

Travel & Tourism

A rough ride for luxury travel?

December 2008



“In recent years the luxury travel market has outgrown GDP by a factor of three. There is no evidence to suggest that the sector will decline at a slower rate.”

Guy Gillon, Head of Travel & Tourism M&A, PwC

“The sector is in for a rough ride, mitigating actions need to go beyond short term measures and be sufficient and material enough for a business to navigate through two to three years of challenging conditions.”

Malcolm Preston, Head of Travel & Tourism, PwC

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1. Luxury travel: A recession proof market place?

1.1 Luxury travel has been a booming market

There is an emerging pattern forming as the recession takes hold - those sectors that achieved the biggest growth during the boom era will experience the hardest falls, and luxury travel is no exception.

In fact, the luxury sector in its entirety enjoyed double digit growth rates over the last decade. With credit readily available, an unprecedented portfolio of investment options and opportunities, and the banking boom, the luxury playground was accessible to a much wider audience than simply the high net worth individuals (HNWIs). As the rich became richer, those aspirational consumers who benefitted from perceived affluence from rising house prices and readily available credit, started to shop in the luxury department.

Travel in this segment has increased significantly. We estimate that the luxury travel market has grown historically at c.10% p.a. to 2007 (vs. GDP growth of c.3% over the same period, which the broader travel market has historically tracked) with the UK spend on luxury holidays reaching c.£5bn p.a. This upward trend has been driven through:

Evolving consumer trends

- Increasing frequency of holidays, with popularity of short breaks and the decline of the traditional 2 week holiday in this segment (14 night luxury holidays have declined by 3% since 2003¹);
- Willingness of passengers to travel further afield has meant that a broader destination offering has materialised. For example, passengers are now choosing Central America, China and Asia, and the Middle East as viable destinations; and
- Consumers demanding a “unique experience”, as they seek differentiation from the increasing numbers willing and able to pay for a luxury holiday.

Favourable growth of core demographics

- The aspirational consumer with perceived wealth rising from readily available credit and house price inflation;
- Significant upper middle class wealth, generated in no small part by the ‘city bonus’ culture which has been prevalent throughout the last decade; and
- An increasing number of HNWIs, estimated at 10.1m worldwide² (globally these have doubled since 1997).

Market sentiment remained optimistic about the prospects for the luxury sector in an economic downturn throughout the summer of 2008. Despite ongoing press coverage, the impact of the credit crunch did not fully materialise for the mass consumer market or for the luxury segments until Autumn 2008.

“Mid income individuals aspire to live the luxury dream, and will do so on credit more than ever before”

Abercrombie & Kent

“The collapse of Lehman Brothers and the scarcity of bonuses in the City this year will also have a huge knock-on effect for the luxury sector since London’s big earners in the financial sector make up a significant proportion of Britain’s high-end travel spend”

TW Luxury, Oct 2008

2. How views of the luxury travel market changed

2.1 Deteriorating economic climate

While the city began to feel the effects of the credit crunch in August 2007 as the UK’s exposure to the collapsing US sub-prime mortgage market became apparent, the wider UK economy initially seemed relatively resilient. However, optimism turned to fear as Lehman Brothers’ collapsed triggering a free fall of market sentiment. Banks unwilling to lend to each other, and depressed market conditions have resulted in a tightening up of mortgage availability, leading to a market decline in house prices and sales. The economy is now faced with a consumer downturn fuelled by a cocktail of issues such as increasing unemployment, falling wages, a stop to the bonus culture, tumbling house prices and no credit availability.

