# A Review of Current Financial Issues Facing the International Hotel Industry

<table>
<thead>
<tr>
<th>Item Type</th>
<th>refereed;article</th>
</tr>
</thead>
<tbody>
<tr>
<td>Authors</td>
<td>Choi, Jeong-Gil</td>
</tr>
<tr>
<td>Download date</td>
<td>2024-07-06 23:38:47</td>
</tr>
<tr>
<td>Link to Item</td>
<td><a href="https://hdl.handle.net/20.500.14394/31095">https://hdl.handle.net/20.500.14394/31095</a></td>
</tr>
</tbody>
</table>
A REVIEW OF CURRENT FINANCIAL ISSUES FACING THE INTERNATIONAL HOTEL INDUSTRY

Jeong-Gil Choi

ABSTRACT

The purpose of this article is to identify the hotel financial issues reflected by articles published in academic and trade journals during the period 1983–1996 inclusive. The journals reviewed for this purpose include: Journal of the International Association of Hospitality Accounts, International Journal of Hospitality Management, FIU Hospitality Review, Cornell HRA Quarterly, Journal of Travel Research, Hotel & Motel Management, Lodging Hospitality, Real Estate Finance, Meeting & Conventions, and National Real Estate Investor. By reviewing these journals, four of the most intensively and frequently discussed issues are identified. These issues are: capital shortage & financing methods, capital sources, tax and deduction, and valuation. These four issues are discussed in the scope of international hotel financial management.

Introduction

The international hotel industry is becoming increasingly competitive for survival, growth, and profitability in a world economy. However, the internationalization of the hotel industry has accelerated under the pressures of dynamic issues such as advances in technology, communication and transportation, deregulation, elimination of political barriers, sociocultural changes, and global economic development. The big challenge to the hotel industry is whether or not it can quickly adapt to changes of these and other related issues. The purpose of this article is to identify current financial issues facing the international hotel industry and discuss the issues for better understanding and further development.

This study employs a content analysis to identify the hotel financial issues. The data bases used in this study include: ABI Inform (business topics), InfoTrac (general business file), PAIS, EconLit, National Economic Social and Environmental Data Bank (NESE). By reviewing academic and trade journals, thirteen issues were identified: tax and deduction, capital sources, capital shortage and financing methods, valuation, capital structure, currency valuation, wage structures, trade agreements, refurbishment problems, operating efficiency, economic issues, infrastructure capacity, technology, foreign investment, and political activities & regulations. Among the above thirteen issues, four issues of the most intensively and frequently discussed in the journals are included for discussion in this study. These issues are: capital shortage & financing methods, capital sources, tax and deduction, and valuation. These four issues are discussed in the scope of international hotel financial management.

Capital Shortage & Financing Methods

Managers of hotel firms often encounter a situation where available cash resources are not sufficient to finance investment in productive assets. Investment in the hotel business generally requires a relatively large initial cash expenditure. The cash return on the investment, however, tends to be spread out over many years in the future. By exhausting both
internal (profit from sales) and external (debt and stock) sources of funds, the pattern of a large initial cash expenditure and delayed cash return strain a firm's ability to make additional investments.

One accepted solution to a shortage is limiting investment to a level that can be supported by available funds. Capital rationing is one action available to the firm for dealing with a limited supply of financial resources. As an alternative the company can raise prices to balance the supply and demand for financial resources. Increasing prices improves cash inflows and therefore does not constrain the acquisition of other resources in the short run. High prices, however, cause a loss of occupancy rate and market share in the long run. Consequently limiting investment and increasing price are not considered as creative financing for solution to a capital shortage. The different methods of creative financing in the hotel business have been used for different time periods.

Eyster (1983) identified and analyzed the investment strategies and techniques being adopted by the developers, lenders, operating companies, and brokers who participate in hotel development as they seek to cope with the changed economic conditions of the 1980s. According to Eyster, during the period of inflation-fueled expansion from 1976 to 1978, the financial methods and sources used in the hotel industry included permanent mortgages with no lender ownership, public debt financing (industrial revenue bonds, urban development action grants), and limited partnerships. On the other hand, permanent mortgages with lender ownership, participating mortgages, convertible mortgages, land purchase and leaseback with participating mortgages were some of creative financing methods used during the transitional period of stagflation from 1979 to mid-1981.

