and are 35.5% higher than the Eurozone average⁴⁵. While the price of fossil fuels is outside policy control, regulatory and competition weaknesses, the failure to avail of the benefits offered by the EU single electricity market, and the failure to adequately develop indigenous energy resources are all contributing to the situation.

The situation facing hotel operators therefore, irrespective of whether they have solvent or insolvent businesses, is that while room rates have been falling, overall costs have been rising. Margins have been squeezed and reserves have fallen. This development has been further added to by the fall in the value of sterling which magnifies the loss of competitiveness relative to the most important international market. Furthermore, the banking crisis has caused a general reluctance to provide working capital. Many hotels therefore are facing a liquidity problem that will get much worse as business slows further during the off-peak.

The future performance of the hotel sector ultimately will depend on rebuilding the competitiveness of Irish tourism. In the short term, reducing costs also has a vital role to play in enabling many businesses to survive. Furthermore, the greater the extent to which the process of adjustment that is required to build a solvent viable industry is assisted by reductions in costs, the less that needs to be achieved by restoring room rates to higher levels. This is a straightforward trade-off as both feed straight to profitability. This is the one glimmer of hope that could give reason to believe that the required supply-side adjustment that is estimated in this report might be excessive: if competitiveness improves then demand could recover more quickly than forecast, a smaller adjustment might be required and, crucially, the stronger hotels will be assisted in surviving the crisis and recovering. However, while some element of improvement in competitiveness is built into the TRG projections, the current situation gives no reason to expect that greater gains will be made. A concerted programme of action is required in this area.

⁴⁴ National Competitiveness Council *Annual Competitiveness Report*. August 2009

⁴⁵ National Competitiveness Council *Statement on Energy*. October 2009

Solvency and Liquidity

There are actually two related but separate financial issues facing operators. The first is insolvency which is a feature of the sector on average and in aggregate, but is not necessarily an insurmountable problem for hotels with strong business models. The key issue here is profitability which depends on prices being at viable levels relative to the level of costs. The second is lack of liquidity which is a widespread problem and is related to cashflow and cash in reserve.

It is important not to see liquidity and solvency problems as the same issues that can be addressed by additional bank credit. Under normal conditions, the only short to medium term solution to a solvency problem is extra equity, either by way of investment or a return to profitability, which is retained in the business. In the longer term it might be possible to trade out of an insolvent position provided the business has supportive arrangements with banks and other creditors. A solvency problem cannot be addressed by additional loans. If a project is sufficiently attractive then this would normally be available from an outside investor. However, for the hotel sector, equity will be unavailable for the foreseeable future meaning that the only prospect of recovery is if returns recover to the extent that the value that can be placed on a room exceeds the debt. The analysis in this report means that the conditions for a sufficiently strong recovery to achieve this in aggregate, given the current imbalance of supply and demand, are most unlikely to occur. The fact is that, for many hotels no feasible improvement in business conditions would be sufficient to address their levels of insolvency.

On the other hand, a liquidity issue can be readily addressed by a bank loan or by other short term improvement in cashflow, irrespective of whether the business is solvent. In an industry such as the hotel sector currently, where there is likely to be considerable disruption, a loan that ensures liquidity and cashflow, while not directly addressing insolvency, may provide an opportunity for a marginally insolvent hotel to trade out of that situation.

Solvent hotels face two issues, one imminent the other developing. The first is the need for working capital. However, the dynamics of the business at present mean that this is not available from banks. This means that other sources of cashflow are required. Relief from expected costs is one possibility and the deferral of local authority rates would be a help in this respect. The introduction of a loan guarantee scheme for small businesses would also mean that banks would have an incentive to provide working capital.

The second issue is that the action of banks in keeping insolvent hotels open is spreading the problem of insolvency through the sector by depressing rooms rates to levels which are not sustainable, given the level of external costs. Hotel accommodation prices in Ireland are now among the lowest in Europe while the cost base is among the highest. In addition, local authority rates are applied at a level that is perceived to be disproportionate to the returns which can be earned by hotels. All this is acting to depress returns and push once-viable hotels towards insolvency.

