International Journal of Hospitality Management 40 (2014) 100–108

Contents lists available at ScienceDirect

International Journal of Hospitality Management

journal homepage: www.elsevier.com/locate/ijhosman

Asymmetric impacts of the asset-light and fee-oriented strategy: The business cycle matters!

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ARTICLE INFO

Keywords:
Fixed assets
Management contract
Franchising
Risk
Business cycle
Economy
Hotel

ABSTRACT

The hotel industry in the United States has witnessed the rapid spread of the strategy of pursuing fee-based business (management/franchise) while going asset light. The two main consequences of this strategy are protection by shaving off fixed assets, and growth without a huge capital investment by expanding fee-based business. We examined how the impacts of this strategy vary with the business cycle. During a contraction period, the stable income stream of fee-based revenue and low operating leverage protect the firms from unexpected negative shocks. However, the efficient management of core intangible assets and the fee income structure resembling option payoffs act as driving forces to growth during an expansion period, increasing the firm's sensitivity to economic recovery. Consistent with the hypotheses, the management/franchising firms' beta was lower during contraction periods but higher during expansion periods than non-management/franchising firms' beta, and the beta movement between the two periods was significant in both groups. However, the proposed effects of the strategy appeared to apply only to the firms substantially engaged in fee-based business. Firms employing the strategy at a low or moderate level had stable beta over the cycle.

1. Introduction

In recent years, many hotel chains in the United States (U.S.) have gradually shifted their positions from owners and developers of properties to franchisors or management service providers with lighter assets on the balance sheet. Fee-based business mostly takes the form of either a management contract or franchising. From 2002 to 2010, the industry-wide fee income ratio, which is the ratio of the sum of fee-based revenue against sales revenue, has increased from 7.5% to 13.3%, more than a 75% increase. In the meantime, the average size of the fixed assets of public hotel firms has been reduced from $2.3 billion to $1.1 billion (Sohn et al., 2013). Sohn et al. (2013) referred to the strategy of reducing fixed assets and increasing fee-based revenues as "asset-light and fee-oriented (ALFO) strategy."

The implications of the ALFO strategy are twofold: reducing risk, and expanding the franchising/management business without huge capital investment. Fee income is less volatile than income earned from operating company-owned properties, suggesting that fee income brings stability to the bottom line (Roh, 2002). In addition, by whittling down properties, hotel firms not only reduce the risk associated with high operating leverage, but also obtain additional liquidity, which further decreases default risk (Denis, 2011). The resource-based view predicts that firms oriented toward fee-based business will grow more quickly with limited capital. Core competencies in the management/franchising business, such as established distribution channels and brand equity, are hard to imitate, but easy to replicate across properties (Barney, 1991; Dierickx and Cool, 1989). Hence, firms doing fee-based business are able to expand the business more efficiently than other conventional hotel firms by leveraging their intangible strategic assets. Considering that the two faces of the ALFO strategy focus on quite different goals from each other, protection and growth, it is expected that the implications of this strategy would not always be the same. Specifically, risk reduction, which is achieved mainly by disinvestment that subdues the susceptibility of hotel returns to the external economy, would be more pronounced during a contraction period. By contrast, during an expansion period, when the economy treats the whole lodging industry favorably, the effects of efficient growth through fee-based business to take advantage

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http://dx.doi.org/10.1016/j.ijhm.2014.03.007
0278-4319/

of the economic recovery would be more significant than that of risk reduction.

Despite the different implications of the ALFO strategy, there has been little research on this phenomenon. Sohn et al. (2013) argued that the strategy is effective in improving profitability and mitigating earnings volatility, thereby increasing firm value. However, although they showed an overall picture of this strategy, they did not take the economy's role into consideration. Given the close ties of the hotel industry to the economy (Wheaton and Rossoff, 1998) and the mixed effects of the strategy across the economic cycle, evaluating the effectiveness of the strategy with no thought of economic conditions would seriously impede the understanding of the ALFO strategy.

To address that concern, the current study was designed to examine how the strategy's two pillars (decreasing fixed assets and expanding fee-generating business) interact with the business cycle. To that end, the beta from the capital asset pricing model (CAPM) was borrowed, which is a measure of the sensitivity of a firm's stock returns to the market. By estimating beta in boom and bust respectively, the authors investigated how the two sides of the strategy exert asymmetric impacts on the operator and franchisor's returns sensitivity during different economic stages.

The authors expect this study to deepen management's understanding of the strategy by introducing them to the varying effects of the strategy during economic expansion and contraction. In addition, this paper makes theoretical contributions as well. Despite its tremendous influence on academia and industry, the static CAPM has been criticized for its poor ability in explaining cross-sectional variation in stock returns (Fama and French, 1992). Jagannathan and Wang (1996) argued that beta changes to reflect timely varying information, rather than being still. Consistent with Jagannathan and Wang's argument, the authors observed that the analyzed hotel firms' beta exhibited significant change according to the state of the economy, rather than staying constant, providing supporting evidence for the instability of beta.

