

# Hospitality & Leisure Services Review

March 2008

## Summary

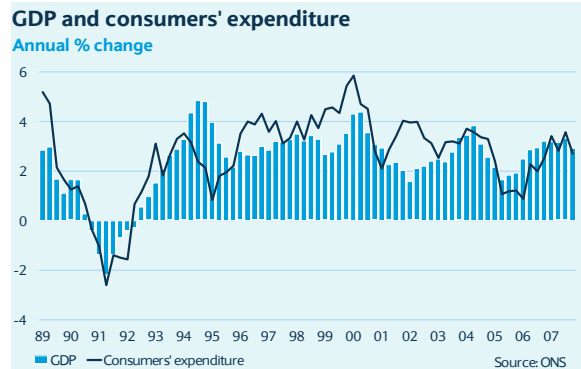
- Growth in consumer spending, a key driver of the hospitality and leisure industry, accelerated steadily during 2006-07, having significantly slowed during 2005.
- The continued increase in overseas visitor numbers has also provided a boost to the hospitality and leisure industries during most of this period.
- However, quarterly data show that visitor numbers weakened during the latter part of 2007, with growth in consumers' expenditure also slowing in the final quarter, at least partly reflecting growing uncertainties arising from the credit squeeze.
- These trends are expected to continue during the first half of 2008, with growth in both consumer spending and the wider UK economy set to slow to rates at least similar to those seen in 2005.
- At the same time, a US-led slowdown in the global economy is likely to impact on overseas visitor numbers (and associated expenditure), which are expected to be fairly flat during 2008.
- London's hotels were once again among the main growth drivers of the hospitality sector last year, with key performance indicators close to their previous 'Millennium peak' in real terms in 2007. However, growth is likely to be more subdued in 2008.
- In contrast to 2006, when turnover was boosted by the World Cup, a hot summer and more flexible opening hours, pubs experienced more difficult trading conditions last year as a result of poor weather, the implementation of the smoking ban and a lack of major sporting events.
- Combined with subdued consumer spending growth, restrictions on drinks promotions and the rapid build-up of capacity in recent years, this could result in a period of consolidation.
- Growth in activity in the highly diverse and fragmented leisure industry has been relatively robust over the past couple of years, although consumer spending on leisure services has slowed. As a result, increased activity may be yielding much slimmer profits for many operators.
- Health clubs appear to have benefited from improved consumer spending over the past year. However, while longer-term shifts in favour of healthier lifestyles will continue to support the sector, it is not immune to short-term cyclical changes in consumer spending.
- Professional sports are likely to continue to experience mixed performances, but for the most popular (especially football) lucrative broadcasting deals are likely to underpin growth in turnover. However, this is likely to be offset by rising wages and the benefits are likely to be highly concentrated amongst the elite clubs.
- The dilution of the government's original plans to liberalise gambling regulations means that the Gambling Act is likely to have a more limited impact, especially when the impact of the smoking ban, recent tax changes and the anticipated consumer slowdown are taken into account. Indeed for some firms, notably bingo operators, the outlook appears rather bleak (at least in the short term).

## Overview

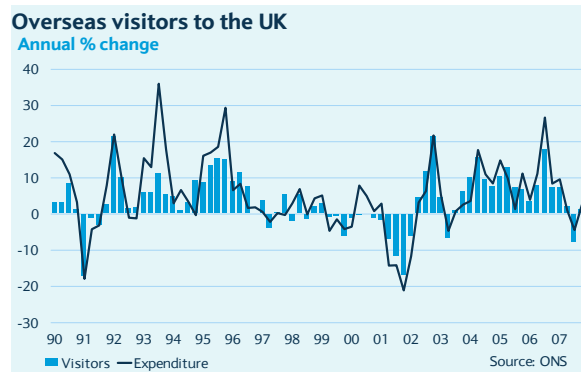
The UK achieved economic growth of 3.1% during 2007. Although GDP growth slowed to 2.9% in the final quarter of the year, in response to the turmoil in credit and financial markets, it remained above the long-term trend rate of 2.5%.

Investment (particularly business investment) was the main growth driver during 2007, but last year's robust growth also reflected the continued recovery of growth in consumers' expenditure, following the marked slowdown that occurred in 2005. Consumers' expenditure, which is a key driver of the hospitality and leisure industry, grew by 3.1% in 2007 as a whole, with consumers

proving resilient to the impact of the five interest rate rises implemented between August 2006 and July 2007 on their discretionary spending power, as well as to pressure on real disposable incomes.

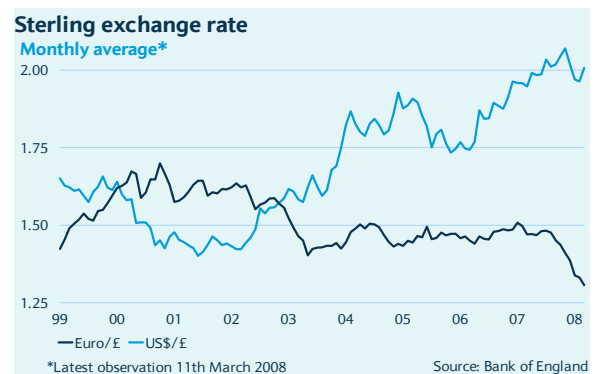


However, quarterly data reveal that, having reached a peak of 3.6% during the third quarter of 2007, growth in consumers' expenditure slowed to 2.7% in the final quarter, as uncertainties arising from the credit market turmoil, allied to a slowing housing market, weaker financial market performance, signs of credit tightening, greater economic uncertainty and declining consumer confidence affected both the willingness and ability of consumers to spend.



Overseas demand is also a key driver of growth in the hospitality and leisure industry. Assisted by the strongest global economic growth rates in three decades (according to IMF estimates) and robust activity in the City of London, foreign visitor numbers (and associated spending) have experienced relatively strong growth for much of the past five years (brief dips related to international tensions and the terrorist attacks in London in 2005 notwithstanding). Last year, a record 32.9 million overseas visitors arrived in the UK.

However, this represented growth of just 0.5%, which compares with average growth of around 10% in each of the previous three years. In nominal terms, related expenditure also slowed from an average of 11.4% during 2004-06 to just 2% last year. This was below the headline rate of inflation. Slower growth was largely concentrated in the latter part of the year and was fairly evenly spread between leisure and business travel. Visits to friends and relatives, which had grown rapidly since 2002, also declined sharply in the third quarter of the year (the latest period for which data are available).