What is occurring is an inversion of what might be expected. Insolvency is normally a concentrated problem and generally remains contained within a sector by creditors, primarily banks, forcing the most insolvent businesses to exit. Lack of liquidity can

be a much more widespread problem but would be expected to hit the financially weakest businesses hardest. However, by keeping insolvent hotels open, banks are distributing the insolvency through the sector via artificially low prices while simultaneously declining to provide the working capital to enable the more viable businesses to operate.

Even if this is addressed, it remains that the fundamentals of the business must change. Restoring stability will support more viable returns. However, this needs to be achieved not just through pricing but through cost control. In this respect, Irish costs are out of line and unless addressed, will hinder rather than promote recovery. With high costs, the potential contribution to recovery from strengthening demand is curtailed and price increases must play the main role in achieving stability rather than the more desirable outcome that would be achieved through the restoration of realistic prices and an improvement in margins from lower costs.

7 Conclusions and Recommendations

7.1 Conclusions

The report shows that the number of hotel rooms in Ireland grew rapidly in the period 1999-2008 and occupancy was maintained only through very competitive pricing. Although there are conflicting data, there is sufficient evidence to conclude that hotels became increasingly dependent on the domestic market in this period. The growth in capacity, was driven by a number of factors but the determinants of the decision to invest become increasingly detached in the period from 2002 to 2008 from the fundamentals of the industry and from the potential returns that could be expected from trading as hotels.

The result has been the creation of excess capacity that is suppressing prices and operating margins to non-viable levels. There is considerable research indicating that demand is inelastic so that price reductions lead to lower aggregate revenues for the sector even though they increase the number of nights sold. This approach has enabled hotels to maintain occupancy rates but has clear negative implications for margins, future investment and viability. As a result, many hotels are experiencing serious financial difficulties, a situation that has been compounded by the collapse in demand in 2009.

The big increase in capacity has been associated with a huge increase in debt. Easy availability of funding and new competitive pressures also led to existing hotels taking on debt as they upgraded their facilities. The analysis shows the hotel sector is effectively insolvent in aggregate as a result of this debt and the fall in asset values since 2008. For rooms built since 1999 the situation is even worse with this group of hotels insolvent in aggregate since 2005 and a debt to value ratio of over 1.5 in 2008. Even more revealing, the analysis shows that in the year of first registration, (which is assumed to be the year of construction), the debt per room exceeded value per room in every year since 2002. This amounts to over 20,000 rooms that could not be justified on the basis of the industry's fundamentals even before the 2008 downturn occurred. The situation is noticeably worse for hotels with over 15,600 rooms that have been constructed since 2005.

Data difficulties that are discussed at various points in the text make it difficult to reach definitive conclusions on a number of issues, such as the importance of the domestic market for hotels, growth rates in various markets and price trends in the hotel sector. However, the consultants consider that there is sufficient evidence to conclude that the international competitiveness of Irish tourism deteriorated somewhat despite improvements in the standard of accommodation and declines in room rates, and that the hotel sector has become increasingly dependent on the domestic market to maintain occupancy. Given the overall loss of competitiveness due to high operating costs in the Irish economy, margins were under serious pressure even before the extent of the excess supply caused room rates to collapse since 2008.

However, the fact that excess capacity is depressing prices does not necessarily mean that there will be a more competitive hotel sector in the longer term. Left to themselves, market forces should eventually force operators out of the market thereby achieving a balance. However, this adjustment is likely to be chaotic and there is no guarantee – indeed it is unlikely given the extent of the distortions that impact on the industry – that those hotels which would remain would be those that are strategically most important to drive the recovery of the tourism industry. Currently there are powerful reasons such as the interests of investors wishing to avail of tax allowances and the interests of banks, for insolvent hotels to remain open and it cannot be guaranteed that these will not persist. The actions of banks are particularly damaging. In order to avoid the need to realise losses due to bad loans on hotels that do not have any reasonable chance of operating as successful businesses, it appears banks are ensuring that these hotels remain open by providing a drip feed of working capital. However, hotels with low debt levels and viable businesses are experiencing liquidity problems. The result is that the insolvency problem, which in a properly functioning sector would remain concentrated and would be solved through the exit of the most insolvent businesses, is being spread through the sector. This means that it cannot be concluded that it will be the most deeply insolvent hotels that will exit the industry.