The remainder of the paper is organized as follows. Section 2 reviews relevant literature and proposes hypotheses. Section 3 introduces the methodology used in the study and Section 4 explains the main results. Section 5 discusses the implications of the findings and concludes.

2. Literature review and hypothesis development

2.1. Business cycle and the hotel industry

It is true that companies adjust their strategies dynamically and asymmetrically over the business cycle (Mascarenhas and Aaker, 1989), implying that the complexity of the economy twists the implications of a strategy so that even the same strategy is unlikely to be consistently effective throughout the business cycle. Therefore, analysis using pooled data that assumes homogeneity over the whole period would obscure the varying influences of a strategy and bias the results accordingly (Bishop et al., 1984).

In this study, the effectiveness of the ALFO strategy in different economic situations was investigated. Hence, it was important to examine the links between the hotel business and the economy first. Two representative links were carefully chosen, real estate and sales revenue. Since every firm makes use of real estate to operate a business, real estate has been argued as a source of systematic risk (He, 2002). The extant research lends empirical support to this idea. He (2002) showed that the real estate factor explains stock returns, even after accounting for five well-known risk factors, including market, size, book-to-market, and two bond-related factors. Similarly, Tuzel (2010) found that firms with more real estate holdings deliver higher industry-adjusted returns, and Hsieh and Peterson (2000) extended Fama and French's 3-factor model by adding the real estate factor and observed that 10 out of 53 industries are systematically related to the real estate factor. Due to the nature of the hotel business, real estate is an essential asset. The average real estate holding ratio, which is the average real estate holdings scaled by total assets, of hotel firms is 63%, with casino and casino hotels at 65% (Lee and Jang, 2012). A myriad of research has argued that the returns of hotel firms are partially determined by the valuable real estate they own (Gyourko and Keim, 1993), and thus are significantly exposed to real estate risk (Lee and Jang, 2012; Newell and Seabrook, 2006; Ong and Yong, 2000). The cyclical nature of the hotel business is another source of exposure to the economy. Wheaton and Rossoff (1998) observed that hotel demand is closely related to the U.S. economy, and Choi et al. (1999) argued that the hotel industry cycle sometimes precedes the macroeconomic cycle. In the following section, the ways in which the ALFO strategy affects these connections are spelled out.

2.2. Implications of the asset-light and fee-oriented (ALFO) strategy

The ALFO strategy is implemented through two practices: decreasing fixed assets and increasing fee-based revenues. These two practices benefit the firm in two ways: risk reduction and expansion without substantial capital investments. The literature in the financial risk management field has shown that reducing cash flow volatility leads to savings in financial costs, thus improved firm value. For example, Smith and Stulz (1985) showed that lower cash flow volatility reduces financial distress costs. Bessembinder (1991) demonstrated that decreasing cash flow volatility enables the firm to capture valuable growth opportunities, thus reducing underinvestment cost. Graham and Rogers (2002) argued that reduced earnings volatility enables the firm to increase debt capacity. Since interest expenses are tax deductible, increased debt capacity leads to additional tax benefits of debt. Graham and Rogers (2002) estimated this tax benefit to be 1.1 percent of firm value. By turning property ownership over to a third party, firms engaged in fee-generating business (fee firms) can reduce the risk that stems from high operating leverage (Mintel, 2007). The risks associated with high operating leverage have been noted by the business press as well:

> A number of analysts express concerns about Hilton and Starwood in particular, because the two companies' real estate poses additional recession risks. . .. Owning hotels is more risky than managing or franchising them because of the cost of carrying and maintaining property. . .. Hilton in particular could be hard hit by the economic slowdown. Hilton owns many of its hotels, unlike Marriott, which mostly franchises and manages properties owned by others. (Binkley, 2001, as cited in Tuzel, 2010, p. 2271)

As discussed in the above paragraph, firms that are not engaged in fee-based business (non-fee firms) and generate revenue from owned/leased properties invest a substantial portion of their resources in fixed assets, and thus are more vulnerable to adverse external shocks than fee firms, since they are unable to adjust themselves to changing economic conditions as easily as fee firms. In contrast, firms that hold relatively fewer fixed assets have more room to accommodate adverse economic shocks, reducing their market risk exposure (Tuzel, 2010).

Zhang (2005) argued that the asymmetric adjustment costs of investment and the time-varying price of risk make assets-in-place riskier than growth options in bad times. Costly reversibility means that firms incur larger costs when they disinvest than when they expand. When the economic situation becomes gloomy, firms try to dispose of their idle assets, but the high cost of disinvestment