1: Source: *Luxury Holidays Leisure Intelligence*, Mintel, May 2008

2: Source: *World Wealth Report*, Capgemini / Merrill Lynch, 2008

2.2 How have perceptions changed?

Since the full effects of the credit crunch hit the financial markets, the widely held view that the luxury travel market is largely recession proof, has changed. Revisiting the typical customer profiles we described, it can be seen how market sentiment towards luxury travel has changed:

Figure 1: Market sentiment by Consumer Group

	Sentiment Pre-August 08	Sentiment December 08
Aspirationals	At risk	Disappearing from the market
Upper/middle class	Robust	Impacted
HNWIs	Unaffected	Impacted

- *Aspirational*: House prices deflation, lack of credit, and employment uncertainty make luxury travel an unaffordable luxury. We believe this demographic will virtually disappear from the market.
- *Upper/middle class*: Unemployment and the end of bonuses in the short to medium terms will negatively impact this section of the passenger population. However, some solace can be taken from recent PwC and Mintel analysis showing that AB consumers place considerable importance on their holidays.

Figure 2: Consumer spend survey extract

Consumer spending priority by demographic	Total population March 2008 ranking	Total population November 2008 ranking	AB Population November 2008 ranking
Repaying short term debt	7	1	3
Holidays	1	2	1
Minor home improvement	3	3	4
Repaying mortgage	8	4	5
Increasing savings	9	5	2
Short breaks	2	8	8

Prepared for PwC by ICM Research. Information also sourced from Mintel

Further PwC analysis also shows that during the last recession AB consumers were most likely to reduce holiday frequency or stay in the UK. It is therefore likely that this demographic will significantly reduce short breaks, as these will no longer be a priority, and either trade down, or maintain the level of quality to which they have become accustomed and reduce the length of holiday.

We have seen examples of major tour operators actively sourcing alternative length holidays, with 10 day holiday duration set to replace the traditional 14 day break.

- *HNWIs*: Pre-August 2008 it was assumed that these customers would be largely unaffected by a recession. However, we believe that the lack of liquidity in the market place will extend and impact even the top end of the luxury market customer base. A good forecast indicator for this segment is analysis of other luxury brands outside of the travel space, which we examine in further detail in section 2.3.

Optimistic views earlier in the year...

“Affluent spenders...are choosing to invest their money in life experiences, not their accessories... upscale is flourishing”
The Luxury Travel Magazine, Oct 2008

“Consumers prioritise holidays, especially the wealthiest, who are not prepared to downgrade or cut-back on what has become essential spend”
Mintel, May 2008

Doom and gloom since the summer...

“...analysis suggests that 2009 will prove to be the worst year on record for the industry and that 2009/2010 will be even more severe than the September 11/SARS crisis of 2001/2002 for the industry...”
Deutsche Bank, 16 Oct 08, European Luxury goods

“After 4 years of double digit organic growth, the Luxury sector will not be immune to the deteriorating environment likely to materialize from Q4/08.”
Oppenheim Research, 27 Oct 08z

“Even super-wealthy travellers and ultra-chic getaways are feeling pain as portfolios plummet”
USA today, 24 Oct 08

2.3 How are other super-premium sectors performing?

Other luxury businesses are also proving to be less insulated from recession, with declining sales across the sector as individuals lose the “feel good” factor following consumer uncertainty and asset deflation. Evidence of luxury products being impacted include:

- **Premium flights:** British Airways announced a 10.8% decrease in premium traffic in November 2008;
- **Private jets:** Some manufacturers have been forced to cut prices and offer incentives such as including a year’s worth of free fuel, maintenance and insurance²;
- **Luxury yachts:** Reduced attendance at yacht shows, slashed prices and a pool of unsold yacht stock are signs of the wealthy buyer population drying up. It has even been reported that this trend is extending into the super yacht market, with discounts of up to a third being offered off yachts valued upwards of £20m;
- **Bulgari:** Announced operating profit in the third quarter was 38% lower compared to the same period last year, with watches and accessories being the worst performers, as sales fell by 6% and 16% respectively; and
- **Hermès:** Despite reporting a 17% increase in sales of leather goods in its third quarter, this leading fashion house also reported that sales in its jewellery and watches division fell by 3% and 6% respectively.

2.4 So why are HNWI’s impacted?

On a macro level, a downturn should not necessarily cause undue concern to a HNWI, but this time the effects are exacerbated by the credit crunch.