A market driven recovery depends crucially on demand recovering sufficiently to reduce the excess capacity. However, there is no prospect that this will be sufficient to achieve an orderly re-adjustment of the industry. On the basis of projections that assume that both demand and supply side measures to grow tourism numbers are implemented effectively and that external factors improve – such as stable oil price and exchange rates, and a return to global economic growth – the excess rooms, which amount to about 50% of capacity in 2009, will persist and only fall slowly to about 46% in 2013. This would cause ongoing downward price pressures and force operators out of the industry. The conclusion therefore is that the projected level of recovery for Irish tourism and hotel room demand will not be sufficient to maintain the existing stock of hotels even if effective measures are taken to strengthen tourism. This would result in a shakeout in the sector. However, as noted earlier, this could result in a sub-optimal range of hotels (in terms of quality and geographic location) from the point of view of stimulating long term demand for the Irish tourism product internationally.

The conclusion is that a managed process of capacity reduction should be developed and implemented. On the basis of the existing imbalance and the need to create a market where returns can recover to a level where the viability of essential parts of the hotel sector can be recovered, it is estimated that between 12,300 and 15,300 rooms need to be removed from the stock within a relatively short period of time. Where in that range depends on the extent to which demand recovers in 2011 to 2013 and on the extent to which cost reductions can be achieved. However, even if tourism recovers slowly in line with projections there is no guarantee that tourist expenditure will recover in line, or that the number of bednights in hotels will recover in line. This means that a target in the upper part of this range would appear prudent.

The important issue is to ensure that the adjustment in room numbers should be in a manner which leaves an overall profile of supply appropriate to the development of demand. An obvious place to start is that the rooms to be removed should be those with the highest levels of insolvency. These are the 15,600 rooms in 217 hotels that

have been first entered onto the register since 2005. Removing these would result in a stock of just under 700 hotels with 44,300 rooms. This approach would result in hotels being removed in all regions of the country and in all segments. Hotel room losses in Dublin and the Eastern region would be proportionately greatest while the South West would experience relatively lower levels of closure. Of potentially greatest importance is that closures would have the greatest impact on the 5* and 4* hotel segment.

However, the danger with this approach is that there is no guarantee, even if the hotels that are removed are those that have entered in recent years, have the greatest levels of debt and insolvency and have destabilised the sector, that the remaining hotels will be those that are strategically best placed to lead the recovery of the tourism industry. Identifying this optimal structure for the hotel sector is therefore an important first step towards finding a resolution.

7.2 Recommendations to Address the Supply Demand Imbalance

Removing Rooms from the Active Hotel Stock

The sector cannot rely on outside intervention to address the problems that have developed so, collectively, hotel operators must work to stabilise the industry. Demand growth will not be adequate to restore balance and stability to the sector. This means that the adjustment process will occur primarily on the supply side but this should be planned and co-ordinated and should not be allowed to be driven by actions of banks. ***It is recommended that the sector should prepare a strategy for the orderly elimination of approximately 15,000 rooms and that this process should begin before the 2010 peak season.***

The first requirement is that barriers to exit of insolvent hotels must be removed. ***It is recommended that a special provision be introduced in the Finance Act 2010 to allow relevant hotels to exit the industry without disadvantaging the initial investors in terms of availing of capital allowances. It is further recommended that an accompanying provision be introduced to the effect that capital allowances that have already been claimed in respect of any hotel should not be subject to any claw back by the Revenue should that hotel exit the industry within seven years.*** Removing this barrier would facilitate the exit of some hotels from the industry but would not necessarily promote the exit of any particular hotel. The costs to the Exchequer of removing this barrier to exit would be zero given the situation that has arisen. Hotel related capital allowances which remain to be claimed have an estimated value of €527 million to investors. Allowances already claimed which potentially could be clawed back by the Revenue have a value estimated at €1 billion. For as long as the current conditions relating to capital allowances are retained, there is a very strong incentive for these hotels to remain open in the industry even in situations where they have no prospect of recovery. Investors will claim and retain these allowances. Therefore, allowing hotels to exit without consequences for investors in terms of the value of the tax allowances would have no financial implications for the exchequer compared with the situation where these remain open for the full seven years. However, the potential costs of retaining this barrier to exit

are substantial for the hotel sector⁴⁶. ***It is also recommended that these provisions should apply similarly in respect of investors in hotels that close completely and those which are converted into alternative uses.***

