

LEVEL 3 ASSESSMENT SPECIFICATION

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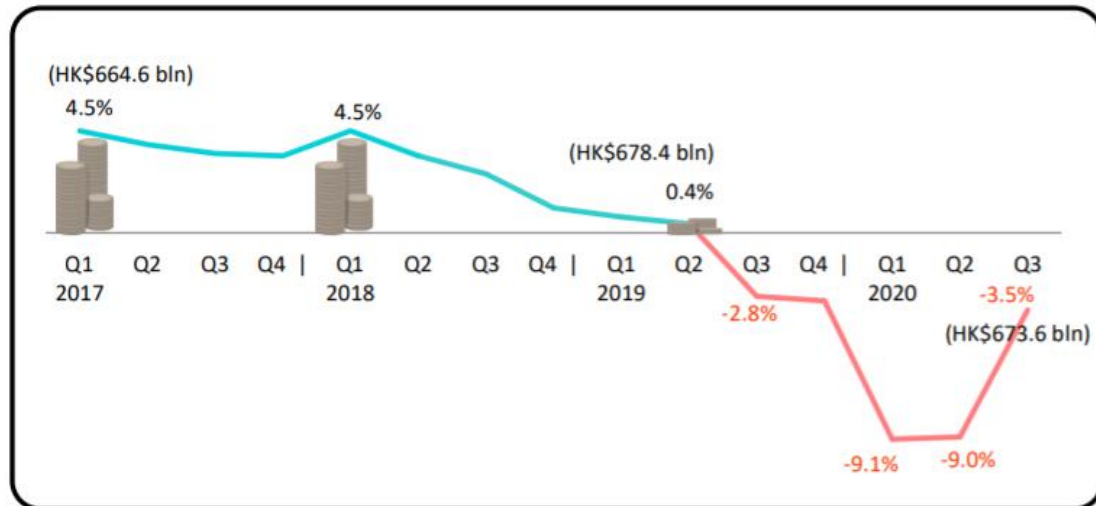
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1 Introduction

In this report, the objective is to evaluate the impact on the tourism industry in Hong Kong since the COVID-19 outbreak. The report would focus on the Hotel sector under the industry to find out what challenges and changes the pandemic situation has brought to the industry. It would also illustrate what strategies and solutions were adopted to engage with those challenges by studying The Hong Kong and Shanghai Hotels, Limited in depth. After the analysis of the case, some recommendations would be also provided.

1.1 Research Motivation

The outbreak of COVID-19 since early 2020 has brought extreme challenges to almost everywhere in the world. Just within one year (2020), this disease caused over 66 million infection cases and over 1.5 million deaths in the whole world. In Hong Kong, there were over 7,000 infection cases and over 110 deaths just in one world. The figures jumped to almost 20,000 infection cases and 224 deaths in mid of February 2022. The crisis incurred by public health problem smashed the economy of Hong Kong. Three rounds of relief measures were rolled out by Hong Kong Government involving up to HKD192 billion to save the economy. The emergence of COVID-19 has hit hard on Hong Kong's economy that the quarterly GDP dropped dramatically record-high of around 9% in first two quarters in 2020.



Source: Census and Statistics Department (2020a).

Among the four pillar industries including Financial services, Trading and Logistics and Professional services and other producer services, Tourism services is the industry with biggest impact. The cross-boundary restrictions were in places globally that brought the travelling activities no matter inbound or outbound to a standstill. In second quarter of 2020, business receipts index for “tourism, convention and exhibition services” have plummeted by 95% reflected the disastrous impact on the tourism industry. Under the pandemic situation, the overall unemployment in different industries had risen to 6.6% in third and forth quarter in 2020 while the average unemployment rate for 2010 to 2019 was around 3.3% only.

