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Financing behaviour of Portuguese SMEs in hotel industry

Zélia Serrasqueiro[a,b,*], Paulo Maçãs Nunes[a,b,1]

[a] Management and Economics Department, Beira Interior University, Estrada do Sineiro, Pólo IV, 6200-209 Covilhã, Portugal
[b] CEFAGE Research Center, Évora University, Portugal

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ABSTRACT

In this study, using panel data models, we analyze whether the capital structure decisions of SMEs in the hotel sector follow the predictions of Pecking Order and Trade-Off theories. The results suggest that these theories are not mutually exclusive in explaining the capital structure decisions of SME hotels. The results obtained indicate that these firms follow a hierarchical order in their selection of financing sources, corroborating the assumptions of theory. The results also show that SME hotels adjust the level of actual debt towards optimal debt ratio as well as size, asset tangibility, growth opportunities, non-debt tax shields, and risk influence debt. These results suggest that the financing behaviour of SME hotels is in agreement with the predictions of theory. Therefore, Pecking Order and Trade-Off theories contribute to explaining the financing behaviour of SMEs in the hotel sector.

1. Introduction

In the context of firms' capital structure decisions, following the important research by Modigliani and Miller (1958, 1963), various studies have focused on ascertaining what the main determinants of firms' capital structures are. In this context, two theories are particularly important in explaining firms' capital structure decisions: (i) Trade-Off Theory (Kraus and Litzenberger, 1973; Scott, 1977; Kim, 1978); and (ii) Pecking Order Theory (Myers, 1984; Myers and Majluf, 1984). According to Trade-Off Theory, firms aim to reach an optimal level of debt, which means balancing debt tax-shields and bankruptcy costs. According to Pecking Order Theory, variations in debt are not motivated by the goal to reach an optimal level of debt, but they are a consequence of external financing needs, because when internal funds are insufficient, firms prefer to turn to debt rather than external equity.

Hotel sector firms have specific characteristics, which may influence firm financing behaviour. The intensive capital nature of firms in the hospitality sector may increase the firm risk, due to the high volatility of earnings caused by a high level of fixed costs, which does not change according to variations in sales (Elgonemy, 2002; Devesa and Esteban, 2011; Lee and Qu, 2011; Hua et al., 2012). The uncertain demand and, consequently, high operational risk may contribute to hotel sector firms having greater difficulty in acquiring external finance, and, preferring to turn to internal finance to fund firm activities (Andrew et al., 2007). However, when internal funds are exhausted, hotel firms use debt to fund growth, because the costs of this type of finance are inferior to the costs of external equity (Dalbor and Upneja, 2004; Tang and Jang, 2007). Consequently, hotel firms may follow the Pecking Order Theory, which is corroborated by various studies (Özer and Yamak, 2000; Sharma, 2007; Karadeniz et al., 2009).

However, the intensive capital nature of hotel firms allows the availability of fixed assets that serve as collateral for creditors. Consequently, those firms may easily acquire debt with better terms (Dalbor and Upneja, 2004; Tang and Jang, 2007) and have higher levels of debt for funding investment opportunities. Therefore, hotel firms may follow a financing behaviour according to the Trade-Off Theory: balancing debt tax shields against the bankruptcy costs associated with debt; and, adjusting the actual debt level towards optimal debt ratio. However, in accordance with Tsai et al. (2011) there are few studies that have analyzed the existence of an optimal capital structure in context of hospitality firms.

The literature on capital structure decisions has mainly focused on firms in the manufacturing sector and the results have been transposed to other industrial sectors, albeit without thorough validation (Tsai et al., 2011). The analysis of capital structure decisions of firms in the hotel sector are important for the firm managers/owners, because capital structure is a determinant of growth and contributes for firm profitability (Jang and Tang, 2009; Karadeniz et al., 2009; Madan, 2007; Tsai et al., 2011). The great

* Corresponding author at: Management and Economics Department, Beira Interior University, Estrada do Sineiro, Pólo IV, 6200-209 Covilhã, Portugal.
Tel.: +351 275 319 700; fax: +351 275 319 601.
E-mail addresses: zelia@ubi.pt (Z. Serrasqueiro), macas@ubi.pt (P.M. Nunes).
[1] Tel.: +351 275 319 600; fax: +351 275 319 601.

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majority of studies (Tang and Jang, 2007; Karadeniz et al., 2009; Devesa and Esteban, 2011) on the financing decisions of firms in the hotel sector take large quoted hotel firms as their subject of analysis. This paper limits the subject of analysis to small and medium-sized (SME) hotels to study the capital structure of hotel firms. This is the first specific contribution of this paper.

Additionally, studies on the capital structure of hotel sector firms (Jang and Tong, 2007; Chathoth and Olsen, 2007; Kim et al., 2007; Canina and Carvell, 2008; Jang and Tang, 2009; Karadeniz et al., 2009; Devesa and Esteban, 2011) do not directly test the applicability of the main theories on capital structure (i.e. Trade-Off Theory and Pecking Order Theory) in this sector. The second contribution of the paper is to test directly the applicability of those theories: in the case of Pecking Order Theory, using specific models for this purpose, namely Shyam-Sunder and Myers's (1999) model and Watson and Wilson's (2002) model; and, in the case of Trade-Off Theory, using the model of partial adjustment.

