

## **EXECUTIVE SUMMARY**

In August 1997, the Federation of Hong Kong Hotel Owners Limited commissioned Jones Lang Wootton Limited to carry out a study on the future of the hotel industry in association with JLW Transact, the specialist hotel and leisure company of JLW.

Since the start of the study, economic conditions in Hong Kong and many of its source markets have changed dramatically. Over the last year, the Asian financial turmoil has led to major movements in regional and world currencies, triggered dramatic falls in regional stock markets and reduced economic growth prospects across East and Southeast Asia. The economy of Hong Kong and a number of other countries throughout the region have entered recession.

In these challenging times, the Hong Kong hotel industry has had to reassess both its short-term and long-term position to ensure it remains competitive in a world and regional context. In generally weaker demand condition, hotels have had to review tariffs, incentives and general marketing approaches in order to try to maintain occupancy levels and revenue. Hotels have had to examine closely their operating costs, particularly staffing, in order to make savings to preserve operating profits.

Within the last few months, the Government has initiated three packages of special measures to try to boost the economy and mitigate the impact on employment. It is too soon to tell how effective these measures will be. However, it is clear that they are likely to have only a modest direct impact on the operating environment for the hotel industry in the short-term. More pro-active steps appear to be needed.

The end of the regional economic turmoil is not in sight. There is no prospect of an immediate recovery in the Hong Kong economy. In this context the hotel industry, which plays a vital role in supporting Hong Kong's international hub functions, needs a clear and co-ordinated approach from the public and private sector to minimise the negative impact on the industry and to help it

to be competitive to the benefit of the economy of Hong Kong.

The approach has two components:

- Short-term actions to boost the hotel industry immediately by reducing the regulatory and taxation burden on the hotel industry; and
- Long-term actions to create a more stable, sustainable tourism industry.

We have prepared two reports, which are published separately. In the first, we address matters of immediate concern to the industry and make recommendations on steps to improve the short-term outlook. In the second we examine the long-term prospects for the industry and the changing nature of the industry. We provide recommendations on steps to enable Hong Kong to take full advantage of the many opportunities likely to arise. The reports are titled:

- Turning the Tide; and
- Catching the Wave.

### **Turning the Tide**

If the private and public sector work together in a flexible, pro-active way, the immediate negative impact of the regional economic turmoil and local economic recession on the tourism and hotel industries can be mitigated. Although there will be pain, the steps we identify in "Turning the Tide" will help to maintain the competitiveness of Hong Kong as an international destination and will help underpin the economic hub functions of Hong Kong into the next century. It will provide the framework for a stronger, stable industry in the longer term.

### **Catching the Wave**

In the long-term, we believe the prospects for Hong Kong tourism are bright. In "Catching the Wave", we set out our views on the potential of the tourism and hotel industries and map out steps to help to realise that potential. It includes:

- Introduction;
- Demand for Accommodation;
- Supply of Accommodation;
- The Future of the Tourism Industry;
- The Future of the Hotel Industry; and
- Conclusions and Recommendations.

### **Trends and Prospects for Accommodation Demand**

World and regional tourism is expected to continue to grow strongly for several decades, although the immediate prospects for intra-regional travel are somewhat reduced because of the regional economic turmoil. However, in the long term Asia remains likely to be a major area of growth.

Hong Kong has long been the leading tourism destination in Asia. Over time it has been evolving into a destination dominated by short-haul visitors from within Asia rather than one dependent on the long-haul market.

The Hong Kong tourism industry stands on the threshold of a new era. In 1997, after many years of rapid growth, the industry contracted. In part this was a product of a tourism hangover after the Handover, in part a result of the regional financial and economic turmoil.

Although visitor's motivations for coming to Hong Kong are many and various, it is clear that for a significant majority, in recent years, Hong Kong held a particular place in the popular imagination. It was viewed as a unique city on the threshold of an historic event, the return to Chinese sovereignty after more than 150 years of colonial rule. In the years running up to the Handover, these geopolitical events added a glamour and excitement to the underlying cosmopolitan atmosphere driven by the cultural diversity and fast paced lifestyles of residents played out against a breathtaking topographical and architectural backcloth.