Hong Kong was the leading tourist city in the world with 29 million overnight visitors and 65 million total arrival in 2018. For last two decades, visitors from mainland China contributed significantly for the financial revenue of tourism sector in Hong Kong. Chinese visitors reached more than 75 percent of total arrivals in recent years and, comparatively, they spend more money during their stay in Hong Kong, the tourism industry, particular hotel sector, is heavily dependent on the revenue brought by mainland visitors. This trend of growth supported the number of hotels in Hong Kong increased almost 100% during 2010 and 2020 and total number of rooms raised over 40 percent. In the middle of 2021, the annual visitor arrivals in Hong Kong dropped dramatically to less than 100 thousand. The average hotel occupancy rate rose to 63% which had already rebounded fairly from the collapse in early 2020 with

the “holiday at home” or “Staycation” concept introduced by Hong Kong Government and Hotel industry. However, considering wave by wave of the pandemic, the hope of lifting travel restrictions, no matter with the mainland or the rest of the world, looks distant. Moreover, the subsidies from local consumers’ staycation spending seems fading after a bloom for over a year and the spread of fifth wave of COVID pandemic.

The case study of this report, The Hong Kong and Shanghai Hotel, Limited (HSH) is one of major market participants in Hotel sector who did not envisage the impact of the COVID-19 coronavirus would be so severe, prolonged and widespread. Though the severe impact of the pandemic across different portfolio of HSH’s global assets, it is extremely heavy on the hotel and tourism-related segments. Since March 2020, They shut down their hotels in New York, Chicago, Paris, Tokyo, Bangkok and Bangkok temporarily and reopened gradually from June 2020 to March 2021. In Hong Kong, which is the major contributor of earnings to the group, they have to implement a wide range of cost cut and financial management measures, including reduction of salary costs, inventory and other expenses urgently.

1.2 Research Framework

To analyse how this COVID-19 pandemic impacted or changed this company, this report will look into the financial reports for last couple of years and what strategies and measures were implemented by the group to deal with the current and foreseeable future external difficulties.

2 Company background

In this section, will take a deep dive on The Hong Kong and Shanghai Hotel, Limited from its history, market position, cost and revenue structure so a more comprehensive evaluation and recommendations could be drawn out.

2.1 Company Profile

The Hong Kong and Shanghai Hotel, Limited was incorporated on 2 Mar 1866 as The HongKong Hotel Company, Limited. HSH was among the first enterprises to be listed on Hong Kong Stock Exchange and one of the oldest hotel companies in the world. For over 150 years, Hong Kong has always been the headquarter of the group even the business has developed to different continents of the world. Currently, the HSH group owns a diverse portfolio of assets worth HKD45 billion including 10 Peninsula Hotels all over the the world, The Peak Tram, The Peak Tower and The Repulse Bay Complex in Hong Kong. As of 18 Feb 2022, The market capitalization of HSH is HKD15,273 million

2.2 The Cost Structure

As an international hotel group, the operating costs of HSH are mainly from inventories, staff costs and related expenses, rent, other operating expenses, depreciation and financing or interest expenses. The following is a brief breakdown of the cost structure of HSH and a comparison between 2019 and 2020.

	2020	2019
Fixed Cost	(million)	(million)
Rent and utilities	373 (10.7%)	441 (8.4%)
Depreciation	553 (15.9%)	589 (11.3%)
Financial interest	149 (4.3%)	154 (2.9%)
Variable Cost		
Inventories	213 (6.1%)	457 (8.7%)
Staff costs and related expenses	1,511 (43.5%)	2,294 (43.9%)
Other operating expenses	674 (19.5%)	1,292 (24.8%)
Total Cost	3,473	5,227