It is imperative that a planned programme of closure must first identify the optimal future structure of the hotel sector in terms of location, grade, etc. ***It is recommended that a group be convened as soon as possible to begin this work including representatives of the hotel industry, tourism development agencies and the financial sector. It is recommended that the aim should be to agree a speedy and orderly decommissioning of supply in a manner that leaves the profile of substantially reduced supply appropriate to the long term demand for Irish tourism.***

There needs to be recognition and acknowledgement, by all stakeholders, especially financial institutions, that failure to foreclose on insolvent hotels is damaging to the long term interests of the hotel and tourism sectors. Should this recognition not be sufficiently forthcoming, ***it is recommended that the relevant financial regulatory authorities should consider the economic arguments with respect to insolvency and the consequences for the hotel sector at large of lack of foreclosure against fundamentally insolvent hotels. Based on this, they should ensure that banks fully recognise bad loans within the hotel sector and face any capital adequacy issues which might follow.*** In part, uncertainty as regards the transfer of loans from financial institutions to the proposed NAMA may account for a forestalling of action by the institutions against insolvent hotels. However, such vacillation is simply transferring the burden of adjustment from financial institutions to the hotel sector as a whole.

While there will be some degree of correlation between the level of insolvency of a hotel and its strategic importance to tourism, the optimal structure of the industry may mean that some insolvent hotels should stay open. ***It is recommended that detailed examination be made of the potential for establishing a Hotel Restructuring Fund. The objective of this fund would not be to preserve the existing stock of hotels but to arbitrate in situations where currently insolvent hotels are deemed to be important for the recovery of tourism against hotels which may be solvent currently but which have little or no strategic importance to the development of the Irish tourism product internationally. Such a fund could attract long term equity as well as participation by Irish financial institutions.*** A role could be to invest by way of long term equity in strategically important hotels whose reason for insolvency is excessive reliance on bank debt and cyclically depressed prices resulting from the current imbalance between demand and supply.

In the longer term, there is the potential either through NAMA or the actions of the banks that hotels with debt written off could be recycled back into the market at low capital cost. This would have long term implications for existing operators. ***It is***

⁴⁶ It is recognised that while there is no accounting implication, this change in the rules does alter the assumptions on which the initial assessment for the introduction of the accelerated allowances was made. This could undermine the case for any such invention in the future as it means that there would be a risk associated with stimulating the hotel sector. However, it recognises the reality of the current situation that the allowances have undermined the viability of the sector in a manner that was not intended and is a consequence largely of new entrants to the sector. Furthermore, the consultants recognise that this initiative would facilitate exit but certainly does not guarantee it.

recommended that the industry examine how this possibility might be managed with a view to ensuring that such hotels re-enter the industry in a manner that does not threaten the stability of existing businesses. The best option in this regard may be to promote consolidation of hotel (groups) where there is sufficient management capacity in order to promote a reduction in average debt per room in operation

Some opportunities may exist for hotels to be removed from the tourist accommodation sector and operate in sectors that do not threaten the stability of the sector. These might include care homes or language schools. ***It is recommended that a High Level Working Group be formed, including the IHF and representatives from the relevant Government Departments, to undertake the necessary research to assess the potential in this area, identify impediments to hotel conversion and co-ordinate with relevant agencies to maximise this potential. It is further recommended that the Department of Heritage, Environment and Local Government instruct local authorities to work with hotels in their areas to identify such opportunities and, in particular, to identify and remove such impediments in the planning systems as might be identified.***

Promoting Demand and Competitiveness

Liquidity is a serious concern for many otherwise viable hotels and there is a serious risk that strategically important hotels might be forced out of business before an effective adjustment programme can be developed. ***It is recommended that a Government Loan Guarantee Scheme, modelled on the UK Enterprise Finance Guarantee, should be introduced and provided to hotels with viable and proven business operations.***

While there are questions in relation to the long term performance of hotels in relation to attracting overseas visitors, there is no doubt that there has been a sharp downturn in recent years. New programmes to promote Irish tourism overseas are being developed and ***it is recommended that these demand promotion programmes should be supported.*** In particular, the focus should be on the British market with a particular concentration on specific parts of the market such as older age groups and the business segment. In addition, special incentives such as extending the free public transport scheme to all EU citizens while visiting Ireland should be supported.