A significant component of this attraction has changed. The moment in history is past. The many visitor for whom the impending Handover made Hong Kong a must see destination have already been and gone. They generally came before not during or after the Handover.

Hong Kong tourism needs to adjust and change to meet the challenge of the new era. The response needs to include both short-term marketing and medium and long term initiatives to develop facilities, attractions,

services, events and tourism infrastructure appropriate to future growth markets.

One of Hong Kong's greatest strengths as a tourism product is its appeal to a wide variety of market segments. Its multi-cultural, cosmopolitan atmosphere appeals to large numbers in short-haul and long-haul markets, Asian and western tastes, young and old, families and individuals, business and leisure visitors, tour groups and independent travelers. The tourism industry in general and hotel industry in particular will both benefit from greater stability through the promotion of this diversity

The new Chek Lap Kok airport opened in July 1998 setting a new standard for travel industry infrastructure in Asia. It will help to promote the diversity by creating the potential to open up new markets, particularly in China. The new infrastructure will also lead to profound changes in the perception of Hong Kong as tourism activity disperses more widely throughout the Territory.

### **The Stock and Supply of Accommodation**

The Hong Kong hotel industry faces a period of unprecedented expansion. Currently there are 90 hotels and 34,393 hotel rooms. There are also currently 22 new hotel projects and 5 extension projects coming on stream which are anticipated to add an extra 10,300 rooms to the total by the year 2002.

It is unlikely that all of the proposed projects currently recorded by the HKTA will be implemented. However, it is noteworthy that the new hotels are being developed by a wider range of developers in a wider range of locations than has been the case in any previous building cycle.

### **The Hotel Development Process**

A hotel is a complex type of development, which generally has higher construction and operational costs than other forms of property development. Operationally, a hotel is subject to international competition, which limits the potential to increase revenue by raising price (room rate) to a far greater degree than any other form of property investment. As a result, although a successful hotel generally offers a secure and stable cashflow to a developer or investor it generates an investment return over a much longer period than other forms of investment.

Generally, the supply of hotels and other forms of accommodation are matters for the market to determine within the regulatory framework provided by the Government in the context of competing uses for scarce factors of production such as land, labour and capital. The regulatory framework provided by the Government comprises planning, environmental, land supply or health and safety controls.

The result is that hotel development is inherently cyclical and only in part related to the prospects of the hotel industry. The more important influence is the prospects for other more valuable uses of the site. At times of high demand and short supply of office or residential property, hotels in prime locations will be under redevelopment pressure. At times of low demand and high supply of office or residential property, developers look hotel opportunities.

### **The Performance of the Hotel Industry**

The deeply disappointing performance of the tourism industry in the HKSAR's first year had a major impact on the hotel industry. Hotel occupancy fell. Average room rates and average room yields also fell. Food and beverage revenues were affected. As a result, despite widespread attention to cost control, particularly on staff numbers and costs, net operating profits were squeezed. Some hotels have lost money.

Among a number of key indicators of hotel viability, the balance between average room rate and occupancy rate is perhaps the most critical. It determines average room yield, which is the driving factor in profitability. When the supply of rooms is tight, with strong demand, both occupancy and room rates tend to rise. When there is a major increase in supply both occupancy and rates tend to fall.

Hong Kong hotels in all market segments had maintained consistently high occupancy rates for the last decade. In 1997, occupancy started to decline prior to the Handover in July. Although average occupancy rates fell 10% in 1997, they remain generally high by world standards.

Average room rates (ARR) had grown since 1992 underpinned by lack of new supply and growing demand. Market-wide ARR peaked in 1996 at approximately HK\$1,238. In the second half of 1997, the ARR fell 11%.

Room yields increased about 5% per annum from 1987 to 1996. In 1997, all three market segments recorded a fall in room yield largely due to a drop in the occupancy rate. Three-star hotels were hardest hit with yields declining by HK\$137. On this measure, four-star and five-star properties experienced a somewhat softer landing with room yields dropping HK\$87 and HK\$124 in 1997.

Income and expenses declined in 1997. Although hotels have cut costs, they have been unable to match the falling revenue. Many hotels are operating at a loss.

