

Ferrier Hodgson

ANALYSIS

WAR STORIES AND CLIMATE CHANGE

Ferrier Hodgson has seen the hotel sector transition through a number of boom and bust cycles over the last 30 years. At various times throughout this period we have acted as one of the largest pub operators in Australia. Through our work with a wide range of hospitality businesses, during the highs and lows of the industry, we have developed a strong understanding of what success looks like. We've also acquired a first-hand perspective of the key triggers that can bring about the undoing of operators – regardless of size, location or reputation.

From anecdotal evidence and our first-hand experience, we are seeing a metropolitan-area led recovery in the sector. Transactional activity continues to gain momentum, notwithstanding that some licensing uncertainty still exists, political pressures on gaming has abated.

Revenues in the broader hospitality sector are improving across all revenue lines; however at the same time, hotels are seeing significant increases in competition from small bars, clubs, licenced cafes and restaurants. Add to this inflationary cost pressures, and more than ever

pub operators need to be on top of their game to deliver profitability.

FINANCING THE DREAM

Debt financing and more creative financial arrangements can be wonderful tools, when used correctly they can facilitate growth and assist in the execution of sound business strategy.

However, time and again we have seen operators seek highly leveraged or complex structures and fail as a direct result of these financial arrangements. This stress is particularly relevant for those operators who make a rapid transition from a single venue to a multi-site operation.

Realistic forecasting requires deep industry knowledge and good operators are those that recognise when assistance/advice from trusted advisors is required. A review of forecasts will validate assumptions to help operators avoid getting caught up in the romance of the moment. As we are seeing the return of more frothy market conditions, we remind investors and operators alike that reliance on yield compression is dangerous, as this can swing both ways.

PATRICK MAHER – DIRECTOR

Patrick brings strong operational experience and an understanding of the hospitality and liquor industries focused specifically on strategic reviews, restructuring and operational turnaround.



Patrick has over 15 years of experience in hospitality management working on the creation of leading hotel venues and multi-site operations, as well as a business turnaround of contemporary and traditional hotel assets. Patrick's focus on restructuring growth strategies enables accurate and timely business analysis to drive results across organisations of all sizes, incorporating food and beverage, gaming and accommodation operations.

MORGAN KELLY – PARTNER

Morgan has over 20 years of experience as a professional specialising in corporate recovery and insolvency. He has been a partner with Ferrier Hodgson since 2006.



Morgan worked for four years in various jurisdictions throughout Asia on cross-border and country-specific insolvency and work-out assignments, including non-performing loan (NPL) valuation and sale transactions. This depth of experience provides a unique understanding of the region and cross-border insolvency law.

His specific experience includes formal appointments over companies ranging from mining, transport, manufacturing and hospitality to hotels, pubs and clubs. Morgan has been engaged to manage turnaround and recovery assignments with businesses varying in size from SMEs to multinational organisations, both in the private sector and assisting regulatory authorities.

Four key areas that require eternal vigilance in pursuit of sustainable profits are:

1. Financial structure
2. Thorough adherence too, and ongoing improvement of, operational and financial management control systems. This includes knowing what your core business is and doing it consistently well.
3. People – having the ability to identify, attract, develop and retain key management and operational personnel.
4. Experience – knowing the market and meeting the changing needs of the consumer. Successful businesses are continually reviewing and adapting their strategy.

CASE STUDY:

Following the imposition of a temporary 2am lockout on one late-night trading gaming hotel in Kings Cross, revenue fell by 20 per cent. This not only created debt-serviceability risk, but also resulted in asset impairment.

	Before restrictions	After restrictions
EBITDA (\$'000)	2,400	1,680
Theoretical yield	10.5%	10.5%
Value (\$'000)	22,800	16,000
Theoretical LVR	70%	100%

Significant shocks to revenue can happen at any time, as we have seen most recently with the NSW Governments CBD entertainment precinct exclusion zone. Other shocks can include increased competition from new entrants, particularly with Big Box liquor outlets to retail revenues, also known as 'the Dan Murphy's effect.'

