2019 Industry Report

Hospitality in Australia

Threats and opportunities

Our Hospitality update this year reveals an industry buffeted by significant external forces. Online ordering is a game changer, a disruptive innovation that is being treated by some owners as an important opportunity and by others as a requirement to offer meals at a discount (after the service fee). Social media can no longer be ignored. One negative unanswered review is all that's needed to steer customers away.

Looming behind the challenges of Uber Eats and Instagram is a country struggling with anaemic economic growth. May's federal election installed a widely supported Coalition majority government; billions of dollars of infrastructure and resource projects are underway. Despite this, the economy is failing to fire. Declining house prices are not only reducing consumer confidence, they are actually taking more money out of mortgage holders' wallets each week. At the global level, the signals are mixed. A US-China trade war will clearly impact Australia, but a weakened Australian dollar will attract more international visitors.

If you operate in Western Australia, describing the conditions as difficult is an understatement. Household expenditure on restaurants has continued to fall in real terms and yet the number of establishments has grown. Queensland is somewhat better off; spending on going out is at least keeping pace with inflation. New South Wales and Victoria, owing to their larger, less resources-reliant economies, are faring better. Hospitality spending for those States is tracking economic growth.

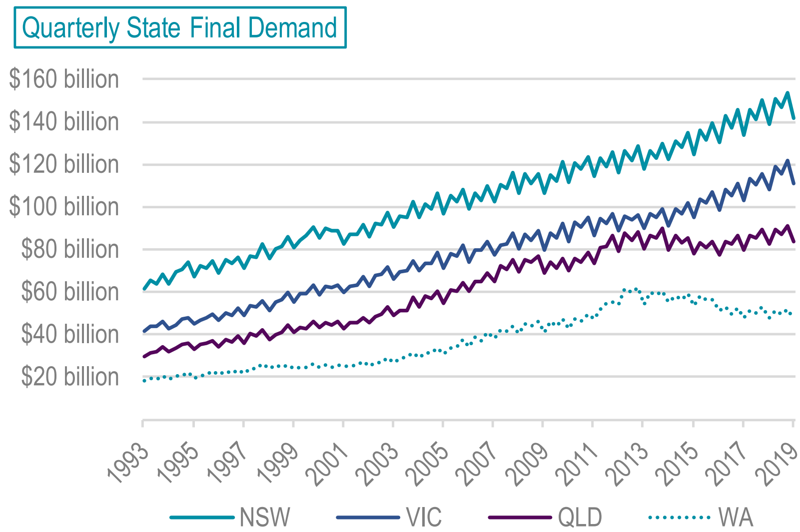
And yet, many of the key elements to operating a successful business remain unchanged. We review those elements, the above issues and more in this report.

Beginning with the big picture...

We look first at how our focus States are performing generally. We use State Final Demand (SFD) of New South Wales, Victoria, Queensland and Western Australia as our key measure as it focuses on each region's use of goods and services, both consumption and investment, for a given period. SFD differs from Gross State Product in that it does not include exports nor trade between the States. It therefore gives a truer sense of the pulse of the local economy from a business and household perspective.

2012 marked the end of the resources super cycle. Western Australia and Queensland have felt the hangover effects of that high growth period since then. At the household and small business level, WA is in a recession, contracting a total of 30% since 2012, and declining 1.6% during the past year. Queensland's economy has suffered less, falling 8% since the end of the super cycle, but up only 0.8% during the last 12 months.

New South Wales and Victoria, with their more diversified economies, have enjoyed steady climbs with their SFD's rising 1.9% and 2.8% respectively during the last year.

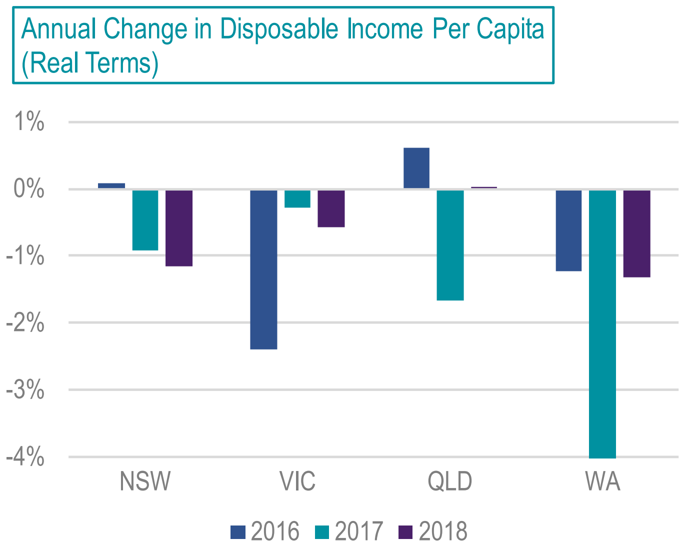


The wallet is getting thinner...