### **The Future of the Tourism Industry**

In the long term we believe prospects for Hong Kong tourism are bright. Although there will be further pain in the short term, there is also an opportunity for Hong Kong to emerge a better, stronger, more competitive tourist destination.

We expect demand from a visitor to Hong Kong looking for commercial accommodation to be maintained and to increase as Hong Kong develops as a major world finance centre and leading tourism destination in the region. We expect the position of Hong Kong as a gateway to and, most importantly, from China to enhance the prospects for the tourism industry. Inexorably, we expect the role of Hong Kong as a domestic tourism destination for PRC visitors to grow as the mainland economy develops and Hong Kong's reintegration into its natural Pearl River Delta hinterland continues.

It is of vital importance that the industry distinguish between the probably "one-off", post-handover structural adjustment and short-term cyclical change. It is important to distinguish between a short-term fix and the long-term future of the industry. The long-term vision lies in the potential of the more emerging source markets. There are numerous opportunities arising as a result of the opening up of the new airport to open up new markets and increase the penetration of existing ones.

Perhaps the most important structural change facing the Hong Kong tourism industry is the growth of the number of people with the means to travel in the PRC. It is already the most important source market for Hong Kong. Over time it is expected to grow. The Hong Kong tourism industry needs to re-orient its product further towards catering to domestic tourism. The regulatory framework for the industry, policies and implementation practice all need to take this into account.

There is growth potential in all source markets. Generally, the needs of long-haul visitors are well catered to. This has been a traditional strong market for Hong Kong. However, it is the growing short-haul market that needs most attention. There are interesting prospects for new attractions to cater to the interests of visitors from some sub-markets.

In order to capture the potential it will be necessary for the key agencies and actors in Hong Kong that make decisions that influence the decision-making process of visitors to pull together in a more co-ordinated manner. They need:

- A clear co-ordinated regulatory framework for the tourism industry within which

individual enterprise is allowed to flourish;

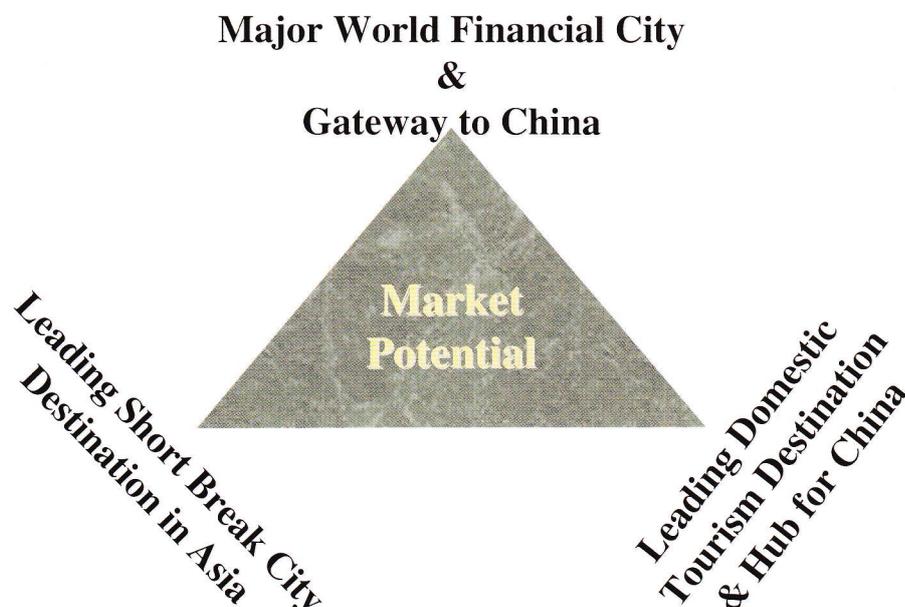
- Consensus on the long term strategic directions for the industry; and
- A strategy and tactics to get there.

### The Role of the Government & HKTA

For many years the Government has appeared somewhat ambivalent to the tourism industry. The Government has seemed loath to accept its valuable economic role. Tourism policy does not feature particularly prominently in the organisational structure of Government.