Except a series of cost saving measures were implemented for the challenging business environment in 2020, the cash and other donations were saved surprisingly due to the cancellation of charity events. Staff cost and related expenses is the major cost for HSH (over 40%) no matter any period of time, the cost saving measure was unavoidable implemented on this sector. However, HSH had to balance this cost saving with the well-being of staff especially under the severe pandemic situation. Neglect of this concern may increase operating cost eventually. HSH has taken a full range of review of each local market situation and conditions to determine how to take care the staff but saving the cost at the same time. During the period, the group laid off some staffs and asked staff to take unpaid leave to save cost. If lay off was unavoidable, the group kept the medical benefits and insurance as long as possible to minimize the financial impact to those staffs. And, when the market demand rebounds, re-hire those staffs with higher priority. With those stringent cost reduction measures, mainly on staff cost, the group managed to reduce the operating cost by 38% in 2020. For a group of high-end luxury hotels, staff cost is always the main portion of the operating costs. The subsidies received by Hong Kong government amounted HKD130 million in total compensated part of the cost. As result, the group achieved the staff cost reduction by 34% to HKD1,511 million compared with HKD2,294 million in 2019. However, this reduction was not sufficient to offset the drop of revenue of the group which will be analyzed further later.

Besides the reduction of staff cost, the HSH group also waived the fees for Non-Executive Directors (NEDs) and the fees for INEDs and Governance Board Committees be reduced by 20% for 2020 and 2021. The review of cost saving measures even extended to the time spent by Directors when discharging the duties, consider the time on preparation for each meeting, and then revised the time spent requirement in the letters of appointment.

2.3 The Revenue Structure

Although HSH group has exposures in other sectors, the hotel division contribute the most to the group's combined revenue. During 2020, up to 6 Peninsula hotels were

temporarily closed due to the public health issues, travel restrictions, government regulations and lockdown arrangements. As at end of 2020, 2 Peninsula Hotels in Paris and New York still shut down. Although the Peninsula Hong Kong, Beijing, Shanghai and Beverly Hills stayed operating throughout the 2020, the revenues were generated from these hotels dropped sharply than 2019. As a result, the combined revenue declined by 62% to HKD1,831 million in the hotels division.

Except the hotel division, the revenue of the commercial properties division dropped 18% as well. The ongoing COVID-19 pandemic impacted the performance of The Repulse Bay Complex (TRB) and The Peak Tower (TPT) which are the major (over 76%) contributor of revenue in this division. Due to the pandemic, the demand for luxury residential market was declined that the rental revenue from TRB was decreased. The Food and Beverage and catering revenue from TRB dropped as well due to the social distancing measures and restrictions on bars and restaurants by Hong Kong government. As the group granted rental concessions to tenants and the sharp drop of visitors, The Peak Tower recorded almost 60% drop in revenue.

The revenue of the group was HKD2,710 million in 2020, dropped 54% and 56% from 2019 and 2019 respectively. Hotels, commercial properties and clubs and services are 3 pillars of the revenue for the group. For hotels division, the revenue dropped from 38% to 81% across The Peninsula Hotels all over the world. The Peninsula Hong Kong, who is the major (27%) revenue contributor in the hotels division, recorded a 45% drop to HKD 603 million in 2020. As the shut down of the global travel, the local domestic market was the main focus for The Peninsula Hong Kong who developed a series of “staycation” packages and promotions to promote art, culture and dining to local Hong Kong residents. Due to social distancing restrictions imposed by government, some facilities in the hotel were closed time by time throughout the year which led to a decline of revenue from food and beverage. However, though the staycation packages could maintain the occupancy and cover a certain level of revenue, the competition in this market is keen. Many hotels at the similar level are targeting this segment.

The group has worked with the tenants to understand the situation of their businesses and adjustments were made to rental and other requirements by contracts so that the occupancy rate of retail units remain a certain of level. Those measures are trying to maintain a stable income stream for tenants in the short to medium term who were suffering heavily by the travel restrictions and sense of risk associated with public spaces of domestic consumers.

To respond to the operational and financial risks due to the global COVID-19 pandemic since early 2020, the Group Risk Committee reviewed the strategies. One of the major actions is to manage day-to-day impact by the pandemic on the business. The group is searching for alternative revenue generators to diversify other than the original 3 pillars which, especially the hotel division, are highly dependent on the tourism and impacted by the pandemic in foreseeable future.