On a regional basis, growth was driven by visitor numbers from Europe during 2007. This is due, in part, to the fact that Europe as a whole accounts for around 70% of overseas visitors to the UK. However, it also reflects another year of relatively healthy growth in the eurozone and, in the latter part of the year, the strengthening of the euro against sterling. Intense competition in the European budget air travel market also provided a degree of protection from last year's sharp rise in oil prices (and resultant increase in fuel surcharges) for short haul European travellers. Nevertheless, European visitor numbers increased by just 1.9% last year, compared to 8.4% in 2006. The slowdown in growth was largely the result of a dip in visitor numbers from this region in the middle of the year, with growth recovering to 5% by the final quarter of 2007.

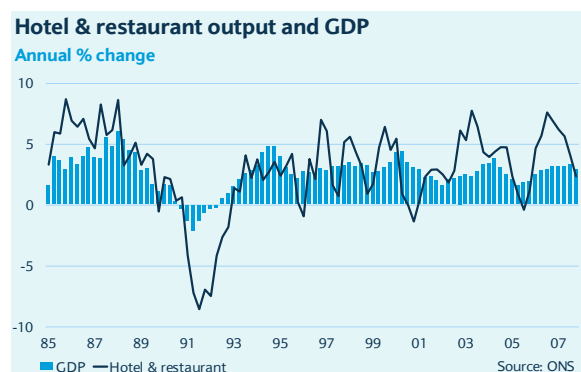
Over the year as a whole, there was a clear east-west split in European visitor trends. Visitor numbers from the 12 European Union (EU) accession states (mainly former Eastern Bloc countries) increased by 9%, reflecting further strong growth in, and continued in-migration from, this region. This compared to an increase of just 1% in visitor numbers from the western European 'EU15' states. Nevertheless, while still robust, growth in inward visitor numbers from

the 12 accession states has slowed markedly from an average of around 50% in both 2004 and 2005 (immediately after the first wave of accession).

In contrast, North American visitor numbers declined by 6% last year, following growth of 12.5% in 2006. This reflected the marked depreciation of the dollar against sterling during the last couple of years, as well as rising fuel costs and economic uncertainties in the US, particularly in the wake of the on-going credit crunch in the second half of the year, when North American visitor numbers declined by 9% compared to the second half of 2006.

Growth in visitor numbers from 'other' regions slowed to just 0.4% in 2007 from 9.6% in 2006. These regions contain a number of fast-growing emerging market economies and although rising fuel surcharges, tighter travel restrictions and the fact that many of these economies have currencies that are tied (either formally or informally) to the US dollar may account for slower growth in visitor numbers, the fact that the slowdown was concentrated in the second half of the year (when visitor numbers from these regions declined by 3.8% year on year) suggests that the impact of credit and financial market developments may have been a more important factor.

### Hospitality Overview

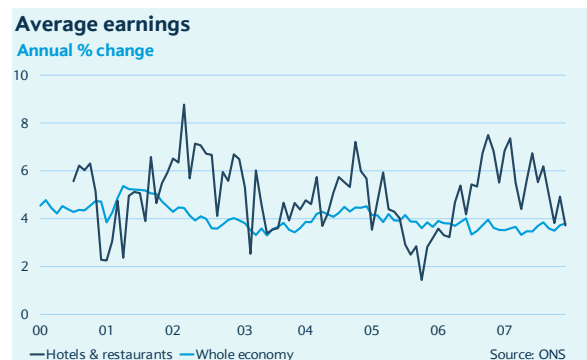


Having achieved its fastest rate of growth (6.2%) for 20 years in 2006, growth in the hotel and restaurant sector, which includes pubs, slowed during 2007. Although it remained relatively robust at 4.5% during 2007 as a whole, quarterly data reveal that growth in the sector slowed to 2.4% by the final quarter of the year.

Decelerating growth in the hospitality sector reflects a number of factors including:

- Slower growth in visitor numbers;
- Relatively weak growth in domestic consumer spending on hospitality services, despite stronger growth in general consumer spending (see below);
- Poor summer weather;
- The impact of the smoking ban on pubs;
- The lack of major sporting events in 2007.

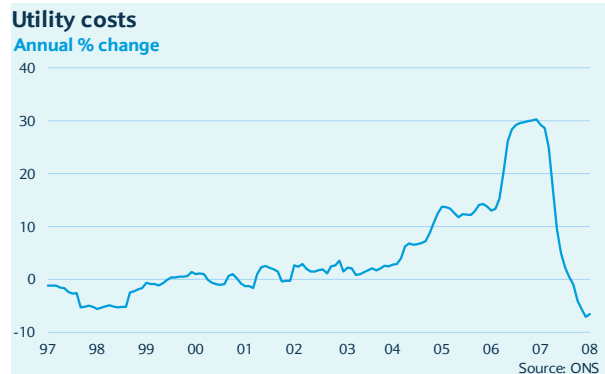
Cost pressures also persisted in 2007, although they began to ease during the latter part of the year. Robust activity in the sector in recent years has resulted in strong demand for labour in both temporary and permanent positions. As a result, labour cost pressures for many operators have been relatively strong, despite the dampening effect of the continued inflow of low cost migrant labour. At 5.4%, average earnings in the hospitality industry continued to increase at a faster rate than for the economy as a whole (3.6%) during 2007.



However, monthly data suggest that the gap closed at the end of the year, as wage growth in the hospitality industry slowed. Wage pressures were further eased when the minimum wage was increased by just 3.2% in October 2007 (compared to an increase of 5.9% in October 2006).

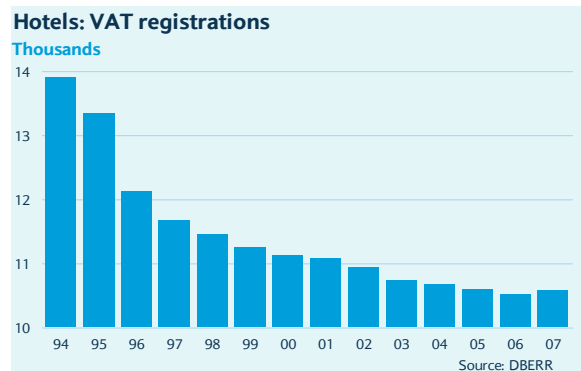
Similarly, although utility costs rose by 7.2% during 2007, this represented a significant slowdown, following a 24.7% increase in 2006. Monthly data also reveal that, having peaked at around 30% at the end of 2006, the rate of annual utility price inflation fell during 2007 and actually began to decline from September. However, while the annual rate of utility price inflation remains negative, recent

announcements by energy suppliers suggest that costs are likely to accelerate quite rapidly once again.