Two key drivers are affecting spending habits.

Number 1: Lower disposable income

When the State Final Demand figures were put under the microscope, we discovered two main drivers affecting spending habits. First, in real terms, per capita household disposable income for our focus States went backward during the three years ending in 2018. In total, Queensland has had the best experience, falling only 1%. New South Wales was next, declining 2%, followed by Victoria, which slid 3% during the period. Western Australians have seen their real disposable income reduce by almost 7% since June 2015. Commentary in the media indicates further declines for 2019.



Number 2: Falling house prices

Our tendency is to tighten our belts when our home (typically our largest asset) falls in value. We feel less inclined to spend, because we feel less certain about the future. The fact that we've borrowed to purchase our residence (and the loan amount has remained the same) reinforces these feelings. This psychology is the initial economic effect of falling house prices in Australia.

The impact is actually going deeper. For many Australians, their reluctance to spend is being exacerbated by the fact that their mortgage payments have increased. The repeating scenario goes like this: a homeowner buys a home in 2014 for $600,000 with a 20% down payment.

To conserve cash he finances the purchase with an interest only loan of $480,000 at 5.2% that he locks in for five years. 2019 arrives and the mortgage expires. His home has unfortunately declined in value by 15%, to $510,000. (This is a good news story. There are many homeowners whose homes are worth less than their mortgages.)

The wallet is getting thinner...

The bank is justifiably nervous about its loan being roughly equal to its security and, to start reducing this problem, requires that the homeowner's next mortgage be principal plus interest, over 30 years. The bank's decision to exert this pressure is not solely an internal one. Australia's banks are also being influenced by APRA's and ASIC's policy directives that the proportion of interest only home loans in the banks' home mortgage portfolio ought to be reduced. Continuing our scenario, the homeowner chooses a 3 year term with a rate of 4.0%. The monthly mortgage payment increases from $2,080 to $2,404, or by 15%. And also at a time when his disposable income has at best stayed the same.

There are two things to note here: first, because the mortgage now exceeds 80% of the house's value, lenders mortgage insurance (LMI) applies and adds $17,766 to the loan amount. Second, the increase in the mortgage payment occurred despite our environment of falling interest rates.

Our scenario above is manifesting on bank balance sheets in the form of increasing mortgage delinquencies. As at 30 June 2019, three of the four big banks recorded increases in their 90+ days past due mortgages compared to 30 September 2018.

	90+ Days Past Due (bps)		% Change
	Sep-18	Jun-19	
Australia and New Zealand Banking Group	86	114	33% ↑
Commonwealth Bank of Australia	68	68	0%
National Australia Bank Limited	72	85	18% ↑
Westpac Banking Corporation	72	90	25% ↑

For example, as a percentage of its total residential mortgage portfolio, Australia and New Zealand Banking Group's 90+ days past due mortgages increased from 0.86% to 1.14%.

In terms of geographic distribution, delinquent mortgages are skewed toward Western Australia and Queensland. They are also weighted toward principal + interest loans.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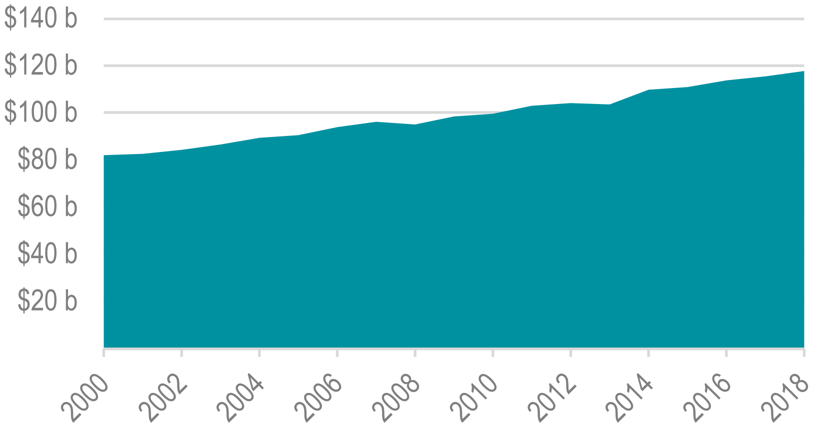
Australia’s hospitality industry