The tax reform act of 1986 affected virtually all individuals and businesses associated with the hospitality industry (Moncarz, 1987). The newly enacted tax law aims to prevent taxpayers from using real estate investment as tax shelters (Gunnar, 1987). For this or other reasons, during the period of recession in the 1980s (the 1980 recession: oil price explosion and credit controls; the 1981-1982 recession: slaying inflation and its consequences; the 1984-1986 growth recession: a manufacturing sector recession as the economy adjusted to a strong dollar), the financial methods used in the hotel industry were quite different from those of previous periods. In this period the creative financing methods in the hotel industry were floating-rate combined construction and term loans, seller mortgages, all-equity financing (developers, operating companies, and money partners), and public debt financing-industrial revenue bonds (IRBs) and urban development action grants (UDAGs).

The most recent and some important hotel financing trends that could characterize and shape the industry in the 1990s were discussed by Anand and Dickinson (1995). According to their discussion, the hotel financing in the 1990s is characterized by (1) continued high volume of sales transactions, as yesterday's bargain buyers flip properties and take profits; (2) consolidation of REITs through mergers and acquisitions; (3) strong re-entry into the market by traditional lenders including domestic and international pension funds, insurance companies, and commercial banks; (4) increased direct involvement of international and domestic hotel companies as their balance sheets continue to strengthen; (5) an increase in the flexibility and decrease in the cost of financing due to lower interest rates and increased competition among lenders; (6) increased participation of Wall Street through (a) a resurgence in REIT initial public offerings (IPOs) and secondary issues, (b) greater lending activity and more flexible loan agencies becoming more familiar with nuances of hotel
loans, (c) additional C-Corporation (or "non-REIT") IPOs and secondary offerings, and (d) increased use of securitization by traditional lenders; and (7) financing for new construction available by the end of the decade. The creative financing trends from late 1970s to the present year are presented in Table 1 in more detail.

Table 1 Hotel Financing Trends

<table>
<thead>
<tr>
<th>Period</th>
<th>Financing Methods and Sources</th>
<th>Comments and Problems</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Inflation-Fueled Expansion:</strong></td>
<td>• Permanent mortgages with no lender ownership (life insurance companies, savings and loan associations, and savings banks).&lt;br&gt;• Public debt financing (industrial revenue bonds, urban development action grants).&lt;br&gt;• Limited partnerships (private offerings).</td>
<td>• Investment in real estate considered excellent hedge against inflation.&lt;br&gt;• Room-rate increases more than offset higher costs of operations.&lt;br&gt;• Inflation forced costs of financial institutions above fixed-rate returns.</td>
</tr>
<tr>
<td>1976 through 1978</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Economic Stagflation:</strong></td>
<td>• Permanent mortgages with lender ownership (life insurance companies).&lt;br&gt;• Participating mortgages (life insurance companies).&lt;br&gt;• Convertible mortgages (life insurance companies, pension funds).&lt;br&gt;• Land purchase and leaseback with participating mortgages (life insurance companies, pension funds).&lt;br&gt;• Public debt financing: Industrial Revenue Bonds (IRBs), Urban Development Action Grants (UDAGs).</td>
<td>• Life insurance companies shifted investment strategies and channeled a greater portion of funds away from securities and into real estate.&lt;br&gt;• By late 1979, following unexpected run on funds by consumers, traditional sources of debt financing for real estate development disappeared.&lt;br&gt;• National life insurance companies made a concerted effort to attract, invest, and manage pension-fund moneys.</td>
</tr>
<tr>
<td>1979 through mid-1981</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Recession:</strong></td>
<td>• Floating-rate combined construction and term loans (commercial banks).&lt;br&gt;• Seller mortgages (sellers).&lt;br&gt;• All-equity financing (developers, operating companies, and money partners).&lt;br&gt;• Public debt financing: Industrial Revenue Bonds (IRBs), Urban Development Action Grants (UDAGs).</td>
<td>• Rate of inflation decreases; despite some drops, interest rates remain high.&lt;br&gt;• Real estate financing brought nearly to a standstill.&lt;br&gt;• Financial projections revised downward and no longer produce rates of return demanded by lenders and developers.&lt;br&gt;• Aggressive developers attempt to finance on temporary basis and plan to convert later to more realistic long-term debt financing.</td>
</tr>
<tr>
<td>1980s*</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>1990s</strong></td>
<td>• Continued high volume of sales transactions as yesterday's bargain buyers flip properties and take profits.&lt;br&gt;• Consolidation of REITs through mergers and acquisitions.&lt;br&gt;• Strong reentry into the market by traditional lenders including domestic and international pension funds, insurance companies, and commercial banks.&lt;br&gt;• Increased direct involvement on international and domestic hotel companies as their balance sheets continue to strengthen.&lt;br&gt;• An increase in the flexibility and decrease in the cost of financing due to lower interest rates and increased competition among lenders.&lt;br&gt;• Increased participation of Wall Street through: (a) a resurgence in REIT initial public offerings (IPOs) and secondary issues, (b) greater lending activity and more flexible loan agencies becoming more familiar with nuances of hotel loans, (c) additional C-Corporation (or &quot;non-REIT&quot;) IPOs and secondary offerings, (d) increased use of securitization by traditional lenders.</td>
<td>Financing for new construction available by the end of the decade.</td>
</tr>
</tbody>
</table>