Many operators in the hospitality sector will have felt the impact of rising food and agricultural commodity prices over the past year. Food prices increased by 4.5% during 2007 as a whole, rising to around 6% by the beginning of 2008. Higher agricultural commodity prices are also putting upward pressure on beer and other alcoholic drink prices. This in turn raises cost pressures and squeezes margins (to varying degrees) across the hospitality sector.

## Hotels

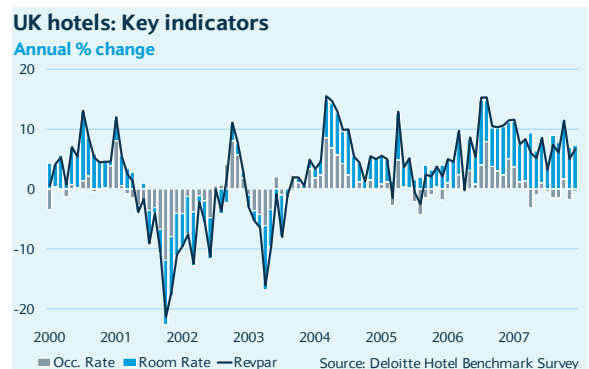


According to the Department for Business, Enterprise and Regulatory Reform (DBERR), the number of VAT-registered hotel businesses in the UK increased by 0.5% in 2006-07. Although small, this marked the first increase in over a decade of consolidation, during which the stock of VAT-registered businesses steadily fell from just under 14,000 in 1994 (the earliest period for which comparable data are available) to 10,590 at the beginning of 2007. This reflects the relative decline of small hotels in the face of rapid growth in the number of budget hotels owned by large chains in recent years, as well as the longer-term decline in the popularity of many traditional UK

coastal resorts. Nevertheless, in terms of overall capacity, industry estimates suggest that the number of hotel rooms in the UK continues to rise.

The hotel industry has benefited from relatively strong growth in the number of overseas visitors to the UK in recent years (see above). This is particularly true of London hotels, with the capital typically host to just under one-half of all foreign visitors.

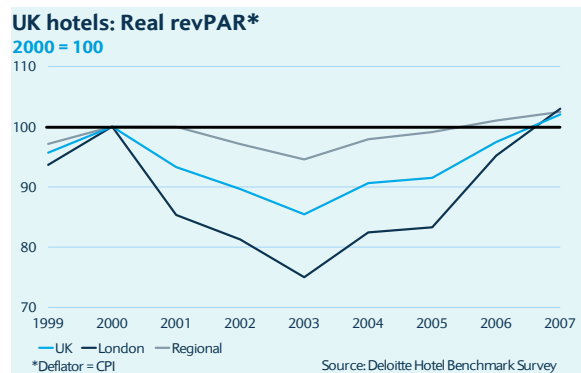
However, this has been offset to a degree by trends in the domestic tourism industry. According to the UK Tourism Survey, the number of domestic visitors continued its longer-term decline last year, with low-cost air travel, cheaper alternative overseas destinations and the UK's unreliable weather continuing to drive UK citizens abroad. The latest survey data reveal that UK residents undertook a total of 104.3 million overnight trips in the UK between January and October 2007, which represents a fall of 1% from the same period in 2006. However, this compares favourably with the fall of 4.2% in domestic visitor trips during the whole of 2006. The value of domestic overnight trips increased at an annual rate of 2% to £18.2bn during the first 10 months of 2007. While this was just below the headline rate of inflation (and therefore slightly negative in real terms), it nevertheless marked an improvement on the 2.3% fall in domestic tourist expenditure in 2006.



UK hotels achieved another year of strong growth in 2007, following rapid growth in 2006. Over the year as a whole, revenue per available room (revPAR) increased by 7.1% in nominal terms, according Deloitte's Hotel Benchmark survey. While this was slower than the 9% revPAR growth achieved in 2006, it should be noted that last year's growth was achieved solely by growth

in room rates, unlike the 'twin engine' (room rate and occupancy) revPAR growth achieved in 2006. At 75.2%, occupancy rates in the UK's hotels were already above their previous 'Millennium peak' during 2006. This left little scope for further growth in occupancy rates, which remained essentially unchanged at 75.1% last year.

Current trends in the national data essentially mirror developments in the London market, where a 10.9% increase in room rates offset a slight decline in occupancy (which nevertheless averaged 82.9% last year), resulting in revPAR growth of 10.7%. The capital's hotels have benefited from rapid growth in recent years. Nevertheless, in real terms, room rates and revPAR have only just returned to the peak levels recorded at the millennium peak following a prolonged downturn at the beginning of the decade.

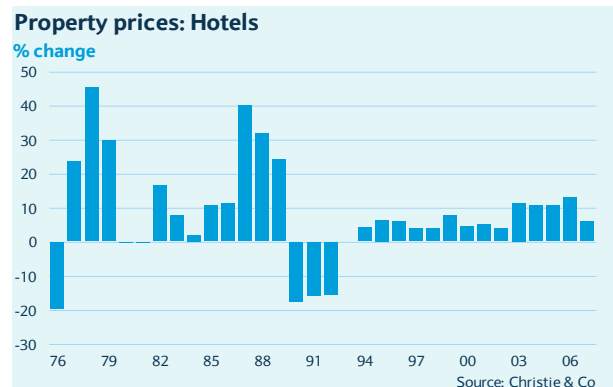


With almost 50% of overseas visitors to the UK bound for the capital, the London market is more exposed to international travel than the regional market and tends to experience greater cyclical swings. This frequently results in periods where the hotel market as a whole becomes polarised between London and the regions (as has been the case in recent years).

Although occupancy, room rates and revPAR have also reached record levels in the UK's regional hotels in recent years, growth has been more subdued than in the capital. Reflecting the national trend, a 4% increase in the average regional room rate offset a slight decline in occupancy, which saw revPAR rise by 3.8%. Performance has nevertheless differed markedly between regions. According to PKF, hotels in Aberdeen and Glasgow achieved double-digit growth in revPAR once again last year, with the economy of (and inbound travel to) the former

boosted by strong growth in oil prices. Birmingham, Northampton, Nottingham, Southampton and Swindon also achieved growth significantly above the headline regional average. However, Reading recorded a marked decline (7%), while Bristol and Liverpool also saw revPAR fall by around 1%.

