

Sector snapshots

Travel: Further turbulence ahead



We have seen a raft of recent travel companies collapsing with Goldtrail Travel in July, followed by Sun 4 U and Kiss Flights.

Whilst Autumn is typically a tough time for travel providers, this year has seen a number of failures in the peak summer months, a time when tour operators would ordinarily be expected to be cash rich. Two of these companies, Goldtrail and Kiss Flights acted as intermediaries in selling seats on charter airlines to agents, tour operators and the public. Many of those agents and tour operators are left having to find alternative seats to honour future bookings and continue to trade.

The travel sector has already been heavily hit by general economic conditions leading to a cut back in discretionary spend. Some consumers are opting for a “staycation”, others are “buying smarter” and either buying their holidays closer to the time of departure or shopping around for budget deals. Additionally the “ash cloud” effect had both a real cash cost to many businesses that had to repatriate or reimburse customers and again delayed the buying decisions of customers that had not yet purchased their holidays.

The picture is not all “doom and gloom” with certain niche operators reporting continuing strong demand and domestic travel remaining strong, PricewaterhouseCoopers expect, however, that a significant number of companies may require additional capital for their annual Air Travel Organisers’ Licence (ATOL) renewal at the end of September.

“Businesses that do not have a firm grip on their finances will find it difficult to understand the impact of late bookings or increased costs. This is critical for working capital requirements, as is the need to forecast movements in cash flow to manage peaks and troughs, and monitor performance against financial and non-financial covenants.”

All tour operators that sell flights as part of a holiday package must have an ATOL; without it they cannot sell or provide holidays on this basis under EU Regulations. In this riskier economic climate, we are seeing evidence that the CAA, the body that administers the ATOL and picks up much of the cost of failure, is taking a tough stance.

For those operators and agents that also issue scheduled airline tickets which they pay for through the International Air Travel Association (IATA) Billing and Settlement Plan (BSP), a loss making year may lead to IATA requiring a bond. There are now only a very small number of bond providers and therefore bonds can be very difficult to obtain.

Issues facing travel operators

Regulatory requirements In advance of the ATOL deadline for travel operators, the CAA will as usual contact operators to set out the renewal requirements. If the business cannot meet these requirements, the CAA may withdraw the licence; the CAA publishes the list of licences that it has not renewed at 5pm on 30 September and 31 March – credit insurers, suppliers and the trade press monitor this list and often react immediately.

It is essential that companies give themselves enough time to respond to the ATOL renewal requirements.

- As a condition of the re-licence, the CAA looks for a certain level of what it refers to as “free” (i.e. unencumbered) assets. If the business has a free-asset shortfall, cash may be required before the CAA will renew the licence – not easy to raise in the current market.
- If cash cannot be provided, the CAA will insist on other measures to mitigate its exposure – perhaps placing customer deposits in an account charged to the CAA, further reducing working capital and liquidity.
- Historically the CAA accepted an insurance bond but in the current market there are very few providers of bonds for travel companies. We have seen cases where the lender has had to provide the bond to save the company and get the ATOL renewed. This increases the lender’s exposure further and leads to further pressure/scrutiny from stakeholders.

A different working capital model

A travel company’s working capital profile differs from many other businesses. As the customer typically books and pays for a holiday or flight (sometimes many months) in advance of travel, the company often has the benefit of strong cash balances from holding customers’ monies for some time before paying for the holiday or flight costs.

As there are generally no requirements to hold this cash in a trust account, some travel companies have relied on this upfront payment to pay for today’s operating costs and to pay suppliers for holidays already taken. Therefore, any changes in booking patterns to later or lower bookings have an immediate impact on liquidity and the ability of travel companies to pay suppliers and other day-to-day costs. Some travel businesses had previously come to rely on the interest earned by banking these upfront payments – with interest rates remaining low that path to profit has ceased to exist.

Living hand to mouth? As many travel providers have typically been cash rich, they have never before lived hand to mouth, and have not relied on the same detailed cash flow forecasting needed by other businesses to manage their liquidity. A lack of sophisticated cash planning and reporting can mean that the riskiness of the business is difficult to assess.

Consumer spend in the travel industry continues to be affected by the recession, resulting in a downturn in forward bookings and pressure on prices. For many businesses, this combined with events outside their control such as volcanic ash cloud, foreign exchange movements, low interest rates and stricter regulatory requirements will react together to create the “perfect storm”.

Decline and changing booking patterns

Customers have changed their behaviour to respond to the recession and the weak pound, reprioritising their spending, perhaps trading down to a cheaper holiday or just booking later either due to uncertainty about their personal circumstances or in the hope of a late deal. For the travel provider this can mean getting cash later and lower margins as well as a lack of visibility on booking patterns.

Cash is king: cash flow and working capital management

Due to the travel company’s working capital profile, the impact upon liquidity of a drop in forward bookings or price discounting can be immediate, whereas any revenue impact will only be observed later when the holiday is taken. In addition to a drop in bookings, companies may have a large number of costs to settle during the autumn:

- Suppliers’ bills for holidays taken in the summer;
- Payments for flights in the autumn – if the IATA BSP system is used. BSP payments cannot be delayed. If a payment is missed, the right to issue tickets will be withdrawn possibly causing the business to collapse;
- Possible additional costs to satisfy ATOL requirements – either in the form of additional debt or a bond.