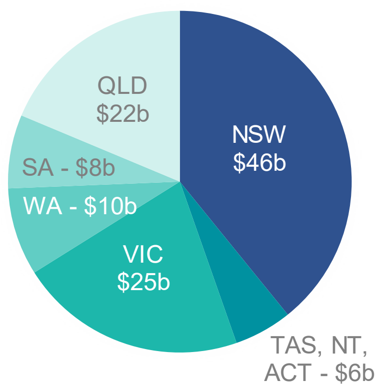
A $120 billion industry that has grown 42% since 2000.

Australia's hospitality industry has grown 42% since 2000. However, growth rates across the country have not been uniform. Queensland’s hospitality sector grew more than 50% during that time, whereas Western Australia nearly doubled, albeit most of that growth was achieved by 2014.

Annual Household Hospitality Expenditure*



2018 Hospitality Expenditure*



Whilst the sector’s gradual expansion exhibits stability, under the surface businesses are struggling. Difficulties for owners include wage pressures, high staff turnover, lease agreements that are no longer commercial, plus a customer base with changing tastes and less to spend.

At the revenue level, competition has never been higher. Online reviews are requiring operators to raise their game, as a single poor review can cause patrons to rethink their choice of venue. This rating system also compels management to actively monitor what people are saying about their business and quickly take steps to resolve any grievances.

Online ordering is also having a significant impact, with a third of Australians living in capital cities using Uber Eats, Menu Log, Deliveroo and Foodora. Many of us prefer the option of enjoying a meal from our favourite restaurant WHILST staying at home. Restaurants are reluctant to turn this business away, even though margins are reduced if the online ordering system is provided by a third party. Furthermore, the absence of drinks and coffee during the meal mean that the dollar spent per person is less. This is in addition to the effect of the shrunken wallets commented on earlier. Suddenly, the owner’s investment in the décor and the dining experience offered have declined in importance. Staff rostering is also affected due to evenings when the kitchen is busy with takeout meals, whilst waiting staff wait for customers to serve.

Online ordering is not all bad. If managed well, it can be additional revenue for the business and not replace existing revenue streams. One previous source of revenue that was largely untapped is food orders from offices at night. Staff working late are enjoying the convenience of Menu Log and Deliveroo instead of waiting until they get home. Some operators have adapted to this paradigm shift by altering the physical layout of their premises to cater better to delivery drivers. Deliveries are managed more efficiently and there is less disruption to the experience of patrons dining in.

* Spending on alcohol, hotels, cafés, restaurants and gambling.