A number of large hotel groups have adopted new business models in recent years, including 'opco-propco', sale-and-leaseback and management servicing models. This shift has been supported by increasing interest in hotel property acquisitions (both in the UK and globally) from private equity houses, real estate investment trusts and property funds and companies, as well as high net worth individuals.

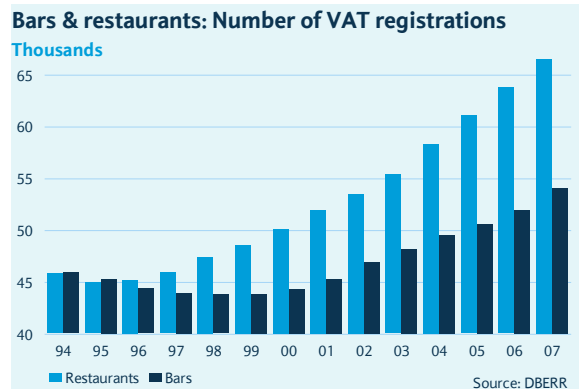


Relatively strong investor demand has been reflected in rising capital values in recent years, with the London market particularly strong. Although growth remained significantly below the rates recorded during the late 1980s, hotel valuations are estimated to have increased at double-digit rates between 2003 and 2006, marking the fastest period of growth since then. According to PKF, the hotel and leisure sector was a steady driver of UK M&A activity in the first half of 2007 and showed some resilience following the turmoil in the financial markets last summer.

However, even before the onset of the credit crunch, there was concern about the high loan-to-value ratios (LTVs) involved in a number of hotel acquisitions and, as a result, the sustainability of the rapid growth in valuations, particularly as the wider commercial property sector began to slow. Since the middle of last year commercial property prices have fallen by around 12% on average. Although the available (largely anecdotal) evidence suggests that, the

hotel sector has held up reasonably well so far, the latest Christies data show that, during 2007 as a whole, growth in hotel valuations more than halved to 6.1% from 13.1% in 2006. Given trends in the wider commercial property market (as well as the credit and financial markets), the full-year figure is likely to mask a somewhat lower rate of growth in the latter part of 2007.

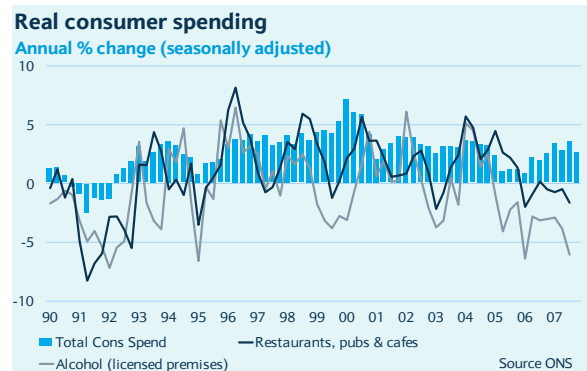
## Restaurants and the Licensed Trade



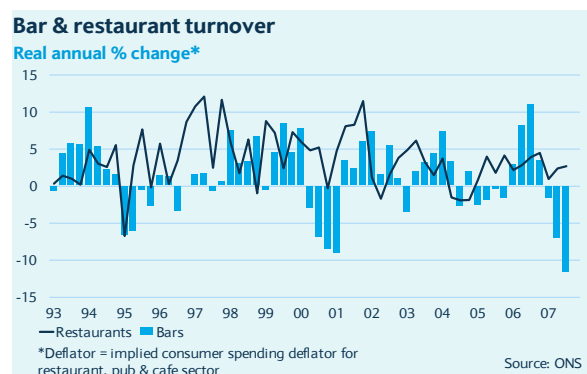
A decade of relatively strong consumer spending, numerous urban regeneration programmes, the withdrawal of many leading retailers from town centres to out-of-town locations and the resultant willingness of many local authorities to fill vacant retail and other commercial space with cafés, restaurants and bars, has seen a significant build-up in capacity in both the restaurant sector and licensed trade in recent years. There were 54,080 VAT-registered bar businesses in the UK at the beginning of 2007, compared to around 44,000 in 2000. In the restaurant sector, the number of VAT registrations has grown by 45%, to 66,560, during the last 10 years. Churn rates have also been relatively high, reflecting relatively low entry and exit barriers in both sectors. This can lead to a build-up of excess capacity in favourable conditions, resulting in periods of consolidation when conditions deteriorate.

In contrast to consumer spending as a whole, official data show that consumer spending in restaurants, pubs and cafés has either stagnated or declined in real terms during 2006-07. The decline is largely due to spending on alcohol in restaurants and pubs, which declined at an even faster pace – a trend which clearly has a greater impact on pubs (particularly ‘wet-led’ pubs) than on restaurants. The decline in spending on alcohol on licensed premises in part reflects a longer term trend towards drinking at home,

which in turn has been driven (at least in part) by intense competition from retailers, which have been able to provide significant discounts on alcohol sales.



Recent trends in consumer spending are reflected in the respective turnover growth rates of the restaurant and bar sectors. Having benefited from the World Cup, a hot summer and more flexible opening hours in 2006, pubs experienced more difficult trading conditions last year as a result of poor weather, the implementation of the smoking ban and a lack of major sporting events. As a result, having increased by 6.4% in 2006 (the fastest rate of growth in over a decade), turnover growth declined by an average of 6.9% in the first three quarters of the year, adjusted for price inflation within the restaurant, pub and café segment. The third quarter saw a particularly sharp decline (11.7%), although available nominal turnover data suggest that the rate of decline, while still strong, may have decelerated in the final quarter.

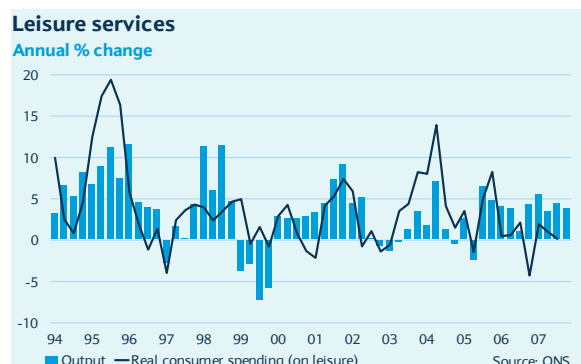


Measured on the same basis, restaurants fared somewhat better. However, inflation-adjusted turnover growth in this sector also slowed from 3.4% in 2006 to 2% in the first three quarters of the year. The available nominal turnover data suggest a further weakening in the fourth quarter of 2007.