As a vital element in the overall product, hotels need to be actively engaged in this process. ***It is recommended that the hotel sector co-ordinate its promotional activities within its industry and with the national agencies to promote Ireland and local regions as a destination for overseas visitors and grow the market that is available to the hotels.***

Improved competitiveness is essential to maximise the return from investment in promotion. The evidence shows that while there have been general falls in prices in 2009, inflation in the case of public services and regulated prices is still very high. ***It is recommended that direct action is taken to address this trend with a freeze on public service charges at 2008 levels.***

Hotels continue to face high rates bills that are unrelated to the actual business conditions, although there is emerging evidence that a review of rateable valuation in

relation to hotels requires immediate review. ***It is recommended that this process under the Valuation Act 2001 should be prioritised in respect of hotels.***

It is important that all incentives are aligned to promote the reduction in the number of rooms on the market. In this respect, ***it is recommended that a formal mechanism be introduced immediately to validate the partial, or full, closure of hotels for all or part of the year and that this would be recognised in an appropriate adjustment to rates liabilities.*** For example, a hotel closing for 3 months would have a 25% reduction in rates or if hotel formally closed a certain percentage of its rooms then its liability would be reduced by a similar percentage.

Hotels' Pricing Strategy

Tourists' decisions to purchase are often only partly governed by rational thinking such as comprehensive comparison of the offerings that are available. Any element of confusion is a huge disincentive. ***It is recommended that the sector develop a single standardised format for pricing and that this is used exclusively in all promotional material.*** It is considered that, to conform with general international practice this should be on a cost per room per night basis, rather than the more usual practice of Irish hotels of a cost per person sharing basis. This of course does not affect the actual advertised room rate or disallow special offers or packages.

There is anecdotal evidence that prices offered on the international and domestic markets differ markedly with the perception that rooms are offered at relatively high prices abroad and the remainder placed at discounted prices on the domestic market. ***It is recommended that transparency should be introduced in this regard including comprehensive data sharing and co-operation between the hotels and inward travel operators.***

Aggressive price discounting does not work in terms of generating overall additional revenue. Reductions will soon be matched by competitors and the cycle undermines the finances of the industry without markedly growing the aggregate number of rooms that are sold. ***While recognising that intervention to limit price competition or to achieve collective price setting would be illegal under the Competition Acts, it is recommended that the IHF take the lead in ensuring that managers understand the implications of inelastic demand in the hotel sector and the potential for non-viable pricing, driven by the demand of banks to provide cashflow to destabilise the sector.***

Provide Consistent Data

Although there is a considerable amount of data produced on the tourism industry, there are some serious weaknesses in terms of its consistency. ***It is recommended that a detailed work programme should be developed and undertaken to address difficulties with the data and to provide a single comprehensive data source for the tourism sector to be used in developing policy and operational strategies and in assessing outcomes.***

Appendix 1: Data Sources

A number of sources are available for data on the tourism industry and the hotel sector. The consultants are aware that there are often differences in the values that can be obtained for apparently similar variables depending on the source being used. The sources are all survey based and it is not unexpected that differences arise given the statistical errors and occasional bias that may be present in surveys. It is not the purpose of this report to reconcile any differences in the values that may be obtained from different sources and the report avoids extensive discussion of this issue. For the most part, the differences that have been seen during the research are fairly minor and none of the conclusions reached would be altered by using a different data source.

There are 5 main survey sources that have been examined in preparing this report. For overseas tourist numbers and expenditure statistics, the main sources are the CSO's *Country of Residence Survey* and *Passenger Card Enquiry*, and the *Survey of Travellers* conducted by Fáilte Ireland. The CSO is the official source of tourism statistics in Ireland and is used in this report in relation to overall tourism trends and the numbers and expenditure of tourists in broad segments. Data on tourists' perceptions of the tourism product, such as satisfaction ratings, are derived from the Survey of Travellers. The data source for domestic tourism is the CSO's *Household Travel Survey*.

