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Scholarly Contributions in Hospitality Finance-Some Trends in 2002-2003

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SCHOLARLY CONTRIBUTIONS IN HOSPITALITY FINANCE: SOME TRENDS DURING 2002–03

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Abstract

This study reviews some research trends in financial management in the hospitality industry during 2002–2003. Five major refereed journals were examined: *Cornell Hotel and Restaurant Administration Quarterly, Journal of Hospitality and Tourism Research, International Journal of Hospitality Management, Journal of Hospitality Financial Management*, and *Briefings in Real Estate Finance*. Refereed presentations at the 2003 International CHRIE Annual Conference and the 2003 Annual Conference of the Association of Hospitality Financial Management Educators were also covered. At the onset, a review framework was established after examining the trend of research topics in the above journals and conferences for the period 2002–2003. Thereafter, all refereed studies in hospitality finance for 2002–03 were discussed using the above framework. As such, the trend of scholarly contributions in hospitality finance during 2002–03 is better understood.

Introduction

Academicians and practitioners have extensively researched the subject of finance in recent decades—from both the theoretical and empirical perspectives. Although much of the existent literature base addresses finance using a general framework, finance studies addressing the hospitality industry have been relatively ignored. This paper is a review of refereed research accomplished in the area of hospitality financial management during the period 2002–2003. At the onset, a review framework was established using distinct financial management topics or themes that emerged from the current literature base. Four financial management themes were identified:

1. Hotels as real estate investments
2. Investment-related risk and equity return behavior in the hospitality industry
3. Capital structure, financial leverage, and debt management in hospitality firms
4. Other managerial finance issues

The next section of this paper discuses research studies reported in refereed hospitality journals using the above review framework. The third and final section concludes with comments about existing trends in the hospitality finance research base for the period 2002–2003.

Theme 1: Hotels as Real Estate Investments

Lodging real estate constitutes a significant portion of the real estate industry in the United States. Over $100 billion worth of unsecuritized investment-grade properties in

the U.S. belong to the lodging real estate sector. The significance of this sector is further highlighted because of its portfolio diversification benefits and its favorable performance relative to inflation. While some seminal studies addressed the importance of hotels as real estate investments in the past (deRoos & Corgel, 1996), the period 2002–2003 saw a positive growth in research contributions in this area.

Some studies during 2002–2003 that addressed the importance of hotel real estate properties within an investment portfolio were Quan, Li, and Sehgal (2002) and Peterson, Singh, and Sheel (2003). Both studies examine hotel real estate investments by focusing on their returns, return risk, portfolio diversification benefits of lodging properties, and their favorable performance relative to inflation. Quan, Li, and Sehgal examine the viability of lodging properties as an investment option for portfolio managers during the1995–2000 period. Their results support the hypothesis that investing in lodging properties provides strong portfolio diversification benefits. Peterson, Singh, and Sheel extend this research using correlation analysis, Sharpe ratio, and a portfolio simulation model to examine the performance of five real estate subsectors over the 1992–2000 period. Their results also support significant portfolio diversification benefits from inclusion of hotels in the real estate investment portfolio. Their results further show that, at least for the analysis period, the hotel sector outperformed all other sectors in terms of total returns.

Some papers also address the increasing importance of recent developments in hospitality real estate. Beals and Singh (2002) address the importance of real estate investment trusts (REITs) as innovative equity instruments during the last decade and their resulting impact on the U.S. lodging industry. In addition to documenting the growth, advantages, and disadvantages of REITs as investment vehicles, they also discuss the impact of the 2001 REIT Modernization Act. Kim, Matilla and Gu (2002) examine the performance of hotel REITs over the 1993–1999 period relative to the overall market and six other REIT sectors. Their results reveal that the risk-adjusted returns of hotel REITs were in line with that of the overall market, although hotel REITs were associated with higher risks. Such risk could be lowered with the help of a conservative growth strategy accompanied by an internally-oriented financing policy.