More flexible opening hours resulting from licensing reforms implemented in November 2005, and pressures arising from slower alcoholic drink sales, have seen a number of pub operators widen their food and non-alcoholic beverage offering to include, for example, breakfasts and morning coffee. This has not only marked a blurring of the dividing line between pubs and restaurants, but has also helped offset weaker consumer spending on alcohol in overall bar turnover.

However, anecdotal evidence from some large pub groups suggest that more flexible opening hours have had little impact on profits due to the increased costs associated with longer opening hours – especially in the increasingly competitive ‘late night’ market. For nightclubs, which were once the mainstay of the late night market, the impact appears to have been greater, with competition increasing as pubs and bars stay open longer.

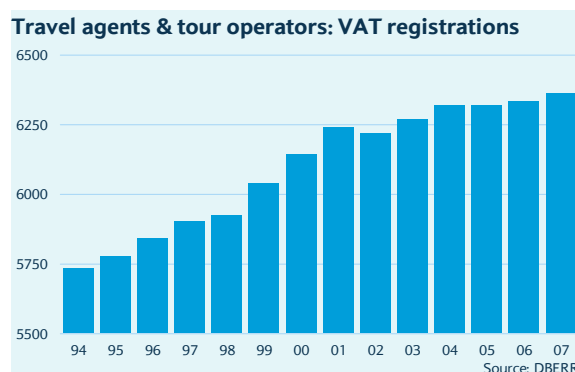
### Leisure Overview



The leisure services industry is highly fragmented and consists of a number of very diverse activities, ranging from state-funded leisure facilities to individual artists and performers. However, overall demand is strongly influenced by consumers’ discretionary expenditure and therefore tends to be cyclical and subject to changing consumer tastes. Like the hospitality sector, entry barriers are low for smaller leisure operators. This can result in a build-up of excess capacity in favourable conditions in some sub-sectors, leading to periodic shakeouts when conditions deteriorate. Some sub-sectors (such as theme parks) are also highly seasonal, while others are relatively low margin.

Despite relatively weak spending on leisure services during 2006-07, output growth in the leisure sector has been faster than that of the wider economy in the last two years, accelerating to 4.3% in 2007 from 3.3% in 2006. This apparent anomaly may be resolved by subsequent data revisions. However, it may reflect the fact that many activities in this sector are essentially ‘non-exclusive’ in their consumption and so, to a certain extent, will take place regardless of how many people watch or participate (for example a play may be performed regardless of whether it is to a full or empty theatre). However, if this is the case, profit margins are likely to have suffered as a result.

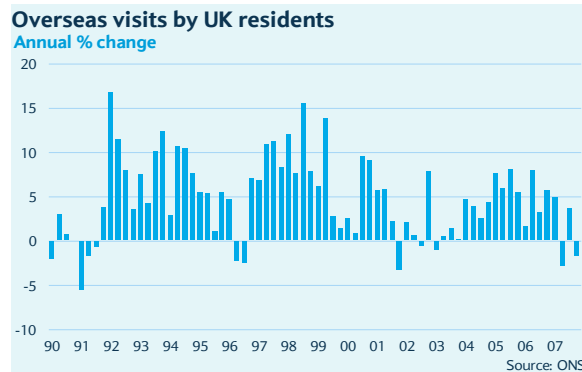
### Travel Agencies & Tour Operators



Growth in the number of VAT-registered travel agencies slowed during the early part of the current decade, relative to the late 1990s, according to DBERR data. Structural shifts, including rapid growth in low cost air travel, growing consumer preference for specialist holidays and a move towards lower-cost, direct, online bookings, (many of which take place on a ‘last minute’ basis) have challenged the traditional travel agency business model. However, while this represents increased pressure on traditional travel agencies and tour operators, developments such as ‘self-assembly’ packages suggest that more innovative operators (and smaller niche providers) have been able to adapt their business models to changing trends.

Although incoming tourists also generate demand for their services, domestic demand for foreign travel is the key driver of growth for UK travel agencies and tour operators. UK residents made a record 70.1 million trips abroad during 2007. However, this meant that the rate of growth in outward travel from the UK slowed to just 0.9% from 4.7% in 2006. This was the

weakest rate of full-year growth in outward travel from the UK since the recession of the early 1990s and likely reflects the impact of increased air passenger duty and fuel costs on air fares, as well as additional security measures at UK airports.

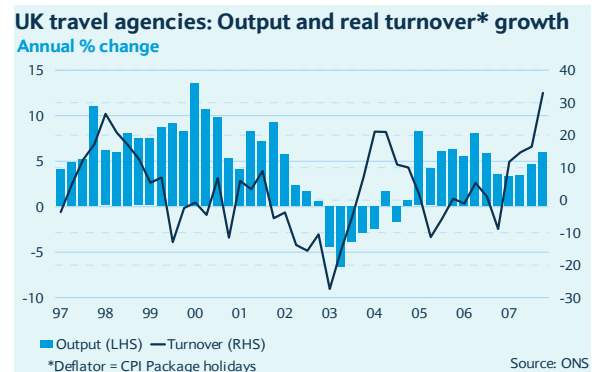


Reflecting the longer-term shift in consumer preference in favour of travel to 'new' and more exotic destinations, growth was driven by travel to the EU accession states (2.6%), non-EU European destinations (4.8%) and 'other' regions (7.4%), with the latter assisted by the weakening dollar, to which many non-European emerging market currencies are tied. Despite the weaker dollar, visits to North America declined once again (by 1.5%, following a 3.4% decline in 2006). Visits to 'EU15' countries, which together account for around two-thirds of overseas travel from the UK (down from around three-quarters earlier in the decade), fell by 0.7%.