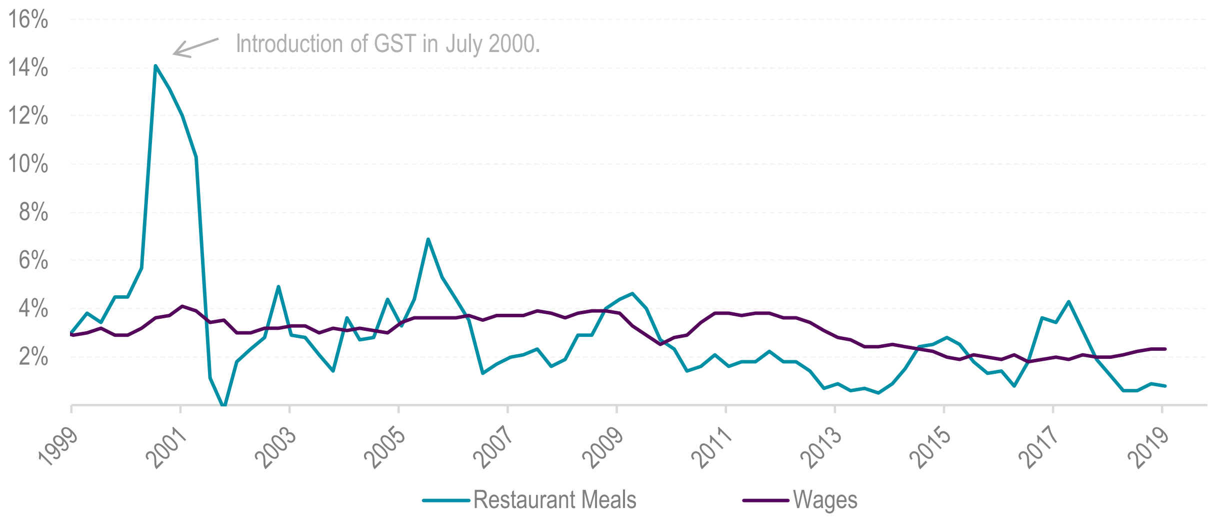
Australia's hospitality industry

Wage costs are rising faster than meal prices.

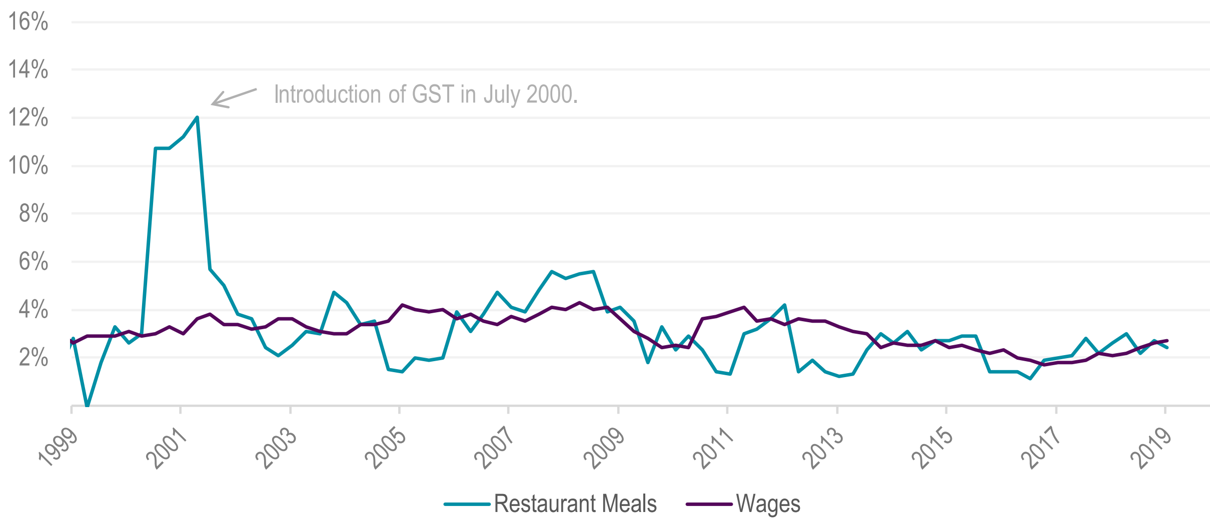
Maintaining quality staffing levels is a constant struggle. The young demographic profile of most employees and the low required skill set results in a transient employee base overall. Employee turnover is very high, approaching 50% per annum and demand outstrips supply. Combined, these attributes mean that even medium calibre employees can leave and find employment when they want.

To attract and keep good people, owners are forced to offer higher pay levels under the State awards than would otherwise apply. As shown by our graphs of private wages and meal prices for each State, owners are seeing their primary operating expense rise with little or no ability to raise prices. The only State not experiencing a divergence is Victoria.