Sustainable growth should be sought through increased profitability and asset enhancement.

Long term, top tier operators are taking the opportunity to pay down debt, reinvest into existing assets and/or purchase new assets. These options have significant upside to enable quick reduction in the LVR equation. Look at the recent acquisitions by the Fraser Short/ Arthur Laundry vehicle, (Watson's Bay, Mona Vale and Northie's Hotels), and Justin Hemmes' Merivale Group (Coogee Pavilion Hotel) to see this in action, writ large.

OPERATIONAL EXCELLENCE

The Australian market has ALH, Redcape and a handful of other major players. But most of the sector is fragmented with the majority of venues owned by small family interests on a stand-alone or small group basis. Pubs, despite the popular romance of being nothing but good times and a simple business model, are actually very diverse businesses with significant operating complexity. Add to this that the industry is heavily regulated and coming under intensifying competitive pressure, and hopefully the picture starts to quickly form about the reality of pubs. They are a specialised asset requiring operational experience, quality processes and management control systems

(MCS) to operate efficiently.

The reality for a large number of operators is long hours of strenuous hands-on labour and the obligations of business reporting and compliance. This covers staffing, WH&S, gaming, liquor licensing, anti-money laundering before getting anywhere near BAS and regular business tax requirements.

With significant cash flow quickly consumed by large pools of casual labour and an array of direct and overhead costs, it is very easy for pub profits to evaporate through a number of areas.

We recommend particular attention be paid to:

- 1. Wages (cost controls)** – Ferrier Hodgson recently conducted a survey of AHA NSW members, with responses from single and multi-site operators across 239 venues. The number one issue identified by publicans was wage costs. The industry's reliance on casual labour, pay rate inflationary pressure and penalty rates make the management of wages a critical factor.
- 2. Cash management** – variances in cash are a killer to business. Whilst we all want to have patrons and staff we can trust, the reality is that without well documented, communicated and implemented cash handling procedures,



KEY MESSAGES:

- **Analyse** your actual costs as a percentage of revenue, benchmark against industry best practice and compare it to your budget. Manage any exceptions ruthlessly.
- **Stocktake**, and act upon variances immediately, communicate with staff and track changes month-to-month.
- **Review** systems and processes. If something seems too good to be true, then it probably is. There are enough horror stories of large quantities of cash and/or stock ripped out of venues to fill volumes of print. Spot check and ensure that no individual is solely responsible for cash or stock control from end-to-end.

there is more likely to be cash losses through theft in any business.

3. Margins – with the cost of goods sold (COGS) combined with wages accounting for up to 70 per cent of the cost of doing business, it is imperative that shrinkage, or unexplained loss, is actively monitored and minimised. With growth in food practically a requirement for every pub in the face of mounting competition, the possibility for wastage and margin shrinkage is expanding, not contracting.



“WE BELIEVE THAT OPERATORS SHOULD TAKE ADVANTAGE OF THE CURRENT LOW INTEREST RATE CLIMATE. NOW IS THE TIME TO REINVEST IN VENUES, DECREASE LEVERAGE AND WHERE POSSIBLE, TAKE ADVANTAGE OF POTENTIAL OPPORTUNITIES IN THE MARKET AS THEY ARISE.”

INDUSTRY INSIGHT

Margins and cost percentage benchmarks should be measured against comparable venues, as they vary significantly depending on location and venue offering. For traditional style hotel assets, we find the following guidelines apply:

	BEST PRACTICE	AVERAGE	POOR PERFORMERS
Liquor G.P	> 67%	62%	< 55%
Food G.P	> 63%	54%	< 45%
Wages % of revenue	Bar: < 15% Food: < 31%	Bar: 18% Food: 34%	Bar: > 21% Food: > 40%



A core component of operational excellence is knowing how to maximise capital expenditure (capex), to maintain competitiveness and drive business performance. One of the common denominators we see in distressed venues is the failure to reinvest. Very quickly market share is lost, and the ensuing spiral of declining revenue, declining profits and declining capex results in lower asset values. Quality operators are those who read the market and constantly improve the quality of their offering. Budgeting for regular capex is vital to maintaining this in the long run.