The main data sources used in this report in relation to the demand and supply of hotel rooms are the Fáilte Ireland *Hotel Survey* and the *Hotel Register*, which is also maintained by Fáilte Ireland. The CSO surveys also provide data on the number of bednights in hotels and these provide data that are somewhat different to the Fáilte Ireland surveys for the relative importance of the domestic and overseas markets in terms of hotel bednights and demand trends on these markets. This issue is discussed in the text. There are two additional sources of information on the hotel sector. The IHF maintain a register on the number of hotels, the number of rooms and occupancy rates, while the annual Horwath Bastow Charleton *Hotel Survey* also provides extensive information on the sector. There are some differences between these three sources in relation to the hotel stock. However, these relate mostly to the number of hotels that existed before 1999 and the timing of entry into the sector of hotels since 2004. The most important issue is the number of rooms that have been constructed since 1999 and the sources are largely in agreement on this measure. The HBC survey is used as a source for financial averages relating to hotels and these are noted in the text.

It has been necessary to relate values from the Fáilte Ireland Hotel Survey to variables from the HBC survey in the calculations. This has required that some definitional differences are reconciled. Similar categories are used in both surveys for hotel size, and the grade classification is reconciled as follows:

Failte Ireland	Horwath Bastow Charleton
1* - 3*	Mid Price & Economy
4*	First Class
5*	Luxury

However, the regional divisions adopted in the two surveys show some non-trivial differences. Table A1 shows the relevant definitions.

Table A1: Regional Definitions used in Fáilte Ireland and HBC Surveys.

	Failte Ireland	Horwath Bastow Charleton
Dublin	Dublin City & County	Dublin City & County
East	Kildare Laois Longford Louth Meath Wicklow Offaly (East) Westmeath Carlow Kilkenny Tipperary (South) Waterford Wexford	Kildare Laois Longford Louth Meath Wicklow Offaly Westmeath Carlow Kilkenny Tipperary Waterford Wexford Cavan Monaghan
South West	Cork Kerry	Cork Kerry Limerick
West	Clare Galway Mayo Roscommon Donegal Leitrim Sligo Tipperary (North) Offaly (West) Limerick Cavan Monaghan	Clare Galway Mayo Roscommon Donegal Leitrim Sligo

The split of Tipperary and Offaly between different regions in the Fáilte Ireland survey is unlikely to make a significant difference. The inclusion of Limerick in the South West region and Cavan and Monaghan in the East in the HBC survey, while both are in the West in the Fáilte Ireland survey, could be significant in relation to the West. However, the regional divisions were set in the databases and it was not possible to recalculate the data based on different county combinations. In recognition of this, the Fáilte Ireland definitions were used when categorising the overall hotel supply in this report, but the HBC regional definitions were used when relating hotel numbers to variables, such as room valuations, which are based on profits estimates that were derived from the HBC survey.

Appendix 2: Price and Income Elasticity in the Hotel Sector

There are a limited number of studies of the price elasticity of supply in the hotel sector but it is not difficult to characterise the market in this respect. In summary, over a relatively short period of time – less than a few months – supply is fixed. This is typical in product markets where the product depends on a building. Even if prices rise, no new supply will come on stream while a temporary fall in room rates, while placing some hotels under financial pressure, would be unlikely to cause permanent closure. Over a period of a year or two, there will be some response as higher prices will lead to plans for new hotels and lower rates would cause some hotels to close. Such studies as are available estimate the price elasticity of supply at only 0.11 even over a number of years⁴⁷. In other words, a 1% rise in prices would bring forth an increase in the number of rooms of just 0.11%. Clearly there are external issues – planning, risk, financing – that mean that supply does not respond quickly to prices. It is also likely that there are economic barriers to entry in this sector, for example, the threat that existing hotels could cut their prices to make a new hotel non-viable, large sunk costs and the existence of barriers to exit. In the longer term, a considerable response could be expected to both higher and lower prices. Stylistically, this would be indicated by a relatively steep supply curve in the medium term (MS) but flatter in the longer term (LS). This is shown in Figure A2.1.