3 The Company's current business performance

It has been two years since the outbreak of COVID-19 pandemic in early 2020 which brought a devastating impact on the group, particular the hotels division. The HSH group recorded an EBITDA loss of HK61 million in 2020 while it was HKD1,390 million in 2019. Although seeing some recovery in the hotels division in first half of 2021, it continued to be impacted by the absent of international travelers and different social distancing measures still in place for the food and beverage sector. With the cost saving measures implemented since the pandemic and the strong rebound in mainland cities as well as other hotels in US are also recovering, the combined EBITDA had recovered to HKD35 million for the first 6 months of 2021. The group's underlying loss reduced to HKD375 million (25%) as well. However, there are still a lot of uncertainty in short to middle term. At the time of writing, Hong Kong is being suffered by the fifth wave of COVID-19 that the daily confirmed cases reached new high. In this section, the report will analyse the internal and external environments for the HSH group as well as how the COVID pandemic would impact on the group's profitability.

3.1 External business environment

The hotel industry in Hong Kong is a collaboration of chain hotels, local grown hotels and international brands. Among the 299 registered hotels in Hong Kong in 2018, 57% of the total properties is international brands while local grown hotels constitute 43%. However, though local grown hotels share less of the market in terms of hotel properties, they supply higher number of total rooms. In terms of market segment, almost 80% of the total registered hotels are mid and upper mid-scale hotels. Around 18% are luxury hotels like HSH group.

To try to maintain businesses afloat and create new opportunities for the industry during the pandemic period, Hong Kong Government and Hong Kong Tourism Board launched a domestic tourism campaign, “Hello Hong Kong - Holiday at Home”. The campaign offered local citizens over 10,000 deals for shopping, dining and hotels, trying to put a start for the revival of the local tourism industry. The COVID-19 global health crisis has changed the perspective of consumers about travel irreversibly, there are lot of opportunities for hotels and other travel enablers to adapt the new normal. The global travel put to a standstill due to COVID-19 is also an opportunity for the hotel industry to rethink tourism and embrace the change of consumer behaviour for coming years.

Although there is a little sense of optimism for the industry in second half of 2021, most of travel experts surveyed by World Tourism Organization (UNWTO) are still being very cautious that not expecting a recovery back to the pre-pandemic level earlier than 2023. Therefore, the hotel industry needs to find demand within the local market so can have room to “manoeuvre” before the tourists and business traveller coming back. Except the staycation concept, hotels in Hong Kong are offering some day-use packages for those looking for a daytime space. This mainly target those business persons who are working-from-home while not everyone has suitable working environment at home.

3.2 Internal business environment

Although the near future is highly uncertain for the group, HSH group maintains the long-term value which is “to develop, own and operate a small number of the highest quality hotels and luxury properties which they believe are considered to be amongst the finest in the world.” To achieve the value and execute the group’s strategies, build and maintain a team of exceptional talents is the key. The group has to balance the cost saving to let the group stays agile financially but ensure all quality talents remain loyal and productive. They introduce a loyal and committed team spirit from the top of the organisation to all levels of the company. Even under the shadow of pandemic, the group added more than a thousand new talents strategically as 2 hotels coming on board in couple of years for the group.

At early of 2021, the group launched a new strategy Vision 2030 the bring the group the strategic focus for coming 10 years. The core value of their attention to detail and commit to provide the best quality service remains the integral part of the strategy and their long-term mindset. Manage risks and seek for right opportunities but at the same time, offering their customers with sustainable, thoughtful and purposeful services. For the foreseeable future, more stringent hygiene requirements, disruption of supply chains and possible temporary shut down of operations are some main challenges for the group due to the pandemic situation. However, the group will continue the value to deliver sustainable luxury and seek to enhance by fully utilizing all internal resources, reigniting the enthusiasm of employees and continue working with different parties with familiar mind-set. The key strategic objectives of the new strategy Vision 2030 are:

- diminishing natural resources like energy, food and water
- climate change
- growing social and political instabilities and inequalities

To address these issues, the group will focus on enhancing guest experience, empowering the employees and enriching the communities.