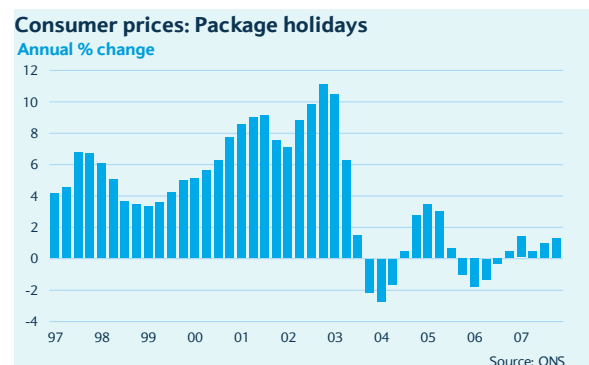
Annual growth in holiday travel, which accounts for the lion's share (around two-thirds) of overseas travel from the UK, slowed again last year, slipping to 1.5% in the first three quarters of 2007, compared to the same period the previous year, when growth of 2.6% was recorded. Business travel also slowed to 1.9% in the first three quarters of 2007 from 6.5% during the same period in 2006, while growth in the number of overseas visits to friends and relatives abroad (VFR) slowed to 5.6% from 10.5%.

Nevertheless, anecdotal evidence suggests that, in the holiday market at least, the slowdown in growth in overseas travel reflects a decline in the number of short overseas breaks taken by UK residents, rather than a decline in longer overseas holidays. As a large proportion of the former are booked direct over the internet, rather than being arranged through travel agents and tour

operators, the impact on the sector appears to have been limited. This may at least partly explain why, despite the slowdown in growth in overseas travel from the UK, growth in activity in the travel agency and tour operator sector remained relatively healthy (despite slowing from 5.8% to 4.3%). Turnover also increased by 19% (adjusted for inflation within the sector), boosted by strong growth in the final quarter of the year, according to official data, although this appears to be a little high and may be subject to revisions.



Despite last year's strong performance, there are signs that competitive pressures persist and that the structural changes referred to above continue to impact upon the sector. Although the cost of package holidays rose by 1.1% last year, having fallen by 0.8% in 2006, pricing power in the sector remains weak relative to the late 1990s and early years of the current decade.



At the same time, merger activity among some of the leading companies in the sector has resulted in significant capacity being removed from the market, as the new companies that have emerged have sought to limit the volume of holidays sold at discounted prices in the 'lates' market.

The sector also faces regulatory change in the near future. Under current government plans, the FSA, which already regulates stand-alone travel

insurance market, will become responsible for regulating Connected Travel Insurance (CTI), which is sold alongside holidays, from 1 January 2009. Once implemented, the plans (which are subject to an on-going consultation) will mean that travel firms must be authorised by the FSA to provide CTI, become representatives of another authorised firm, or cease to offer CTI products altogether. They may also become an unregulated introducer in certain limited circumstances. With an estimated 20 million consumers purchasing travel insurance in the UK annually, it is a significant source of income for travel agents. However, industry bodies have expressed concern that the planned changes will result in travel agents exiting the travel insurance market.

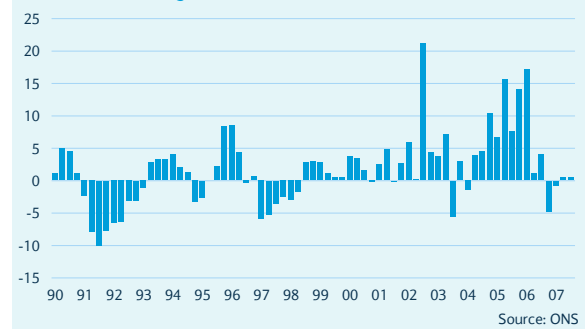
However, many operators may receive a boost from the Department for Transport's plans to reform the Air Travel Organisers Licensing (ATOL) bonding arrangements and replenish the Air Travel Trust Fund (ATTF). The ATOL bonding and ATTF scheme, which is operated by the Civil Aviation Authority (CAA), was introduced in 1971 to ensure that, in the event of a tour operator becoming insolvent, consumers already abroad could complete their holidays and be repatriated to the UK, while those who had paid for their holidays, but had not yet departed, received a full refund. Under the new plans, which will be implemented from 1 April 2008, tour operators will no longer be required to post ATOL bonds, but will instead levy a £1 ATOL Protection Contribution (APC) on holidays protected by the Air Tour Operators Licence. Operators are expected to benefit from a significant reduction in costs as a result of the new scheme. It will also help to create a more level playing field, as the old scheme afforded many non-ATOL regulated holiday companies and low-cost airlines an unfair price advantage.

### Sport, Health & Fitness

In contrast to the general pattern of consumer spending, household spending on recreational and sporting services was flat in real terms during the first three quarters of 2007, compared to the same period the previous year. However, growth has at least resumed following a marked decline at the end of 2006.

### Consumer spending: Recreation & sporting services

Real annual % change



The sports, health and fitness sector is highly diverse, with activities ranging from international professional sports to more localised amateur activity undertaken in a range of publicly and privately run facilities. This is reflected in the variable performance of individual sub-sectors.

The professional sports segment consists of a diverse range of activities, with performance generally reflecting their respective popularity and resultant ability to generate sponsorship, advertising, television coverage, live audiences and merchandising, as well as wider consumer spending.

According to the latest data compiled by Deloitte, English Premier League (EPL) clubs remain by far the biggest earners in world football, with six English clubs listed among the world's 20 wealthiest teams in 2006-07. EPL clubs are expected to make up half of the top 20 in 2007-08 as a result of lucrative new domestic, overseas internet and mobile phone broadcasting rights deals worth some £2.7 billion over the three seasons beginning in 2007-08. This will earn EPL clubs over £1 billion more than the previous three-year deals and is expected to see EPL revenues increase from an estimated £1.4 billion in 2006-07 to around £1.8 billion this season.

Partly as a result of the increased broadcasting fees and other revenues flowing into English football, EPL clubs in particular have attracted significant overseas investment interest in recent years, with reports suggesting that further takeover activity is likely. In addition to increasing transfer fees and wages, this has helped support a raft of stadia investment projects. Total stadium investment by English clubs increased to £233 million in 2005-06 (the latest period for which data are available). Of this, some £204 million was invested by Premier League clubs (of which

85% was accounted for by just two clubs). This represents the highest level of investment recorded since the EPL began.

However, stadium development has contributed to a sharp rise in aggregate net debt from £674 million at the end of the 2004-05 season to £1,035 million in 2005-06. As a result, the aggregate Premier League gearing ratio has risen from 134% in 2005 to 220% in 2006.