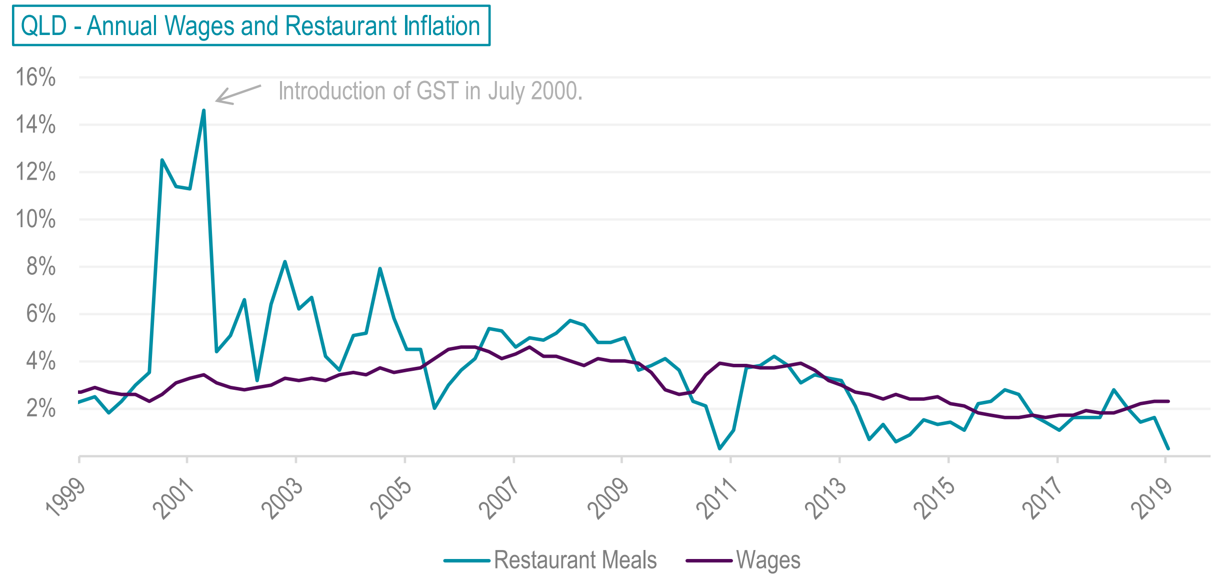
NSW - Annual Wages and Restaurant Inflation

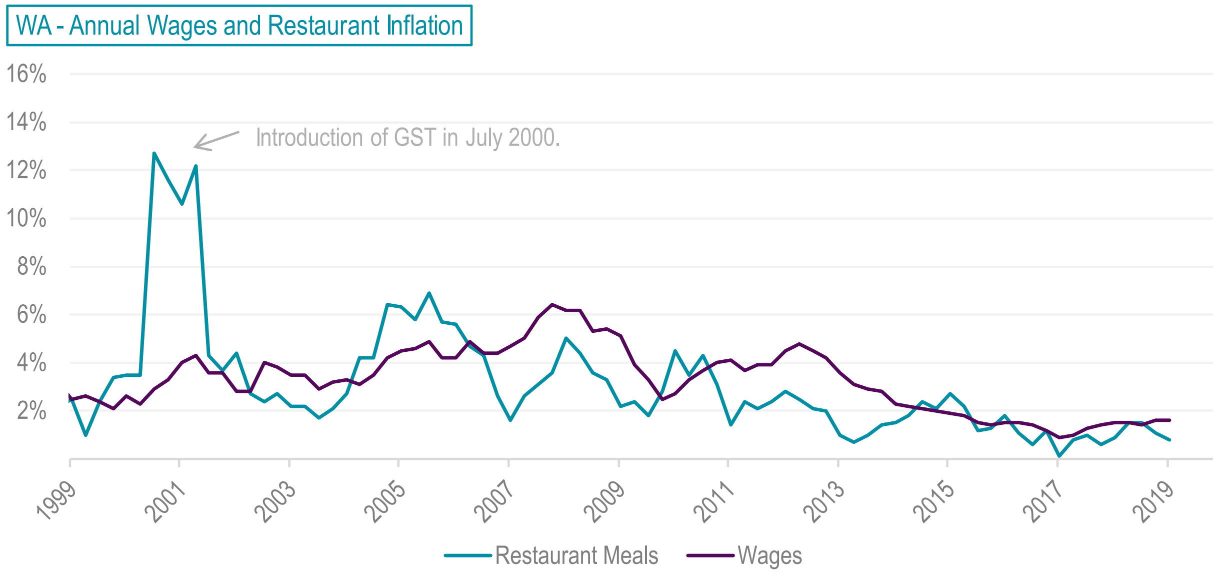


VIC - Annual Wages and Restaurant Inflation



Australia's hospitality industry





The industry is not sitting idly in the midst of this challenge. One development that may help address it is a new ordering system comprising table-mounted tablets. The tablets are attached to the tables and allow patrons to choose, submit and pay for orders without having to engage with waiting staff. Although likely not easy to implement at the outset, the result could be wage savings and a partial solution to the challenge of finding good people.

Leases also remain problematic. Rents in most agreements are structured to increase by the higher of CPI and 3 or 4% per annum. CPI has not been above 3% for years, so this provision is clearly not in the tenant's favour.