The collapse of Lehman Brothers and other reputable institutions highlighted that no investment is without risk. Globally, wealthy individuals have been struggling to find a safe haven for their funds.

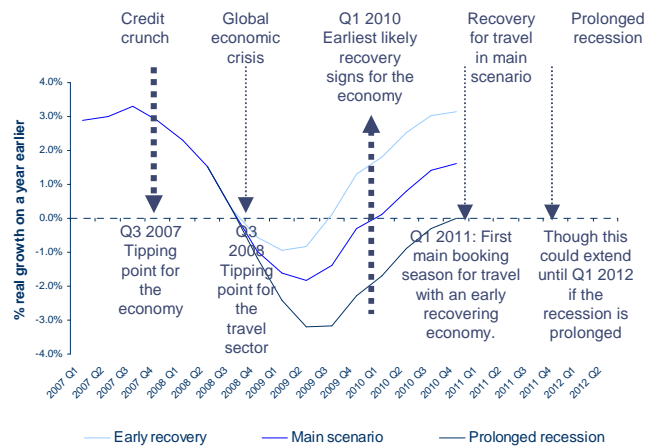
Many HNWI’s are sophisticated investors and will have some degree of leverage, often through more complex financial products and structures than are generally available to consumers. Due to market volatility, HNWI’s net worth on a day to day basis is unclear. These investors are as exposed to the economic uncertainty as much as other segments of the financial market. We anticipate HNWI’s adopting a “wait and see” approach as well as dropping extravagance and booking closer to departure dates.

3. What will happen in the luxury travel market?

Travel business trends traditionally lag behind the rest of the consumer market owing to lead times in bookings and the highly seasonal nature of departures. A quick glance at recent positive results posted by TUI or Thomas Cook further supports this. The first challenging year for travel in the current market will be the winter 2008/9 season.

PwC economic models indicate that growth is not forecast to return before Q4 2009/Q1 2010 (refer to Figure 3). Due to booking highly seasonal booking patterns and associated lead times in travel, this could mean an impact extending until Q1 2011.

Figure 3: Alternative GDP growth scenarios



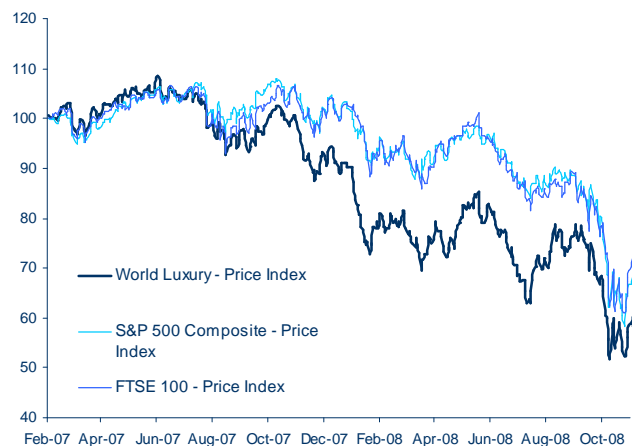
Source: PricewaterhouseCoopers UK Economics

Note

- High uncertainty exists around these extended projections hence all three scenarios are shown
- Risks are weighted to the downside – Any business should stress test their plans against the prolonged recession scenario

The performance of the World Luxury Index, which tracks the 20 largest stocks in terms of market capitalisation from the luxury goods sector, further indicates that premium brands are not immune to the distress suffered by the rest of the market. In addition to the downward trend which materialised in July 07, the luxury index has shown more volatility than other general indices (Figure 4).

Figure 4: World Luxury Index performance: Feb 07 – Nov 08⁵



“Paola Pecciarini, a luxury goods analyst at Banca Leonardo in Milan, warns the luxury industry faces ‘a very tough few years, not just a few quarters’ with no resurgence in demand before 2010 at the earliest.”