Capital Sources

Mace (1995) said, "There is an enormous pool of capital swirling about the globe today. It can and does touch down anywhere." According to Mace, there have been waves of overseas investment flooding different segments of the industry from time to time. There was a Middle Eastern wave in the 1970s as oil wealth grew in that region of the world. A Japanese wave in the 1980s splashed ashore not only in places like Hawaii, but also in the American mainland and European capitals. Some might say that the 1990s will be remembered for the Hong Kong and Southeast Asian wave.

Stefanelli (1984) explores the advantages and disadvantages of various financing alternatives for the hospitality industry and discusses their potential effect on the profitability of the firm. The author also provides background and perspective for developing the appropriate financing arrangements for a specific hospitality enterprise. In this study, four different capital sources discussed in the literature as alternatives of current capital sources are identified. These include capital from foreign investors, capital from wealthy entrepreneurs of the world, capital from the franchisers, and capital from securitization.

Foreign investors continue to represent a significant force in providing capital to the hotel industry. Less aggressive than a decade ago, the Japanese are selling many of their assets while pension funds from the Netherlands and the United Kingdom have remained relatively silent. Investors from the Middle East, as well as Hong Kong and Singapore, are routinely making headlines as they collect trophy assets in U.S. gateway cities, or as they buy into upscale hotel companies (Anand & Dickinson, 1995). Hong Kong companies like New World, Peninsula, and Mandarin have all been active players. For example, the CDL Hotels and Quo International have been active investors in Europe, Asia, and North America. The Dusit Thani, a Thailand-based company, sprang onto the world stage with the acquisition of Germany-based Kempinski Hotels. And the Sultan of Brunei has been a significant buyer for the top end of the international hotel market. Foreign investment is expected to continue.

While capital can be provided for the appropriate borrower and project, a greater portion has been generated by entrepreneurial capital instead of by financial institutions (Rowe & Baltin, 1993). Financing from wealthy entrepreneurs of the world has many advantages. For example, the Fairmount Hotel Management Company got a financial boost from Prince al-Waleed bin Talal bin Abdulaziz al Saud, a member of the Saudi royal family who has become a 50 percent partner in three Fairmount properties and who has committed $50 million to upgrade existing properties and capitalize future ones. Prince al-Waleed’s move is expected to have positive industry effects, since it shows that wealthy investors are still individually attracted to hotel investments. Fairmount is already planning expansion activities to capitalize on the increased funds (Troy, 1994).