The HSH group focus on the very long term with their over 150 years history even

they will be well prepared for a lot of uncertainties and challenges that nobody would predict. They focus on doing whatever they could to maintain their operations and help their people to recover from the global pandemic. They would ensure the group would remain at the same pace with the rapid development of technology for the needs and opportunities of their business. Most important, the group has maintained a strong balance sheet and liquidity position, highly motivated and committed team of management and staff to deal with the short to mid term challenges and achieve the long-term vision.

3.3 A summary of the Covid-19 impact on the company's profitability

As a luxury hotel brand for over 150 years with Hong Kong as the home market, the prospect of the group's profitability is mainly determined by the pandemic situation in Hong Kong. Looking into the interim report in 2021 of the group, the revenue did not improve significantly from the same period in 2020 even the pandemic situation at that time being improved. However, with a series of cost saving measures were implemented throughout the 2020, the combined EBITDA and EBITA were back to positive while both were negative in 2020. Considering the market in Hong Kong and other countries are still very weak and uncertain, the ongoing cost saving measures are the main solution to let the group remain competitive and agile for any challenges in foreseeable future. However, after 2 years with the cost saving measures, there may be not much room to further squeeze the spending especially on staff cost. As a luxury hotel brand, the quality of staffs is extremely important to maintain the brand value and, when the market rebounds with the pandemic situation and other travel restrictions released, to capture the opportunities with a competitive and highly committed team.

Explore new revenue generators is another alternative to diversify the revenue sources. It is a challenge for the management team to balance seeking new revenue sources and maintaining the long-term group core value. After all, the brand value is the most integral asset for HSH group.

4. Analysis and discussion

4.1 Identification of the major challenges

4.1.1 Costing challenges

Cost saving is an obviously most effective way for HSH group or any organization to adopt when most of the revenue was heavily impact by COVID-19 pandemic and there is no sight of the end. HSH group managed to reduce the damage by the drop of revenue with different cost saving measures. Staff cost and related expenses is the main area to be focused on. Lay off of staff and no pay leave contribute a major cut of the costs. However, as a traditional luxury hotel brand in Hong Kong and globally for over 150 years, the reputation of the group and to maintain or even rise the high quality of services, maintain the team with loyal and committed staffs is the key. It could bring irreversible damage on the brand if the group compromise the service quality with cost saving. As mentioned in the report, only 18% of the hotel industry in Hong Kong are luxury segment. HSH is in this segment and ensure they are among the most top hotel brands is vital for the group's long term strategy. It is impossible to achieve that without a team from management team to all levels of staffs to remain loyal and committed after a series of cost saving arrangement including lay off and no pay leaves. And if the market in Hong Kong and overseas rebound after the pandemic situation improved, it is also challenging to re-hire enough manpower to capture the opportunities as there will be keen competition from other hotel groups.

Operating cost is another key link for HSH group as a luxury hotel. The supply chain cost has risen significantly since the outbreak of COVID-19 due to knock down in many major logistics hubs all over the world. It is another challenge for HSH group to maintain the service quality but attempting to reduce the cost on daily operation basic. During the shut down of international travel, all hotels are focusing on the domestic consumer market and this would remain the major target segment in short to mid term. HSH has to differentiate with the brand and new elements to attract

local consumers to spend relatively higher rate with most of other options in the market. To achieve that, HSH could not compromise with the quality of service. They have to attend to the detail and create an unique experience to the customers as, under the information age, consumers are making decisions riding on others' comments online more than other promotion or traditional marketing media. But that would mean high inventories and operating costs as the pandemic situation is so unpredictable that the hotel has to maintain a high inventory level on different categories in order to keep the highest service quality. Not only the hotel room quality, inside the Peninsula Hong Kong there are some highest quality restaurants (Michelin 1 and 3 stars) that the hotel must ensure the highest hygiene standard and following the social distancing requirement from government to avoid any COVID cases in the facilities and on the staffs and customers. All these required a challenging task of the management team and staffs to balance the cost saving.