Some 2002–2003 studies addressing recent trends within U.S. lodging real estate finance were Singh (2002) and Nagpal & Sheel (2002). Singh enriches the current lodging real estate finance literature by addressing the issue of securitization of U.S. lodging real estate finance in detail. Nagpal & Sheel address the fundamentals of securitization and provide a detailed examination of commercial mortgage backed securities (CMBS). They also provide useful insights for borrowers in lodging real estate markets to successfully deal with CMBS loans.

Oak and Andrew (2003) explore yet another dimension in the area of lodging real estate finance. They test for evidence of weak-form market efficiency in hotel real estate markets by measuring how rapidly price changes diffuse in geographically proximal areas. Using autocorrelation and cross-correlation analysis, their study found that buy-and-sell trading strategies based on information in past hotel prices did not earn higher

returns than buy-and-hold strategies. Results in their study support the existence of weak-form market efficiency in the pricing of hotel real estate.

Theme 2: Investment-Related Risk and Equity Return Behavior in the Hospitality Industry

The behavior of a firm's equity returns and its relationship to the firm's systematic and unsystematic risk has fascinated investors and finance researchers for decades. Researchers have frequently used the capital asset pricing model (Sharpe, 1964; Lintner, 1965) and related market model to examine equity return and risk behavior in finance literature. However, studies addressing equity risk and returns within the hospitality sector are relatively new. Several interesting studies examined firm risk and stock return behavior in hospitality industry firms during 2002–2003.

One important study addressing the issue of systematic risk in restaurant firms is Gu and Kim (2002). Gu and Kim use weighted least square regressions on a sample of 75 U.S. restaurant firms to examine determinants of systematic risk or beta in restaurants. Their results reveal that systematic risk correlates negatively with a restaurant firm's assets turnover, but positively with its quick ratio. Their results also reenforce the concept that high efficiency in generating sales revenue helps lower systematic risk in restaurant firms, while excess liquidity tends to increase such risk. Kim and Gu (2002) is another similar study that uses financial data from 1993–1999 to examine the systematic and unsystematic risk associated with US hotel REITs. According to this study, systematic risk of hotel REITs is positively associated with debt leverage and growth, but negatively with firm size. Liquidity, efficiency, profitability, and dividend payout ratio did not affect a hotel REIT's beta significantly. The paper suggests that slow-growth, large hotel REITs with low debt are likely to have low systematic risk as opposed to fast-growth, small hotel REITs with high debt levels.

Canina and Gibson (2003) examine the behavior of first-day initial public offering (IPO) returns of 102 restaurant and 35 hotel firms. Their study identifies the reasons underpricing is a necessity for managers of private hospitality firms if they choose to go public. Their study tests whether existing underpricing theories of IPOs hold true for IPO s within the hospitality sector. The study also provides an empirical characterization of first-day IPO returns of restaurant and hotel firms, and explains why it is not possible to make easy money from IPO underpricing.

In a similar study of stock return behavior, Leung et al. (2003) investigate the return behaviors of hospitality firms (airline, hotel, eating places, and amusement parks) listed in NYSE, AMEX, and NASDAQ from 1981 to 1999. According to their results, hospitality firms revealed momentum trends in stock returns during the 1980s. However, price reversal was a dominant behavior for hospitality stock returns during the 1990s. Results also showed a substantial increase in shares held by institutional investors during the 1990s. The study contends that increases in institutional holdings could be one of the major factors causing change in stock return behavior of hospitality firms.

Some other studies further investigate the behavior of equity returns in hospitality firms during 2002–2003. The first, Prakash, Moncarz, and Valesquez (2003), examines the use of the market model for equity valuation within the hospitality sector. The second, Prakash, Moncarz, and Lee (2003) uses the Brown and Warner (1985) event study approach to analyze the negative impact of the terrorism-related attack of September 11, 2001, on the rates of return on equity and risk within the U.S. hospitality sector.