Financing from the franchisers has become another source of funds (Wolff, 1994). Generally, franchisers provide favorable terms because the success of their franchisees enhance the hotel chain’s image, distribution and marketing power. Hotel franchisees looking for financing sources can consider their franchisers rather than traditional lenders as a source of funds. For more detail, see Dotey (1971) and Piedmont & Whitehead (1990) providing a
checklist by which franchisers can expect to be measured by financing sources and outlines of the financial alternatives available to franchisers.

Securitization has become a new method of hotel financing (Wilson, 1994). Hotel loans are marketed as securities to investors. These securities may be mortgage-backed securities or bonds. Four different groups are needed for securitization. They are the borrower or hotel that needs funding, the originator/underwriter or bank that sets up the loan, the conduit or Wall Street investment firm that markets the loan and the investor who purchases the mortgage-backed securities or bonds. More long-term, securitization will be increasingly used by traditional lenders as an additional avenue to help their loan portfolios become more agile in volatile conditions.

The traditional financing becoming available is subject to relatively conservative underwriting criteria (Anand and Dickinson, 1995). Loan-to-value ratios rarely exceed 60-75 percent and debt service coverage ratios vary from 1.3 to 2.5 depending on the nature of the property, as well as the vehicle used. Amortization is typically calculated over 10-20 year schedules, and interest rates vary from 150 to 500 basis points over five-year treasury bills. Another key factor in the underwriting decision is having proven management expertise in place. It has been said that the collective institutional memory lasts approximately 8 to 10 years before the decision makers of tomorrow commit the same errors of their predecessors. It is hoped that the stricter underwriting standards of today will prevent the recurrence of the bitter years of the late 1980s. The tighter regulation of financial institutions and a focus on minimum required rates of return also bode well for the future.

**Tax and Deduction**

Higher energy taxes, corporate taxes and lower tax deductions are critical issues in the hospitality industry. There is no doubt that higher energy taxes will result in fewer auto travel trips, higher corporate taxes will result in less hotel improvement funds and lower tax deductions will result in fewer business launches and business trips. Gregg (1993) indicated that the 1993 budget act passed by the U.S. Congress has meeting planners and hospitality industry officers worried over the 80% to 50% reduction in the deductible portion of business entertaining. Business and industry officials are also worried about the 4.3% fuel tax that is expected to increase transportation costs. Also, the reduction of tax deductibles in spouse travel forms another area of concern for the industry. As a result, the hotel industry expects fewer conference attendees, shorter stays and decreased occupancy rates.

Several studies of the tax and deduction issues, although they are hypothetical, have been conducted. For example, Heimstra and Ismail (1993) conducted a study to measure the burden of room taxes on guests and the lodging industry by using the price elasticity of demand and supply. They concluded that the elasticity of supply was 2.86 while demand elasticity has a value of - .44. This yields a tax incidence value amounting to 6.2. This means that six out of seven dollars in taxes is placed on guests while the remaining one dollar is indirectly shouldered by the lodging industry. The impact of the room tax on operating income is substantial. Laura (1993) reported that the 5 percent occupancy tax of New York City and Long Island, NY, has experienced the loss of $133 million in sales because 73
organizations have chosen other places to have conferences since the tax was implemented in June 1990. Fortunately, local hotel and tourism officials' lobbying efforts have resulted in the repeal of New York state's 5 percent occupancy tax. According to them, millions of dollars have been lost in tax revenue since the tax policy on occupancy took effect in June 1990. Aside from New York, NY, other cities around the U.S. are lobbying against the unprecedented tax hikes on hotels (Koss, July 1994).

Tarras (1997) highlights the important tax law changes in 1997 which are related to the hospitality industry. The changes include work opportunity credit, employer tax credit for tips, election to expense depreciable property, simple retirement plans, spousal IRA deduction, distributions for medical expenses and insurance, and employer-provided educational assistance. Perhaps the biggest change in the new tax law is the reintroduction of a credit for wages paid established by the "Work Opportunity Credit." This program will be popular within the hospitality industry because it can help lower net payroll costs, just when the increase in minimum wage will be raising them.