Market reviews also seldom result in a reduction in the base rent.

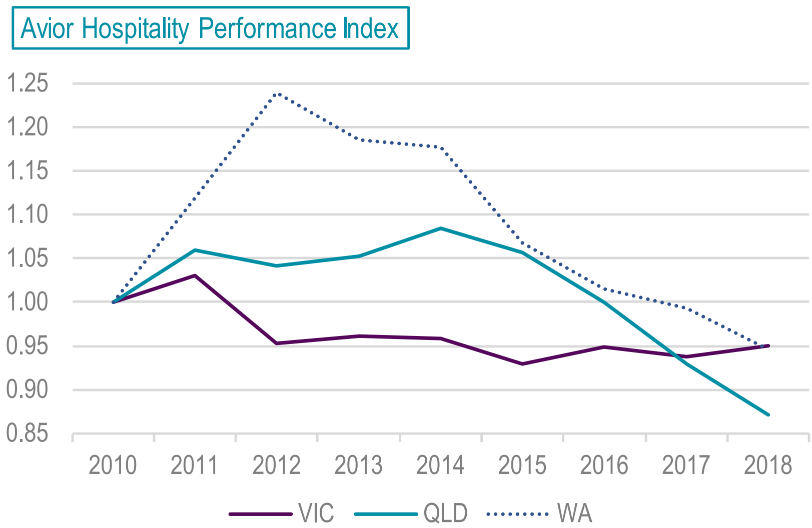
There is, however, evidence that landlords are becoming more accommodating. Lease agreements are being entered into where a portion of the rent is based on the business' turnover. To be considered, the landlord will want evidence of capability to achieve revenues that generate the targeted total rent. Such evidence includes revenue amounts for previous periods or the results of another location. To keep things fair, some form of audit verification will also be needed, albeit not necessarily full audited accounts. The point is, rents do not necessarily have to be a fixed overhead.

Pie slices remain small...

New establishments are opening their doors whilst consumers are reducing their spending.

The Avior Hospitality Performance Index examines household expenditure on hospitality relative to the number of liquor licences issued. An increase in the index is a positive sign as it means that the expenditure per licence, or slice of the economic pie for a given operator, is increasing.

Our 2018 hospitality report observed that the performance index for Western Australia has been declining since 2012. In this year's update, which includes 2018 figures for liquor licences, WA's index has again declined. Queensland's has been falling since 2014, whilst Victoria has been reasonably steady since 2012. Liquor licence data for New South Wales was unavailable.

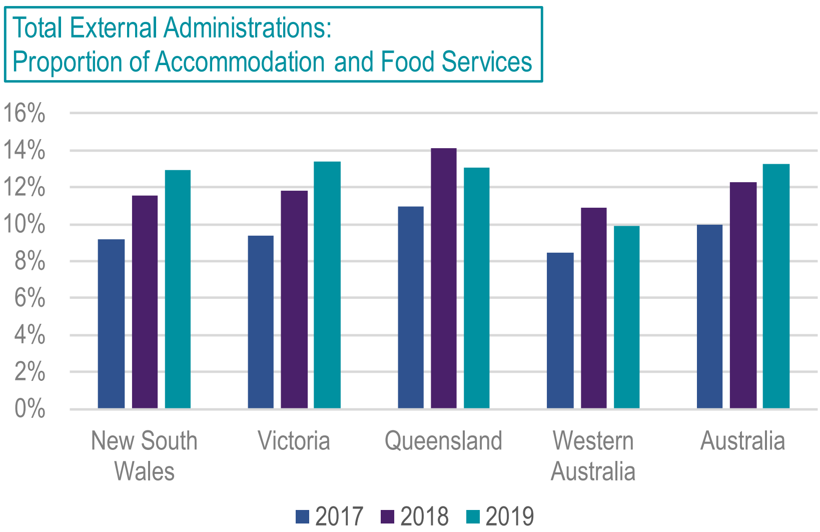


Formal appointments increased

Hospitality is suffering more than other businesses.

Thinner wallets, increased competition, wage pressures and unabating rents are converging in a bad way. The result is that for the past two years we have seen an increase in the proportion of external administrations (liquidation or voluntary administration) from accommodation and food services.

A total of 959 restaurant and accommodation external administration appointments occurred in our focus States during the year ended 30 June 2019, a 10% increase over 2018. The sector has suffered the most in Queensland.