The constantly changing behavior of equity returns in financial markets continues to fascinate investors and finance researchers. Although several research papers address equity return behavior from a conventional framework, industry-specific studies addressing equity return behavior are relatively few. Consequently, the above 2002–2003 industry-specific research contributions examining equity returns of the hospitality sector have a special significance.

Theme 3: Capital Structure, Financial Leverage, and Debt Financing in Hospitality Firms

The impact of capital structure and debt financing on firm value has been a subject of recurring interest since Modigliani and Miller (1958) first suggested its irrelevance in perfect capital markets, and then showed its relevance in "real world" situations including taxes and bankruptcy costs. Debt can be a useful source of external financing, but only up to a certain extent, beyond which the costs of potential financial distress begin to outweigh the benefits of leverage. This is an important issue for investors because debt-to-invested capital affects a hotel's cost of capital and, therefore, the overall value of the property. Kwansa, Johnson, and Olsen (1987), Arbel and Woods (1990) and Sheel (1994) were some early exploratory studies in hospitality finance literature addressing the issue of financial leverage. Thereafter, several interesting financial leverage studies enriched the literature base in hospitality finance. Some of these came during 2002–2003.

Elgonemy (2002) highlights four important considerations for hotel owners before seeking debt financing—business risk, need for financial flexibility, degree of ownership's risk aversion, and tax considerations. The paper also discusses several debt-financing alternatives as well as refinancing and restructuring issues for lodging firms. Chatfield and Chatfield (2003) examine whether there are any systematic differences in the cost of debt relative to rating standards between firms in the hospitality industry and firms in other industries. Their study also examines the impact of make-whole call provisions, a relatively new innovation in the corporate bond market, upon the cost of debt. Findings provide some evidence of a positive hospitality industry impact upon bond yields. Results also show that the make-whole call provision appears to be valued by investors, reducing the investor loss from early bond redemption in a period of declining interest rates. In a similar bond-related study, Kim and Gu (2003) attempt to identify financial factors that affect bond ratings of hotel and casino firms by estimating a bond rating prediction model. Their findings suggest that large hotel and casino firms with high return on assets and great debt service coverage tend to receive high bond ratings from Moody's. In the context of the restaurant sector, Dalbor, Kim, and Upneja (2002)

enrich the existent literature base further by expanding onto the research efforts of Sheel and Wattanasuttiwong (1998). Dalbor, Kim & Upneja explore the factors affecting long-term debt in restaurant firms. They find a restaurant's firm size and Ohlson's O score to be positively correlated with its long-term debt ratios.

Theme 4: Other Issues Relevant to Managerial Finance and Corporate Governance

Some papers also emerged during the 2002–2003 period that related to other topics in managerial finance or corporate governance. Ryu and Sanchez (2003) address the importance of financial forecasting as a managerial function. Their study examines seven techniques that could be used in financial forecasting in a foodservice facility. The accuracy of the forecasting methods are measured using mean squared deviation, mean squared error, mean percentage error, mean absolute percentage error, root mean squared error, and Theil's U- statistic. Results reveal that although managers have a tendency to choose simpler (less accurate) techniques, multiple regression is the most accurate methodology. In a second context, Dopson (2002) addresses the importance of financial modeling as a managerial function. This paper illustrates the use of spreadsheet simulations as a means to link cost-volume-profit analysis decisions of hospitality managers with goal analysis decisions.

Conclusion: Trends in Current Research Literature in Financial Management in the Hospitality Industry

In summary, research in the area of hospitality finance revealed significant growth during the 2002–2003 period. On the positive side, a broad variety of financial management issues in the hospitality industry were addressed. The use of more mature financial analysis techniques (e.g., Brown and Warner event study methodology or more sophisticated versions of multiple regressions) suggests a positive trend in the quality of current research. Such a trend also signals the need for more rigor in the review process of hospitality finance research manuscripts in future. On another note, however, the fewer number of studies in this area relative to those in other hospitality management areas suggests a clear need for encouraging more research submissions dealing with financial management issues in the hospitality industry.

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