HKTA was established in 1957 and historically, it has tended to focus on tourism promotion rather than tourism development. The Government tacitly endorsed the HKTA's de facto diversification over the last few years into a tourism development authority. Indeed, the Government has set up additional special funds to help the HKTA to execute policy

Nevertheless, the Visitor and Tourism Strategy completed in 1995, which underpins the HKTA's move towards tourism development has no strict statutory or policy backing from Government and is not endorsed formally acknowledged as planning policy by the Town Planning Board. This has constrained the speed with which decisions on the implementation of projects are made.



To be effective in tourism development, a clear, concise medium and longer-term strategy should be drawn up. The Government and Town Planning Board should be asked to give it broad endorsement. Relevant Government committees and departments should be required to take it into account pro-actively in formulating their plans and where possible to be supportive when asked to re-act to specific proposals brought forward under the umbrella of the strategy. It may be necessary to consider whether the HKTA should be more formally upgraded, perhaps to a Tourism Development Corporation similar in nature to the Land Development Corporation and other public corporations, charged with the implementation of key strategic projects.

In relation to HKTA, there is some concern in the industry that the allocation of resources would benefit from greater transparency and consultation with the industry at an early stage. This would allow the industry to better understand the HKTA's intention in order to co-ordinate its expenditure better with the anticipated focus of the HKTA. The Tourism Task Force set-up as an emergency response to the tourism downturn is a welcome step in this direction.

Hong Kong needs to be repositioned and promoted. A broad consensus is needed on the future of tourism. This should be in the framework of a broader vision for the future of Hong Kong. This will facilitate greater consistency in policy and resource allocation by the public and private sector to deliver both the message and the underlying product.

A mechanism is needed to speed up the Government response to the HKTA's implementation of its strategy. It is lamentable that more than two years after publication of the Vistour strategy and despite much effort, so little has actually been implemented. Although tourism development projects must follow the same statutory procedures and pass the same tests as any other development project, it appears that despite the Vistour strategy, most proposed projects still have to convince Government of the potential benefits that tourism can bring to Hong Kong before resources, particularly land, are committed.

It is clear that the implementation of the Vistour strategy projects needs to be streamlined. Probably the most important component is for the Government to agree and give broad in principle endorsement to a strategy for tourism development. This would at least allow adequate provision to be made by the Town Planning Board and, if necessary, the Lands Department so that the implementation of feasibility studies can be carried out within a policy framework rather than on an ad hoc basis.

### **The Future of the Hotel Industry**

With the future stock expected to increase to about 44,700 rooms in 2002 from 34,393 in 1997 (30%), there will likely be continued pressure on occupancy and average room rate. Over the same period, provided the Government and industry take appropriate steps to allow it to do so, we expect visitor arrivals to grow by 23%.

At the same time, we expect the profile of visitors to change. This will fuel demand in the three-star and four-star market but we consider competition in this sector likely to be fierce because it is the focus of most new supply. As a result we expect only marginal increases in average room rates in these market segments as hotels compete on price to maintain and increase occupancy rates.

We have projected the likely future performance of each market segment taking into account our earlier forecast scenarios of visitor arrivals, market segmentation, changing composition of visitors and affordability. We have systematically projected the occupancy rate and average room rate for the period from 1998 to 2002. We envisage great pressure on occupancy rates, ARR and room yield in all market segments over the next five years.

The accommodation value for a hotel can be compared to the accommodation value of permissible alternate uses to help to determine whether hotel development would be attractive on any given site. In all locations throughout Hong Kong, commercial office or residential development would be more valuable by some considerable margin.

Thus on a strict site-by-site financial viability basis, the current boom in hotel development is