Figure A2.1: Impact of Fall in Demand in Long and Short Term

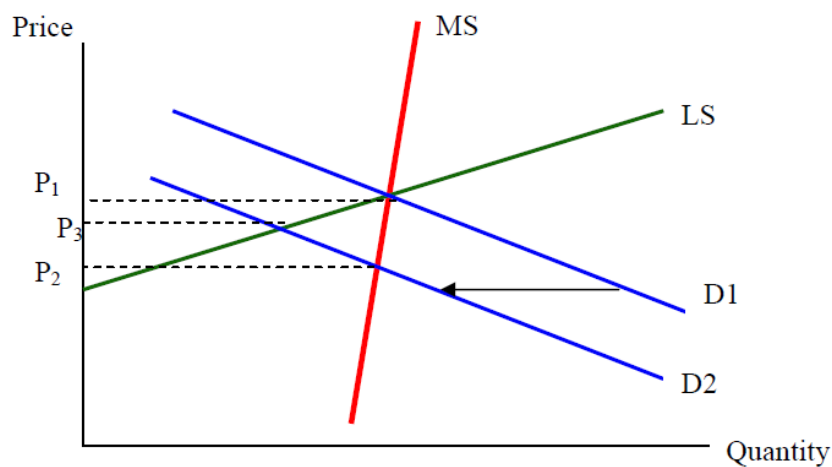


Figure A2.1 also contains a demand curve (D₁). Assume that something happens the demand for hotel rooms such that at any given price the over number required by the market falls (D₂). Notice that in the medium term there is a big impact on prices (P₁ to P₂) but over the longer term prices recover somewhat as hotels close (P₁ to P₃). This is effectively what is happening at the moment in Ireland although, so far, the longer term effects have not had a big impact. Note that when the adjustment is complete prices are somewhat lower than initially and the quantity of rooms sold is also lower. Of course, if demand recovers then this will not be the case.

⁴⁷ Hiemstra, S. and J. Ismail (2001) Research Note to 'Incidence of the Impacts of Room Taxes on the Lodging Industry'. *Journal of Travel Research*, Volume 39 (3) pp319-320

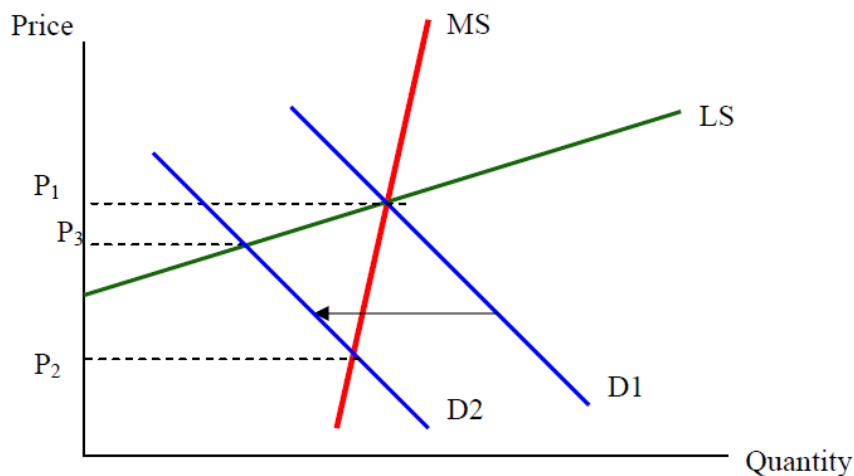
So, in terms of the stylised analysis, the slope of the curve is important and this depends on the response of quantity to price changes i.e. elasticity. Figure A2.1 contains a demand curve but this is just placed in the diagram without reference to demand elasticities.

There has been more research on the elasticity of demand for hotels than on the elasticity of supply. In summary, this research finds the price elasticity of demand for the hotel sector to be quite low.

Given this insight, it is necessary to revise Figure A2.1. In Figure A2.2 the demand curve is steeper reflecting inelastic demand, although not as steep as the short run supply curve. As a result of inelastic demand, the expected fall in prices for a similar change in demand is greater than indicated by Figure A1. Therefore the fall in revenue and impact on margins is increased. The supply effects will be similar so that the expected price recovery – from P_2 to P_3 – is also greater once hotels have closed.

This is reflected in what is happening to Irish hotels but opinions vary on when this price recovery will take place. To understand what is happening it is necessary to analyse the initial fall in Demand from D_1 to D_2 . The simple answer is that it is caused by the recession. What this means is that demand has fallen as incomes – or, perhaps more accurately, expectations about future incomes and fears about the sustainability of current incomes – have fallen.

Figure A2.2: Impact of Inelastic Demand on Prices



In summary, the hotel sector is characterised by low price elasticities of demand and supply with the price elasticity of demand in the region of -0.15. The income elasticity of demand is much higher with estimates from research studies indicating a value in the region of 1.