Cafe
Vicolino
Laneway Cafe
Cafe
MELBOURNE CENTER PLACE
PH: 9654 2997
Princess Highway
in a rush
HELLS

Our experience...

Six appointments, three businesses saved.

Avior Consulting was appointed as liquidator or administrator over six hospitality companies during 2018 and 2019. In three of those cases, the underlying businesses were sold as a going concern and the employees kept their jobs. These outcomes were achieved because the directors took steps before the damage to the businesses was irreversible.

The businesses of the other three companies could not be saved and had to be closed permanently.

As shown in the table below, the factors contributing to the companies' failures varied. The most common reason was the general economy, followed by poor financial controls and strategy / choice of niche.

Company	A	B	C	D	E	F
Sold as going concern, employees transferrred	✓	✓	×	✓	×	×
Traded on	✓	✓	×	×	×	×
Reasons for failure						
General economy	✓	–	✓	✓	✓	✓
Shareholder dispute	✓	–	–	–	–	–
Landlord dispute	–	–	–	–	✓	–
Poor financial controls	–	✓	✓	–	✓	✓
Employee issues	–	✓	–	–	–	–
Poor location	–	–	–	–	✓	✓
Strategy / choice of niche	✓	–	–	✓	✓	✓

Our guidance...

Currently a difficult sector to operate in.

If you are considering starting a restaurant, café or food service business in Western Australia, give careful thought to the statistics in this report. At the outset, the odds of succeeding are not currently in your favour. Queensland is also a difficult economic environment, but better than WA. New South Wales and Victoria hold greater promise.

For those with existing businesses or who are intent on establishing one, our guidance is as follows. First, to survive and succeed in this environment, businesses must be able to react quickly as conditions change. This requires access to accurate, real time data. Point of sale systems should provide daily sales breakdowns by revenue category with unexpected or adverse trends investigated immediately.

Second, find your niche and tell the world about it. Setting your business apart from your competitors will help achieve a sales mix between online ordering and dining in, such that online ordering will be additional and not replacement revenue. Whilst determining the right strategy involving brand, furnishings, marketing, social media and menu may not be easy, getting the combination even partially right will still help attract new customers and encourage loyalty.

Third, customer service above all. Whether it's the quality of the meal delivered or treatment by the waiting staff, providing your customers with a positive experience has never been more important. Actively monitor the online ratings for your business and respond quickly to negative feedback. Even if the grievance cannot be remedied, a constructive response will show your audience that you care.

Fourth, monitoring online reviews goes hand in hand with social media. Surveys indicate that Gen Y or Millennials (birth years between 1981 and 1996) and Gen Z customers prefer to interact with businesses via social media in the first instance. Instagram, your website, Facebook: these are now the sources of the first impression a potential customer will receive when considering whether to give you their business.

Last but not least, if the current branding strategy is working, don't take it for granted. Recognise the need to reinvigorate your business and attend to this before the décor starts showing its age. A budget for periodic capital expenditures should not be overlooked and should also include a component for technology.

Sources include Avior analysis of the following:

Australian Bureau of Statistics, Catalogue 5206.0 - Australian National Accounts: National Income, Expenditure and Product - Table 26, 27, 28, 29, 30, 31, 32 and 33.

Australian Bureau of Statistics, Catalogue 5220.0 - Australian National Accounts: State Accounts - Table 12, 13, 14 and 16.

Australian Bureau of Statistics, Catalogue 6345.0 - Wage Price Index, Australia – Table 3b.

Australian Bureau of Statistics, Catalogue 6401.0 – Consumer Price Index, Australia – Table 11.

Australian Securities & Investments Commission, Series 1A – Companies entering external administration by industry, July 2013 – June 2019.

Liquor licensing information requested from the Victorian Commission for Gambling and Liquor Regulation, Queensland's Office of Liquor and Gaming Regulation and Western Australia's Department of Local Government, Sport and Cultural Industries.

Michael C.G. Davidson, Nils Timo, Ying Wang (2010). How much does labour turnover cost? International Journal of Contemporary Hospitality Management, 22(4), 451-466.

Property Observer, 2019, Westpac mortgage delinquencies hit two decade high. Available from: propertyobserver.com.au.

2019 quarterly financial update released by National Australia Bank Limited and Australia and New Zealand Banking Group.

2019 results presentation released by The Commonwealth Bank of Australia.

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