Our 2015 industry survey shows 78 per cent of respondents budgeting for capex in 2015, with the split of major projects showing the importance of investing constantly into all aspects of operations.

PEOPLE NEED PEOPLE

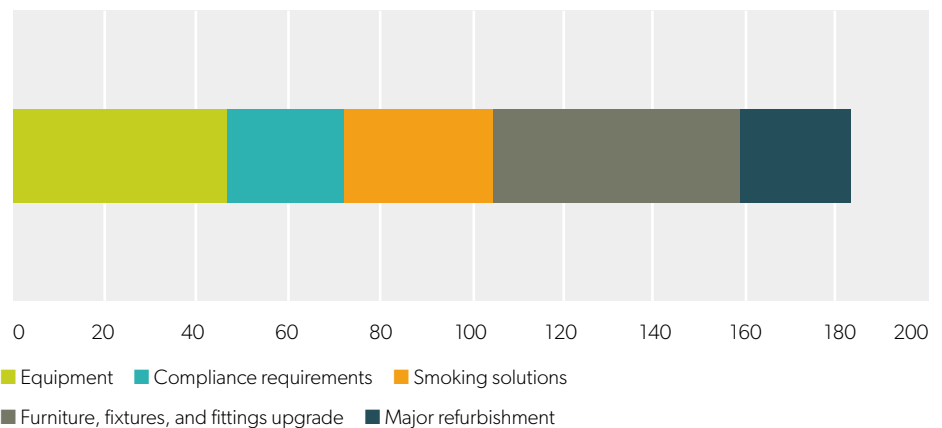
In the ever shrinking global village, large areas of the retail sector and other industries are moving towards automation and online commerce. Despite this, one thing remains consistent:

"Hos/pi/tal/i/ty" – noun: *the friendly and generous reception and entertainment of guests, visitors, or strangers.*

In essence, hospitality involves the interaction of people; (at least) one to provide and one to receive the hospitality. As such, the need for quality people will always be a key determinant of business performance.

High staff turnover is nothing new for pubs. Given the casual engagement of many employees and the often transient nature of staff, getting people educated in the right way to do things as quickly as possible is vital. The best operators attract the best people because

2015 NSW LICENCED HOTELS CAPITAL EXPENDITURE ALLOCATIONS



Source: Ferrier Hodgson 2015 NSW Pub Sector Survey

they have the most desirable venues, however this 'nothing builds success like success' mantra is not self-perpetuating. Operators with well delivered and constantly evolving staff development programs reduce their exposure to shrinkage, reduce wage costs and enhance the customer experience.

As soon as you step above casual front-of-house service staff to supervisors and management - things become critical. These are the people controlling cash and top line revenue as well as costs, from wages to wastage and everything in between. Think about security, and compliance costs and what they mean to your bottom line. Management are also often controlling that essential business enabler: the liquor licence. Potential restrictions, strikes against the liquor licence and damaged relationships with police and community can all impact performance. **AH**

WHAT DOES SUCCESS LOOK LIKE?

Experienced/Top tier operators	Everyone else
Understand their customers	Unable to remain current in market
Operationally savvy	Inadequate/poorly implemented systems
Commitment to reinvest	No capital expenditure and venue refreshment

"REALISTIC FORECASTING REQUIRES DEEP INDUSTRY KNOWLEDGE AND GOOD OPERATORS ARE THOSE THAT RECOGNISE WHEN ASSISTANCE/ADVICE FROM TRUSTED ADVISORS IS REQUIRED."