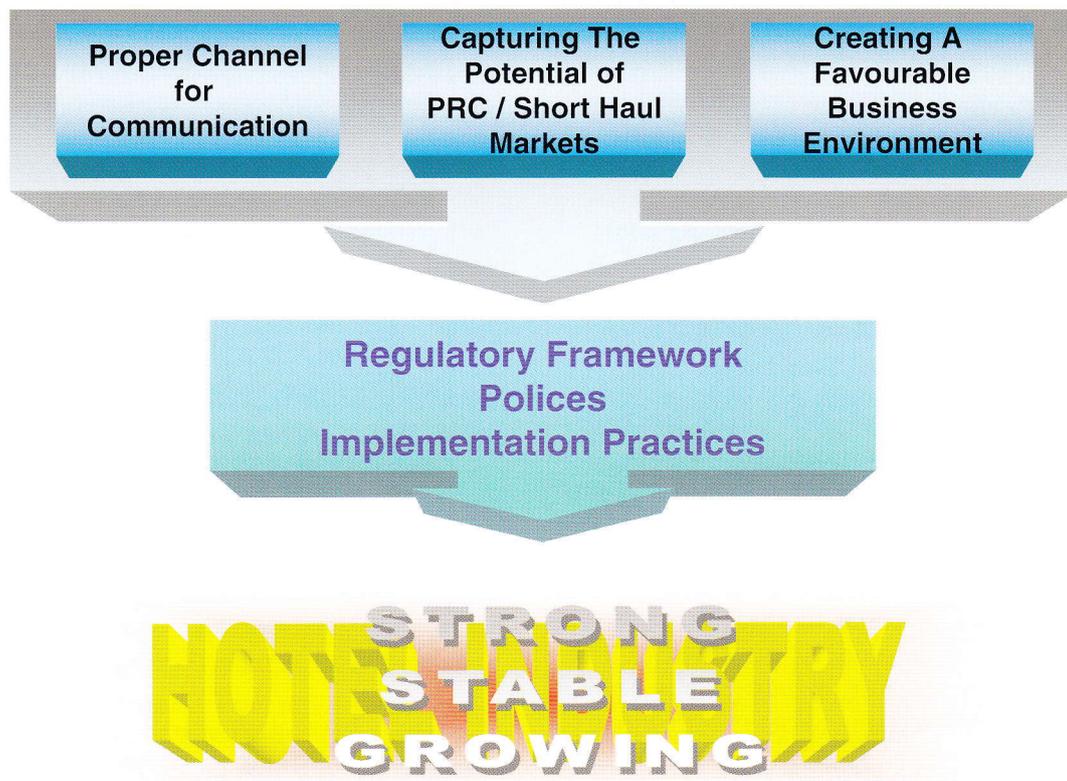
difficult to justify. However, there is nothing too unusual about the current disparity. Hotels have a lower site value because of the complexity and cost of development and operation.

The current boom in hotel supply is in part a result of HKTA and Government activity. In 1994-1996 when Hong Kong hotels were being demolished and the number of available rooms was falling, considerable publicity was given to a potential shortage of rooms as the tourism industry continued to grow. Many developers responded to this and market signals such as high occupancy rates and good profits. They also reacted to the prospect of a major increase of office space in the Territory in 1997-1999 and proposed to build hotels as part of a more diversified development portfolio. In addition part of the new supply has been stimulated by the relocation of the airport and special initiatives such as the recent sale of a site restricted to hotel use only in Ma On Shan.

There is therefore no immediate need for further hotel development to cater to visitor needs in the short term. However, there is likely to be a need in the medium and longer term to make provision for hotel development to cater to the potential growth in visitor numbers beyond 2002. If the new hotel supply is to be in optimal locations for the tourism and hotel industries in the longer-term it is essential to plan for it now.

In any event, despite the likelihood that most market segments will be oversupplied in the short term, there may still be opportunities for hotels that cater to unexploited or underexploited market niches such as:

- Boutique hotels;
- Resort hotels; and
- The conversion of historic buildings into hotels.



## IMPLEMENTATION OF RECOMMENDATIONS

On July 1<sup>st</sup> 1997, Hong Kong moved into a new era. It did so just as regional economic turmoil struck Asia. As a consequence, a downturn in visitor numbers from most of Hong Kong's short-haul markets has been superimposed on a wider structural change as Hong Kong's place in the international spotlight passed. Visitor arrivals and spending have dropped sharply. It is essential that the momentum of the decline over the last twelve months not be allowed to build.