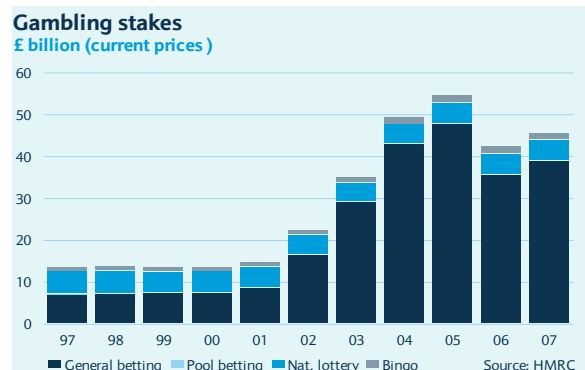
While lower-league clubs have emerged from the collapse of the ITV Digital deal in 2002, there remains a significant financial gulf between the elite clubs and those in the lower leagues. In 2005-06 the gap between the average Premier League and Championship clubs' revenue was a record £56m. This is expected to rise to around £70 million in 2007-08, according to Deloitte estimates, as the new EPL broadcasting deals come into effect. For clubs promoted to the Premier League, this means that the financial rewards are now greater than ever. However, the financial risks associated with relegation from the Premier League (and, to a lesser extent, from the second tier) are also set to increase.

According to the latest State of the UK Fitness Industry report, produced by the Leisure Database Company (LDC) and the Fitness Industry Association (FIA), the number of public and private fitness facilities in the UK increased by 232 in 2007 to 5,714 (an increase of 4.2%). Of these, 106 were public sector facilities. Like-for-like gym membership increased by 3%, supported by improved growth in consumer spending during 2006-07 and increased consumer awareness of health issues. This saw the sector as a whole generate revenues of £3.6 billion. Overall, gym membership in the UK totalled just over 7 million, which means that the proportion of the population with a gym membership has increased to 11.9%. Although methodological changes make a direct comparison difficult, this represents an increase or around two percentage points since the beginning of the decade.

However, reports also suggest that improvements to, and growth in the number of, public facilities are impacting on private sector operators. In addition to increased competition, this has led to a growing trend towards pay-per-visit fees. As a result, although subscription fees continue to

grow and to account for the lion's share of rising income, the growing proportion of irregular and unpredictable income streams may result in some operators feeling the impact of the anticipated consumer slowdown more quickly.

## Gambling

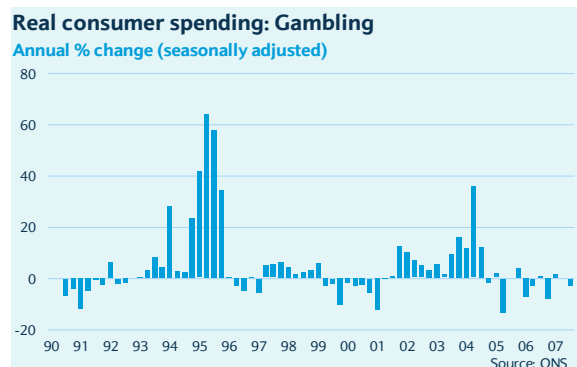


Provisional HM Revenue & Customs (HMRC) data show that gambling stakes rebounded by 7.5% in nominal terms last year to £45.5 billion. This followed a sharp fall of 22% in 2006. The turnaround was driven by a 9.8% increase in general betting, which had decreased by 25.8% the previous year. However, this was offset by the continued decline in pool betting and a 4% drop in national lottery sales, which had enjoyed something of a renaissance during the previous three years.

There was also a second successive decline in bingo stakes, with the rate of decline deepening from 1.4% to 5.2% reflecting a mixture of increased competition (notably from online operators), the implementation of the smoking ban and the imposition of restrictions on lucrative, high-jackpot, 'Section 21' gaming machines in bingo halls under the Gambling Act, which came into force last year (see below). Bingo operators also argue that the decline has been exacerbated, in terms of their overall profitability, by the fact that their activities are subject to both VAT and gaming duties, which they claim puts them at a competitive disadvantage against other forms of gambling. A number of bingo clubs have closed over the past year, with reports suggesting further consolidation lies ahead.

Retained revenues give a better indication of profitability, but also suggest that gambling is slowing. Following relatively strong growth in 2002-04, consumer spending on gambling,

(which is based on stakes net of winnings) declined in real terms in both 2005 and 2006. Data for the first three quarters of 2007 suggest that the decline continued last year, albeit at a much slower pace (1% or less) than in 2006, when a 4.6% fall was recorded. However, it should be noted that the recent fall in gambling may at least in part reflect a shift towards online gambling, which is still largely based in offshore tax havens and which may therefore not be adequately captured in the official data.



The 2005 Gambling Act, which was designed to modernise increasingly outdated UK gambling legislation, was fully implemented in September 2007. However, having initially stirred significant investment interest among large overseas gambling operators, the government's plans to liberalise the casino sector in particular have encountered significant difficulties. This has seen initial plans to allow the development of an unlimited number of large, 'super casinos' in the UK to be significantly scaled back before being abandoned altogether earlier this year. While the development of eight new 'second tier' and eight new, smaller 'third tier' casinos, has been approved (subject to new restrictions, including a requirement to close for six hours a day), reports of waning interest among the major operators has raised doubts over whether all of the new licences will be taken up.

While this represents a setback for the industry as a whole, it will help to alleviate concerns among incumbent casino operators that the new complexes, which will be larger than the 140 casinos currently in operation in the UK and which would benefit from greater operational freedom, would have an unfair competitive advantage over existing casinos.

Nevertheless, the casino sector's prospects have also been negatively impacted by the increase in

duty announced in the 2007 Budget. Casinos had previously had their winnings taxed on a sliding scale of between 2.5% and 40% depending on their size. However, the lowest rate has now been set at 15%, with large casinos now liable for a maximum 50% rate of duty.

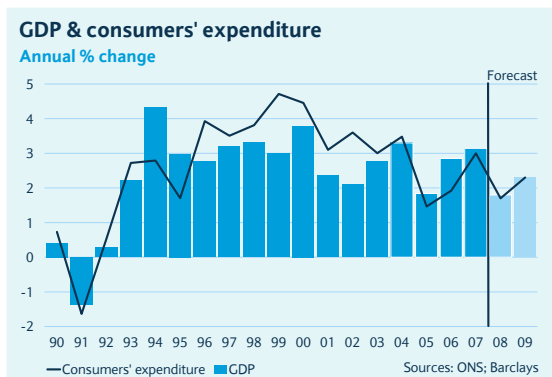
The government had also previously hoped that the full implementation of the Gambling Act would see the UK become the international hub of the fast-growing, but previously prohibited, online gaming market. However, the 15% level of duty which has since been applied to such operations is likely to act as a significant barrier to online gaming firms moving their operations to Britain from low-tax, or tax-free, jurisdictions.