FT.com, Oct 08

3: Source: halogenguides.com, 20 Nov 08

4: Source: telegraph.co.uk, 17 Nov 08

5: Source: Thomson Datastream, 22 Nov 08

4. Managing in a downturn

Over the recent months the outlook for the Global Economy has become increasingly uncertain. One thing is clear though, and that is that the down turn will not be a short term blip, and therefore strategies adopted should not be short term remedies. Luxury travel businesses should prepare for a prolonged period of difficult trading. We believe that the luxury travel businesses that will emerge from the downturn agile and fit will be those that focus on PwC's fundamental priorities.

Take advantage of the opportunities

M&A activity is key in the current market, the need to exploit synergies is more important than ever. Financing this strategy can be largely avoided through a share for share exchange. We have seen large operators entering into the luxury market with Thomas Cook acquiring Elegant Resorts and Kuoni acquiring Carrier which is a trend that may continue as they invest for the long term.

"Cash is king"

Ensure your finances and working capital are in good order; protect your liquidity; re-examine your treasury, financing, funding and pension exposures. Monitor your performance against financial and non-financial covenants. Adopt a hands on approach to cash management.

Organiser / Agent

Focus on customer tastes – take a closer look

Get to the bottom of what's driving the business; understand how the business is being impacted by the downturn. How are consumer tastes altering?

Plan for different scenarios

Winners demonstrate agility and flexibility. Model a range of scenarios to reflect the impact of the downturn on your business – adapt quickly!

Manage your risk profile

Evaluate which products, customers and channels create or destroy value.

Identify and proactively manage ongoing commitments.

Asset owners / Suppliers

Manage your cost base

Go for targeted rather than across the board cuts.

Look at whether your business model needs to change.

Dialogue with stakeholders

Evaluate the likely impact of the downturn on your stakeholders and understand their agenda. Perception is often reality so maintaining regular and open dialogue is essential.

Route to market

Efficiency of marketing expenditure and effectiveness of marketing channels is paramount and must be reviewed and carefully monitored.

Ensuring a route to favourable market demographics is key.

ACT DECISIVELY

For more information about managing in a downturn visit:

www.managinginadownturn.com

5. So how will luxury travel perform?

Historically, leisure spending trends has tended to track GDP but over the last decade or so, the luxury travel market has outperformed UK GDP threefold (the overall travel market has broadly tracked GDP). Due to this meteoric rise, early credit crunch fears in 2007 seemed irrelevant to this sector, which appeared not only robust in the face of a possible recession but actually above it.

Ten years ago the main holiday was a fixed concept in the calendar. However, in the event of increased airline capacity, more travel operators than ever before, the online revolution and new aspirations to travel the globe, holidays in the luxury sector became more frequent and less structured. As the World became smaller, luxurious trips to emerging markets and beyond seemed only a stone's throw away. However, the resilience of this sector in troubled, financial times was a misperception as even luxury travellers question the reliability of their investments and the necessity of that extra holiday.

In order to cope with the squeeze on credit and spending, the customer base and its priorities are changing. We are seeing a loss of aspirational and a portion of middle and upper class. Trade will reduce through a retraction in spend as travellers trade down and take shorter holidays. The annual / main holiday is back on the schedule as the fancy-free jet set lifestyle is reigned in. Holidays once again will become planned and budgeted for by this particular subset of the luxury travel market. High net worth individuals will be impacted but should recover quickly. This however requires an end to market volatility and uncertainty.

Premium and ultra premium brands are already feeling the effects of the downturn which indicates that all areas of the luxury market will be impacted including the super premium end, previously thought to be insulated. This will continue until liquidity returns to the market and confidence is reinstated, albeit at modified levels.

Based upon the economic forecasts and bookings cycle, it is likely that the impact of this downturn will continue until the 2011 season for the whole travel industry including the luxury segment. Even though predictions lean towards GDP growth in 2010 the natural lag that occurs between regaining confidence and booking the next holiday will stall this industry even when others are on the road to recovery.

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