Tax incentives and deduction policies for foreign hospitality investment are becoming hot issues in many countries. In Warsaw, Poland's hotel Bristol has proven a challenge for Forte Hotels, Inc., because of the high tax on imported supplies, such as a 270 percent tax on imported wine, a 1,200 percent tax on imported vodka, and 20 percent daily tax increases on milk (Neth, 1993). On the other hand, Nicaragua has adopted Costa Rica's investment code of 1994. If the code becomes law, both small and large investors are likely to benefit. The code includes tax breaks for hotel investments and renovations under $1 million. Past investment incentives, such as no government taxes or import duties on hotel supplies, in place since 1984, will remain in place (Austin, 1994). The Panamanian government also has decided to grant tax breaks for local and foreign companies constructing and developing tourism-related projects. Twenty-year renewable tax concessions are being provided to companies, which can also be exempted from import taxes on equipment and machinery used for a twenty-year period (Koss, Sept. 1994).

Valuation

Sound hotel investments require a complete understanding of the relationships between asset value, cost and age. Essentially, hotel value is associated with the net return to the property, sales comparison and cost (Ciraldo, 1992). In order to value hotel projects and investment in international markets, the internationally applicable valuation techniques are required. There are several valuation techniques. Rushmore (1994) discussed seven hotel valuation techniques and summarized the strengths and weaknesses of each technique. More recently, Corgel (1993) examined how well the ADR rule-of-thumb model predicts property values. The results of comparative analysis of estimates from the ADR model with those from a hedonic valuation model indicate that the ADR model performs well in the aggregate, but is an inconsistent estimator at various levels of desegregation, such as when property sub-samples were organized by number of rooms, age, occupancy rate and number of restaurants. The application of these western-style valuation techniques for hotel projects in developing economies of eastern and central Europe may pose many problems
because there are no existing real estate markets suitable for these techniques (Haggerty & Lostaglio, 1994).

Hotel values appreciate over time, depending on factors relating to changes in market supply and demand balances, capital availability, property quality and life cycle position and the current replacement cost discount represented in the purchase price. These factors should be a concern in any valuation practice. Especially, the international hotel firms have more risk factors such as home and host countries' economic, political changes that create changes of hotel values unexpectedly. The accuracy of the appraisal of a lodging operation depends on eliminating unfounded financial assumptions (Rushmore, 1984). Universal applicable valuation techniques explaining every possible risk factor will be the next homework of every hotelier.

Summary

This paper has identified four financial issues, which exemplify some emerging issues of importance to the hotel industry in recent years. Managers of hotel firms often encounter a situation where available cash resources are not sufficient to finance investment in productive assets. Capital shortage in the hotel business is mainly caused by a relatively large initial cash expenditure in investment. The limiting investment and increasing price are not ultimate solutions to the capital shortage. Some creative financing methods that can be adapted to different economic situations are required. Four capital sources have been identified: entrepreneurs, franchisers, use of securitization, and foreign investors. The future study is required to estimate the equilibrium point of hotel capital in the international markets. Estimating the equilibrium point may be the first step for the maximization of efficiency in terms of using the international capital. The tax and deduction issue is one of the big issues facing the international hotel industry since this issue can affect the industry's profit directly. Multinational firms, which are competing, with domestic firms are required to do continuing lobbying against unprecedented tax hikes on their hotels and to take advantage of government incentives and deduction policies. Developing hotel valuation techniques that are internationally applicable is inevitable as the industry continues expanding its market internationally. The new valuation techniques should handle the problems of change in market supply and demand balances, capital availability, property quality and life cycle position, current replacement cost discount represented in the purchase price, and the risk factors such as home and host country's economic, political changes that create unexpected changes of hotel values.

References


---

Jeong-Gil Choi is a Ph.D. candidate in the Department of Hospitality and Tourism Management at Virginia Polytechnic Institute and State University.