The previously buoyant online sector has been hit by a number of setbacks in recent years – notably the enactment of the US Unlawful Internet Gambling Enforcement Act in September 2006. The Act prohibited financial institutions from processing online gaming payments originating from the US, which most estimates suggest accounted for around half of all global online gaming revenues. Uncertainty over the legality of online gambling activity in other regions (notably Europe) has also had a negative impact on the sector.

Following a period of consolidation, as operators closed their US businesses, recent results suggest that online gaming firms have begun to turn the corner. Nevertheless, while growth in Europe and Asia may help to offset losses arising from US restrictions in the longer term, it may prove insufficient to fully compensate for the long-term loss of US revenues if current US restrictions remain in place.

### Outlook

Consensus forecasts suggest that UK GDP growth will slow appreciably this year, falling below the 2.5% trend rate to 1.8%. The slowdown is expected to be led by weaker growth in consumers' expenditure, as pressures on household incomes persist and housing and financial markets slow amid the on-going credit squeeze. Although expected to hold up reasonably well, growth in business investment is also likely to slow somewhat.



The prevailing financial markets view suggests that the base rate could fall to 4.5% during 2008, although much will depend on the extent to which the Monetary Policy Committee (MPC) is constrained by potential inflationary pressures. However, as lenders remain cautious in the wake of the recent credit market turbulence, it remains to be seen to what extent base rate cuts will feed through to households and businesses.

The global economy faces a great deal of uncertainty in 2008. The IMF recently cut its forecast for global growth to 4.1% from an estimated 4.9% in 2007. This remains a reasonably healthy rate of growth, from a longer term perspective. However, the IMF also warned that, in the face of continued financial market turmoil, "risks to the outlook remain tilted to the downside." As a result, visitor numbers and associated expenditure are expected to remain relatively flat during 2008, especially if high oil prices continue to exert upward pressure on air fares.

Growth in the US is expected to be subdued, with many economists suggesting that the risk of a recession in 2008 has increased. US visitor numbers are therefore expected to continue falling. As they typically spend twice as much as their European counterparts, their loss will have a significant impact.

Although expected to slow, growth in the eurozone is likely to remain relatively healthy in 2008. At the same time, the strong euro means that visits to the UK will be increasingly affordable for Europeans. The opening of the Eurostar at St Pancras International, at the end of last year has also given European visitors a faster rail service to the UK, with immediate access to high speed domestic services to other parts of the UK. However, this is unlikely to be enough to boost

European visitor numbers significantly, and is unlikely to offset any loss of US visitors.

Emerging markets currently show no sign of significant slowdown. However, their reliance on income from exports means they are unlikely to be immune from a global slowdown. Oil prices also remain high and volatile and are likely to continue to impact on air fares (especially for long haul travellers) in the near term at least.

As regards cost pressures in the hospitality, although growth in utility prices slowed last year, they are set to accelerate once more. Suppliers have announced that households face a 15% increase in the cost of energy in 2008, and hotels, restaurants and bars are likely to see energy bills rise by a similar order. The 6% real increase in alcohol duty announced in the 2008 Budget will also add to costs for the hospitality industry. The Chancellor has also announced that duty will continue to rise by 2% above the rate of inflation each year until 2013.

However, wage pressures in the sector may well ease. The minimum wage rose by just 3.2% in October 2007 and is set to rise by 3.8% from October 2008, which is in line with current wage rises in the wider economy. At the same time, growth in demand from the hospitality industry for skilled workers looks unlikely to be sustained at recent levels.

This all suggests that the industry as a whole faces a more challenging environment in the year ahead. Although it should be noted that many operators, such as London's hoteliers, will do so from a position of strength, signs of stress are likely to appear in some sectors. The catering and licensed trade has seen a significant increase in capacity during the past decade. However, given the relatively low entry barriers facing new entrants, the sector is prone to a build-up of excess capacity in cyclical upturns. With consumer spending set to remain subdued and the full impact of the smoking ban still to be felt, some consolidation appears likely. 'Wet-led' pubs (especially those with little outdoor space to accommodate smokers) are likely to be under a greater threat of consolidation than those which generate a significant proportion of income from their food offering. Nightclubs are also likely to continue to be impacted by a combination of the

smoking ban and increased competition from pubs and bars.

Similarly, although the health and fitness sector will continue to benefit from a longer term shift towards healthier lifestyles and government initiatives to tackle health issues, it remains subject to short-term, cyclical, variations in consumer spending.

Although the Gambling Act will bring some beneficial effects, there is currently a high degree of uncertainty about the future of those sectors that originally appeared set to benefit most from the liberalisation of the industry. While the government has not completely abandoned its plans for the casino sector, it is clear that the degree of liberalisation originally envisaged will not now be realised. Allied to the increase in the duty levied on casinos, new restrictions on opening hours and the impact of the smoking ban, this will act as a deterrent to potential investors, a number of whom have already announced that they no longer intend to compete for new casino licences.

The rate of tax imposed on online gambling is also likely to act as a deterrent to establishing onshore UK operations, especially as many of the key firms in the sector are still feeling the impact of regulatory changes in the US.

However, within the gambling sector, bingo operators appear to face the most challenging conditions, with the consumer slowdown likely to exacerbate the continued impact of the smoking ban, the loss of lucrative gaming machines and growing competitive pressure from other forms of gambling (and alternative leisure pursuits), especially as bingo operators failed to secure the tax relief in the recent Budget that they had been lobbying for.

The hospitality and leisure industry as a whole should receive a boost from the London Olympics. While the games themselves will not take place until 2012, the industry should benefit from investment in transport and other infrastructure in the build-up to the games. Although much of the planned investment in London's infrastructure had already been committed independently of the Games, the Olympics should at least ensure that these

investments projects are operational by 2012. They should also result in additional investment.

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All data and factual information referred to in this report were correct as of 12 March 2008  
Source of ONS data: National Statistics website:  
[www.statistics.gov.uk](http://www.statistics.gov.uk)  
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