### Turning the Tide

Urgent steps need to be taken to address the short-term issues. These are mainly about promoting Hong Kong and addressing the financial hardships of the industry. In the current more straitened circumstances in Hong Kong's short-haul markets, careful selection and targeting of promotion is needed. A concerted effort is required to maintain the price

competitiveness of Hong Kong as an international destination and to offer cheaper packages to those short-haul markets which are considerably less wealthy than a year ago.

Urgent steps also need to be taken to speed up changes to Hong Kong's tourism product to ensure that it caters to the future growth markets. Chek Lap Kok airport has recently opened and a major expansion of visitor accommodation is underway. However, to date, the implementation of visionary new attractions and events to rejuvenate the tourism product has been slow.

There is a risk that without action, Hong Kong's position as the leading tourism destination in Asia could be threatened. What could happen? In the worst case scenario Hong Kong could lose market share and visitor numbers and tourism receipts could continue to fall. To avoid this a series of long-term measures are needed to allow Hong Kong to capture the economic benefits a rejuvenated Hong Kong tourism industry could bring.



### Catching the Wave

Despite the short-term difficulties, we believe strongly that the medium and longer term potential is great. With the return of economic stability and growth in short-haul markets in two-three years, there is potential for significant growth in visitor numbers from today's level. The long-term potential of the PRC market is immense. If it develops as we envisage, Hong Kong will emerge over the next twenty years as one of the world's leading visitor destinations.

To capture this potential the Government and the tourism industry need to tackle the challenge head on. Our recommendations address three key issues that must be addressed for the benefit

of both the wider tourism industry and the hotel industry in particular:

- Creating a proper channel for communication;
- Taking advantage of the potential of growing markets particularly in the PRC and other short-haul markets; and
- Creating a favourable environment for hotel development and operation.

We have prepared a package of recommendations on the regulatory framework, policies and implementation practices for the industry with a view to promoting a strong stable growing hotel industry that provides opportunities in a free, transparent market for hotel investors, developers and operators.

**Recommendations**

KEY ISSUE	RECOMMENDATIONS
To create a proper channel for communication within the hotel industry and between the hotel industry and Government:	<ol style="list-style-type: none"> <li>1. Government should commission an independent consultancy study on the case for a Secretary for Tourism and/or upgrading the status of HKTA;</li> <li>2. Government, HKTA and the private sector should work to develop a broad consensus on the future medium and long-term strategic direction of the industry</li> <li>3. The industry should carry out an annual survey of hotel performance to be published in aggregate form as a briefing to investors and developers;</li> <li>4. The industry should hold an annual seminar on hotel investment;</li> <li>5. The industry should provide an annual briefing to Government, Legislators, Town Planning Board and others on issues affecting the hotel industry;</li> </ol>
To take advantage of the potential of emerging markets in the PRC and other short-haul markets:	<ol style="list-style-type: none"> <li>6. HKTA should submit a tourism development strategy to Government for broad, in principle, policy endorsement;</li> <li>7. HKTA and Government should streamline the implementation of the strategic projects promoted through the Vistour strategy;</li> <li>8. The PRC and SAR Governments should further relax permanently travel restrictions on PRC visitors to Hong Kong;</li> <li>9. HKTA should cooperate with airlines to give priority to the promotion of Hong Kong in new emerging markets to take advantage of Chek Lap Kok;</li> <li>10. HKTA should continue to promote Hong Kong strongly in short-haul markets as the leading short-break destination in Asia;</li> <li>11. HKTA should promote Hong Kong in the PRC as its most accessible international/domestic tourism destination;</li> </ol>
To create a favourable business environment for hotel development and operation:	<ol style="list-style-type: none"> <li>12. Government, the HKTA and the private sector should encourage the development of a sufficient range and quantity of hotel accommodation;</li> <li>13. Government and the Town Planning Board should look very carefully at local market potential and consult the HKTA in determining appropriate sites for hotel development;</li> <li>14. Government and the Town Planning Board should allocate land in prime areas restricted to hotel use only;</li> <li>15. HKTA should develop a database on visitor arrivals taking into account side-visits to the PRC and Macau;</li> <li>16. Government should consider further encouraging the provision of higher standard facilities in hotels by providing incentives in the Building Planning Regulations; and</li> <li>17. Government should work with the private sector to establish an internationally accredited hotel management school.</li> </ol>