4.1.2 Pricing challenges

When the market is on downturn and for a long period of time like what happened since the COVID-19 outbreak in early 2020, it is especially challenging for a luxury brand. If the luxury is dependant on tourism from mainland china and overseas, it would be even worse. As a hotel group grown locally for over 150 years, local consumers were obviously not the target group for the hotel's room facilities. Instead, local consumer would only visit the food and beverage facilities of the hotel. For non domestic visitors especially from mainland China was the main target for last decades before COVID, the high end pricing is one of the key drivers to stay with the hotel. HSH group, the Peninsula Hong Kong hotel, provides the most luxury experiences to those foreign visitors that pricing was not a concern. Since the COVID outbreak, the whole market pattern changed. Visitors from mainland China and overseas are not coming back any time soon. Peninsula Hong Kong entered a market they were not familiar with. For domestic consumers, the brand is famous and familiar for its long history. However, to spend such significant amount, which could be double or even triple of other options, is an obstacle that HSH group has to handle. A sharp cut of room rate may drive many local consumer to experience this

most long story luxury hotel in Hong Kong but it could damage the brand forever. If a luxury brand is not as luxury as before, the core value would be lost which was built for over one and half century. Therefore, generating revenue by targeting local consumers but maintain the brand position and image is the most challenging task for the group. To deal with that, the Peninsula Hong Kong packaged a total experience with dining and other facilities offers as well as the room to the market. With that, the hotel does not have to drop the room rate but created more incentives to customers to pay for a total luxury local experience. However, as the hotel is located at the heart of Hong Kong downtown and the building was built 150 years ago, there is limited room for any significant innovation or expansion that the group needs to think how to create incentive for consumer to revisit the hotel.

4.2 Strategies to ensure business continuity under the Covid-19 crisis

To survive as an organization in this COVID-19 pandemic, HSH group needs to be agile for any uncertainty. Applying traditional strategies and mind-set to deal with such highly uncertain environment could bring serious damage on the group. Minimize the cost and maximize revenue is the fundamental principle. Keeping a tightened but highly motivated workforce could contain the staff cost but maintain the highest standard of service. On the other hand, the revenue is not going to recover fully before the travel restrictions are released. The group need to create more incentives to target wider range of local consumers. They need to justify the high price with extraordinary experiences and differentiate with other younger luxury hotels. Diversify the revenue sources is another key strategy for the HSH group to survive or even grow under post-pandemic period. Consumers at the high end segment are consistent in terms of lifestyle. Peninsula Hong Kong needs to extend the range of service at the high end segment.

5. Conclusion and recommendations

The COVID-19 pandemic impacted the economy of Hong Kong especially the tourism industry greater than ever. As one of the four pillars of Hong Kong economy, tourism

industry had enjoyed golden years for almost 2 decades since the Individual Visit Scheme launched in 2003 after another pandemic situation of SARS. The visitors from mainland China contribute a lot of revenue of the industry from retail, food and beverage to hotel. Most in the industry targeted visitors especially from mainland but neglect the local consumers. When the city knocked down from the rest of the world including mainland China in 2020, the whole industry including and particularly hotels who usually invested heavily on fixed assets, had to rethink the way they conduct business and learn again how to attract local consumers. For a luxury hotel with over 150 years long history in Hong Kong, HSH group or Peninsula Hong Kong maintained its core value and brand position for very long time. The task for the group is how to present the value to those domestic consumers who are very familiar with them but were not their target customers. While no foreign visitors could come to Hong Kong, people in Hong Kong could not travel to outside as well unless who could accept the quarantine period. How to attract those people who were spending heavily on foreign countries is the main mission for Peninsula Hong Kong and other hotel groups. Therefore, there are still many opportunities for Peninsula Hong Kong to capture but they have think and execute in different way. The COVID-19 would change the world forever. Even the pandemic is over, the market pattern and consumer behaviour will not go back to the same as before. HSH group has to provide some experiences so unique that consumer would not shift to other alternatives even they maintain or even rise their pricing. They have to fine tune their brand to wider range of consumers especially younger group with relatively lower purchase power but more willing to spend. Inject some young elements to their brand and facilities of the hotel would be the key for them how to maintain the legacy but get the brand alive again.

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