A&M INSIGHTS

Pragmatic Zero-Based Budgeting in Travel, Hospitality and Leisure: A Private Equity Perspective

It goes without saying that the travel, leisure and hospitality industries have faced unprecedented challenges this year. All the same, there is hope that with mass rapid testing and vaccines on the horizon, companies can begin to think about a world beyond global lockdowns. Executives must begin to consider what the post-COVID operating model will look like, but strategic planning has never been harder.

Decimated demand has effectively ripped up the restructuring playbook. Conventional restructurings that remove, say, 30% of costs will simply not address the root-and-branch change that lies ahead for some organisations. PE firms that invested at high multiples in recent years may have to accept that the same market conditions will take many years to return, if they ever do.

Although it may seem counterintuitive, this environment does present opportunities for productive change. In a normal restructuring scenario, cost reduction happens in the context of preserving or continuing to grow top-line revenues. This time, the travel, leisure and hospitality industry has seen the top line driven down significantly. With 2020 revenues effectively written off in many cases, management teams in the sector really can go back to basics and start from first principles in building a post-COVID operating model.

In this context, zero-basing all business activities makes a good deal of sense, and zero-based budgeting (ZBB) is a long-established methodology for businesses under pressure. We see lean, targeted Pragmatic-ZBB reviews as a core component of restructuring and transformation plans for travel and leisure companies. They can deliver impactful results at pace, strengthening organisations ahead of what will be a very difficult few years ahead.

The pandemic arrived after a decade of growth for the industry that was primarily driven by both:

- **Increasing demand from key demographics:** For example, millennials, who (until 2020 at least) prioritised travel and experience over other consumer purchases, have entered their high-income phase in recent years.
- **Regulations constraining supply:** For example, the regulatory environment in Europe has restricted supply somewhat, such as municipal restrictions in several European gateway cities that have limited the development of new hotels to control inbound tourism and preserve historic attractions.

Years of pre-Covid 19 growth have underpinned sustained price increases, both at the consumer level and in terms of the multiples in M&A transactions. However, from an operating perspective, too few businesses pushed to bring more flexibility into their cost bases and operating models during these good times. Government support has aided cash management through 2020's lockdowns. But as volumes slowly begin to return, businesses with higher fixed costs will face burning unnecessary cash during what is likely to be a multi-year recovery.

Maximising variability and agility in the cost base will be fundamental to long-term success. Our work with hospitality clients does not just concentrate on leveraging ZBB approaches to rightsize the cost base. We are also highly focused on increasing variability in the cost base through operating model transformations that encompass organisation, processes and systems. Using ZBB methodologies, we have delivered sustainable cost base reductions of 15% for complex global travel and leisure businesses.

This dual approach to cost transformation will enable companies to go beyond survival in the coming years. It is possible to actually improve margins relative to competitors during recovery and – once business returns to the same levels – even come out ahead compared to 2019.

To deliver these improvements, ZBB approaches must address the top line as well as simply reducing costs. Historic assumptions about where demand will come from have to be revised, as pre-COVID purchasing drivers are simply out of date. The balance of urban vs rural locations, and business vs leisure travel, will probably never return to exactly where they were at the start of 2020.

The best travel and leisure businesses will take a zero-based approach to their demand expectations and top line, build a new understanding of segmentation and use this information to rebase their operations, building in a high degree of flexibility and variability. No forecast will be 100% correct, but being able to adapt will help organisations move past the assumptions that underpinned pre-COVID business models.

Private equity and ZBB in travel and leisure

Private equity (PE) stakeholders in travel, leisure and hospitality may well be assessing potential transactions at present, although many will be keen to hold off until it is clearer that a market 'bottom' has been hit, when the industry could present attractive targets. When M&A does begin to pick up again, it is imperative that PE investors approach transactions with a robust approach to rightsizing operations alongside the value creation plan. Pragmatic-ZBB reviews can be customised to suit the requirements of either pre-deal diligence phases or post-deal integration and operationalisation.

At present, PE firms are seeking more open and active partnerships with portfolio companies and prospective investments. In some cases, this is because investors want to be close to management teams that were built for growth but now have to pivot and focus on a recovery. In addition, when historic revenues and current trading are both inadequate measures of performance and potential, more interaction can only help to guide sensible valuations.

In light of this, when is a zero-based review the right move for companies in the travel and leisure space? A few key trigger events can help guide investors and executives in kicking off Pragmatic-ZBB reviews:

Operating model triggers

- Changing distribution models in response to evolving competitive threats from new alternatives and entrants, for example Google.
- New drivers of demand and segmentation
- Digitisation of the value chain
- Right-sizing following prior inorganic activity, including transitioning to more asset-light business models (for example, applicable to travel and hospitality)
- Changing customer / guest expectations, especially from Millennials

Transaction triggers

- Carve-out events where sellers divest assets that are viable but were a neglected part of the portfolio and are in need of a 'spring-clean'
- Post-merger integration where organisations need to realise synergies and rationalise back-office or shared services functions
- Buy-and-build scenarios where a corporate or PE investor seeks to 'roll up' smaller competitors or firms with adjacent specialties

We have direct experience working with travel, leisure and hospitality companies in these situations. Pragmatic-ZBB reviews can quickly improve transparency and enable closer links between cost transformation and the broader strategic plan, helping move the organisation towards the end goal of a new target operating model. Those interested in learning more about A&M's Pragmatic-ZBB approach can read our full report here.

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A&M has worked with private equity firms in Europe and globally to stabilise financial performance, transform operations, catapult growth and accelerate results through decisive action. Our senior operators can rapidly assess and respond to challenging situations, delivering value for PE firms and other stakeholders.

Our professionals have extensive experience supporting travel and leisure companies and investors through tough, complex situations. To learn more about our expertise and to understand the full scope of our Private Equity Performance Improvement work, contact our team here.

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