We choose the Portuguese situation, since it formed a suitable laboratory with SMEs, being involved in 99.6% of business activity carried out in Portugal, employing 75.2% of the workforce and accounting for 56.4% of the total sales of Portuguese industry (IAPMEI, 2008). In Portugal, 4095 of firms, in the accommodation sector are hotels and SMEs represent 99.7% of firms in the hotel sector (INE, 2008). Additionally, the great majority of Portuguese hotels are national unquoted firms, which causes great difficulty in acquiring external equity (Santos, 2004; Barros et al., 2011). We use a database made up of 177 SME hotels for the period 2000–2009, the Iberian Balance Sheet Analysis System (SABI) being used to collect data referring to Portuguese SME hotels.

The empirical evidence obtained in this paper allows us to conclude that Pecking Order and Trade-Off Theories are not mutually exclusive in explaining the capital structure decisions of SME hotels. On the one hand, hotel firms seem to acquire debt as a function of their financing needs, and follow a hierarchical order in their choice of finance sources, resorting firstly to internal finance, secondly debt and, finally, external equity, these results being in agreement with the forecasts of Pecking Order Theory. On the other hand, the financing behaviour of SME hotels seems to follow the predictions of Trade-Off Theory, given that these firms: present an adjustment of the actual level of debt towards the target debt ratio; increase debt as a function of size and asset tangibility; reduce debt as a function of growth opportunities, non-debt tax shields as well as level of risk. Therefore, both theories contribute to explaining the financing behaviour of SMEs in the hotel sector: these firms prefer internal finance, probably, because it is a cheap finance source and, when internal funds are exhausted, they choose to finance their needs with debt. Additionally, these firms, providing collateral to creditors, seem postpone some obstacles in acquiring debt, but transaction costs prevent these firms to have a quicker adjustment of the actual level of debt towards the optimal debt ratio.

The remainder of the paper is structured as follows: Section 2 presents a brief characterization of Portuguese hotel industry; Section 3 the research hypotheses and estimation methods; Section 4 presents the database and variables used in this paper; Section 5 presents the results and discussion; and Section 6 presents the conclusions, implications and limitations.

2. The Portuguese hotel industry

In recent years Portugal has experienced a particularly severe recession, when compared with the average of the 27 countries in the European Union. For example, in 2012, the rate of variation of the real GDP in Portugal was −3.2%, whereas in the 27 EU countries on average, it was −0.3%. In 2013, the rate of variation of real GDP in Portugal was −2.3%, while in the 27 EU countries on average it was −0.1%. However, despite the severe recession recorded in Portugal in recent years, the 3-month Euribor interest rates, widely used as a reference in granting firms credit, register sharp falls. For example, in 2007 and 2008, the 3-month Euribor interest rates were 4.3% and 4.6%, respectively, and in 2012 and 2013 were 1.3% and 0.19%, respectively. This fall in that interest rate reflects the possibility of obtaining credit on more advantageous terms.

Tourism is one of the Portuguese economy's key sectors and its relative weight on GDP is about 6.27%, above that of competing countries around the Mediterranean Basin such as Spain, Italy, Greece, Tunisia and Turkey. In 2011, the non-resident tourist arrivals were about 7.2 million, which, when considering all countries in the world, corresponds to a market share of 0.7%, with Portugal in the 35th position in a ranking, which the first three positions are occupied by France (8.2%), United States (6.3%) and China (5.8%) (Da Costa and Palmeira, 2013).

According to the National Statistical Institute (INE, 2011), in Portugal there are 85,205 firms operating in the sector of Accommodation, Restaurants and Similar, representing 7.3% of all firms. The accommodation sector accounted for 6478 firms, 4095 of them being hotels and SMEs represent 99.7% of firms in the hotel sector (INE, 2008). According to Santos (2004) and Barros et al. (2011), Portugal is an attractive destination for foreign tourists due to competitive prices practiced by supply and Portuguese climate.

3. Research hypotheses and estimation methods

3.1. Pecking Order Theory

In the following we present the models of Shyam-Sunder and Myers (1999) and Watson and Wilson (2002) used to test the applicability of Pecking Order Theory to SME hotels' capital structure decisions.

3.1.1. Research hypotheses

3.1.1.1. Shyam-Sunder and Myers's (1999) model. According to the Pecking Order Theory, variations in debt occur, exclusively, as a function of the firms' financing needs, i.e., variations in debt are a function of the financial deficit identified at a given time (Shyam-Sunder and Myers, 1999). Firms prefer internal finance rather than debt, because the costs of internal finance are less than those of debt (Myers, 1984; Myers and Majluf, 1984).

In the SME context, the preference for internal finance rather than external finance may be influenced by the greater information asymmetry between SME owners/managers and creditors. Smaller firm size contributes to a greater likelihood of bankruptcy and it makes easier for SMEs to change the composition of their assets. The problems of asymmetric information impose lenders to set up credit terms less favourable for SMEs.

Hotels are firms with considerable operational risk (Tang and Jang, 2007; Devesa and Esteban, 2011), thus we can expect that risk is proportionally higher in SME hotels, given the greater business risk associated with SMEs in general. The possibility of lenders hindering access to credit due to the high level of risk may imply SME hotels resort to debt only in situations of insufficient internal finance. Based on the arguments presented before, we formulate the following hypothesis:

H1. SME hotels only resort to debt as a function of their financing needs.

3.1.1.2. Watson and Wilson's (2002) model. In the theoretical framework of Pecking Order Theory, Watson and Wilson (2002) examine how firms finance the growth of assets, and conclude that when retained earnings are exhausted firms fund their needs with debt. According to Pecking Order Theory, recourse to external