Financial forecasting and reporting

Businesses that do not have a firm grip on their finances will find it difficult to understand the impact of late bookings or increased costs. This is critical for working capital requirements, as is the need to forecast movements in cash flow to manage peaks and troughs, and monitor performance against financial and non-financial covenants. Having the right management information and clearly defined performance measures are essential – decision making needs to be based upon facts and the speed of decision making needs to improve. Companies need to focus on the timing and value of receipts or payments, rather than profit or contribution for managing short term liquidity.

Exchange rates

Exchange rates are not only an influence on consumer destination choice, but also impact the travel providers costs and the price at which they can sell their holidays – if operators have had the wrong foreign exchange hedging strategy their costs may have increased significantly at a time when bookings may be down.

Lower interest rates

Some companies have only been profitable because of interest on cash balances received from holiday deposits; now interest rates are low and cash is being received later this generates significantly less cash and profit.

Extraordinary events

Travel companies continue to be vulnerable to global events, whether terrorist led or natural disasters.

Industry outlook

Many travel operators have survived a tough 2009, but may well have eroded any cash buffer during the year.

Travel companies that have struggled through the summer may find the autumn very difficult, and we expect to see a further wave of failures from September onwards.

Potential issue	Key questions	How we can help
The CAA has set out its requirements for ATOL renewal. They are applying their criteria more strictly than in prior years or disallowing certain classes of assets. We are not sure we can satisfy their free asset test.	Are you talking to the CAA? Do you know why the ATOL requirements have changed? How do you plan to satisfy the requirements of the ATOL renewal – can your shareholders provide support?	We have experience of helping companies to understand the requirements of the CAA for ATOL renewal. We can facilitate dialogue with the CAA and provide support to assist in the preparation and presentation of meaningful and timely financial information. Free-asset tests require sufficient cash or assets that can be quickly turned into cash – injecting additional funding into the business through lending may not solve the problem as it will impact other balance sheet measures considered by the CAA. We can help you find optimal structures to meet their requirements. We have significant expertise in crisis situations where there are financial, resource and time constraints.
We are worried that the business cannot sustain a continued drop in bookings, and dread an extraordinary event.	Have you undertaken scenario planning to fully understand the impact of sudden events on liquidity? What is your short term cash flow situation? How much have you kept aside as reserves to pay suppliers? What timely financial information such as management accounts, do you have readily available? Do your historical accounts focus on cash or just margin and profit? Which products are making money and why? What actions are your competitors taking?	We can conduct a review of the business, as well as benchmark and stress-test any existing contingency plans against potential scenarios. We can analyse trends and changes in booking patterns to examine what impact changes might have on cash flow whilst developing scenarios to assess the ability of the business to respond to changes in the market.
Liquidity is squeezed and we are not certain there is enough cash to pay suppliers' bills in the autumn. We don't know if this is due to lower bookings and cost cutting or just later booking patterns.	Are you analysing the forward cash impact of your booking patterns? How is the business being impacted by reduced investment income? What facilities do you have to fund increased working capital? How much headroom do you have? What support can your shareholders and other stakeholders provide?	We can help optimise cash and working capital to respond to short term liquidity issues, whilst balancing any potential knock-on impact with the CAA. We work to understand cash concerns and explore the cash levers across the entire P&L and balance sheet, both in the short term and on a sustainable basis.
The weak pound has led to a significant increase in costs, and the price of the holiday. Customers are concerned about additional costs when abroad, particularly in the Euro zone.	Is the hedging strategy appropriate? Can the product be made more attractive through including some "in resort" costs in the upfront price?	We can provide advice on optimising the foreign exchange or fuel hedging strategy, cash pooling across a group and how to ensure that any free cash is earning a competitive return. We can also help you to understand which of your products are making and losing money and why.

Vital signs

Well positioned

- Value for money, clearly targeted proposition
- Exposure to more resilient segments and consumer trends
- Well defined and differentiated brand values and target market
- Price right first time approach to avoid unnecessary discounting
- Flexible operational structure, enabling response to changing demand
- Appropriate remote/e-tail channel strategy
- Strong financial management and reporting

Potential to struggle

- Poor financial management and reporting capabilities
- Wrong foreign exchange hedging strategy
- No cash reserves
- Price premium for no tangible quality benefit
- Over-reliance on underperforming sectors, little scope to alter mix to meet consumer demands
- Poorly targeted brand/proposition
- Overcapacity necessitating discounting
- Inflexible operational structure: unable to respond to fluctuations in demand
- Reliant on interest on upfront payments for profit

Further reading: pwc.co.uk/publications

Contacts:



Ian Oakley-Smith
T: 020 7212 6023
ian.oakley-smith@uk.pwc.com



Caroline Rifkind
T: 0207 213 1033
caroline.rifkind@uk.pwc.com



Strategy
David Trunkfield
Tel: 020 7804 6397
david.trunkfield@uk.pwc.com

pwc.co.uk

This publication has been prepared for general guidance on matters of interest only, and does not constitute professional advice. You should not act upon the information contained in this publication without obtaining specific professional advice. No representation or warranty (express or implied) is given as to the accuracy or completeness of the information contained in this publication, and, to the extent permitted by law, PricewaterhouseCoopers LLP, its members, employees and agents do not accept or assume any liability, responsibility or duty of care for any consequences of you or anyone else acting, or refraining to act, in reliance on the information contained in this publication or for any decision based on it.

© 2010 PricewaterhouseCoopers LLP. All rights reserved. 'PricewaterhouseCoopers' refers to PricewaterhouseCoopers LLP (a limited liability partnership in the United Kingdom) or, as the context requires, the PricewaterhouseCoopers global network or other member firms of the network, each of which is a separate and independent legal entity.