



Capital structure in the hospitality industry: The role of the asset-light and fee-oriented strategy



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ABSTRACT

An asset-light and fee-oriented strategy (ALFO), which reduces risk and facilitates firm growth with minimum capital investment, has increasingly gained attention from industry practitioners and academic scholars alike, especially in the service sector like the hospitality industry. We empirically examine how ALFO is employed and how it is related to the capital structure, i.e. the proportion of debt and equity financing, in hospitality firms. Using a sample of 982 firm-year observations over the period 2002–2016, we find that ALFO is widely used by the hospitality industry, and as expected, the fee-income ratio and the degree of franchising have increased, while asset tangibility and capital intensity have decreased. Interestingly, although ALFO is positively related to long-term debt ratios of hospitality firms, our sub-sector analyses indicate that the relationship is only significant in the restaurant sector and not in the hotel sector. Our study contributes to the literature by identifying an important industry-specific variable that affects the capital structure of hospitality firms.

1. Introduction

The trend that began a few years ago of hospitality firms shifting to a more fee-driven business model, referred to as an asset-light and fee-oriented strategy (ALFO), has now clearly emerged as a dominant strategy. Similar to the asset-light strategy employed by other industries (e.g., the telephone communications industry and the semiconductor industry) that enable firms to give up plants and facilities to focus on developing intangible assets that are more profitable (Lin & Huang, 2011; Liou, 2011), an ALFO strategy enables hospitality firms to own fewer (or no) hotel or restaurant properties and invest more in technology and loyalty-based assets using franchising and management contracts. That is, what differentiates ALFO from other types of asset-light strategies is that it allows hospitality firms to generate sizable income from franchising and management fees collected from establishments that are not owned by the company. As an example of the prevalence of ALFO, Marriott and Hilton, two of the major hotel companies in the world, have clearly stated in their latest annual reports that they follow an asset-light strategy (Marriott International Inc., 2018) and rely on the fee-based business for continued expansion (Hilton Worldwide Holdings Inc., 2018).

In a franchise agreement, the franchisor receives an initial fee and

ongoing royalties from the franchisee by providing the franchisee the right to use its brand name and operating process (Combs, Ketchen, & Short, 2011b). While not all hospitality firms choose to franchise, firms that do franchise sometimes operate up to 100% of their total units through franchisees (e.g., Dunkin' Brands Group, Inc.). In a management contract agreement, a hotel chain sells a property but signs a long-term contract with the buyer to continue to operate the property for the buyer in exchange for management fees. Following a strategy shift from “asset-recycling” to “asset-light,” Hyatt Hotels announced a plan in 2017 to sell \$1.5 billion in hotel real estate over the next 3 years (Ting, 2017).

Despite its prevalence, only a few studies have examined the implications of ALFO in the hospitality industry (Sohn, Tang, & Jang, 2013; Sohn, Tang, & Jang, 2014). Overall, these studies indicate that ALFO reduces risk and allows firms to expand without large capital investments. Specifically, Sohn et al. (2013) argue that ALFO reduces operational risk (i.e., operating leverage and earnings volatility) because asset-light translates into a lower fixed-asset ratio that decreases operating leverage (i.e., the ratio of fixed to variable costs) and fee-orientation translates into a higher fee-income ratio (i.e., the proportion of income generated by fees) that lowers earnings volatility. In the same vein, Sohn et al. (2014) argue that ALFO reduces systematic risk

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because firms that invest less in fixed and illiquid assets are less vulnerable to economic ups and downs and are more flexible to adjust themselves to economic conditions. To the best of our knowledge, no study has explicitly examined the implication of ALFO for the financial risk of a firm, which is part of the overall risk encountered by hospitality firms and a significant concern for many investors and other stakeholders.

Unlike many industries that are not geographically distributed, the hospitality industry is traditionally confronted with a higher need for financial capital to invest in fixed assets such as land, building, and equipment, and since debt is relatively cheaper than equity, it has been widely used as a source of capital to fund investments. Using a sample of S&P 1500 firms over 21 years, Singal (2015) finds that the mean leverage was 22.8% and the difference between hospitality and non-hospitality firms was a hefty 9.8%. Although debt can lower the cost of capital and potentially increase firm profitability, research shows heavy debt financing has also led to bankruptcy of a number of hospitality firms (Gu, 2002; Kwansa & Cho, 1995).

Due to the importance of debt, many scholars have examined the manner in which a firm uses debt and equity to finance its overall operation and growth, i.e., the capital structure of the firm. Capital structure decisions are vital to firms because they affect the profitability and survival of firms. While debt increases firm value through the interest tax shield (Modigliani & Miller, 1963), it also reduces firm value by incurring bankruptcy costs (Andrade & Kaplan, 1998) and agency costs (Jensen & Meckling, 1976; Myers, 1977). Compared with equity financing, debt financing lowers the cost of capital. Given the costs and benefits of debt financing, whether an optimal capital structure exists has thus received plenty of scholarly attention.

In the hospitality field, researchers have also examined capital structure decisions. In particular, Sheel (1994) shows that traditional leverage determinants have varying effects on the short- and long-term debt behavior of hotel and manufacturing firms, whereas Tang and Jang (2007) report that some determinants, such as earnings volatility and firm size, affect long-term debt usage only in software firms but not in lodging firms (Tang & Jang, 2007). Both studies conclude that there are industry-specific variables affecting the capital structure decisions that are not included in the specifications, which in part explains the low explanatory power of the regression models.

In this study, we attempt to answer the call by Sheel (1994) and Tang and Jang (2007) by linking ALFO, arguably the primary distinctive characteristic of the hospitality industry, to capital structure decisions of hospitality firms. By definition, both franchising and management contracts allow companies to expand their business with little capital investment and therefore lead firms to reduce capital expenditure on fixed assets. Since fixed assets can be used as collateral for borrowing, leverage of hospitality firms is expected to decrease over time. However, increases in fee-based income from franchising and management contracts are also shown to reduce earnings volatility, which leads to savings in financial distress costs. All else being equal, firms with lower costs of financial distress can afford more debt, thus a higher leverage ratio.

Due to the mixed influence of the asset-light and the fee-oriented components of ALFO on capital structure, especially predicted by competing capital structure theories discussed later, a systematic analysis of the potential impact of ALFO on capital structure decisions is warranted. To do so, we first examine how ALFO is adopted in the hospitality industry over 15 years by using univariate analyses. We then examine how ALFO is related to the capital structure of firms by using panel regressions with firm- and year-fixed effects as well as robust standard errors. Our expanded measures of ALFO – fixed-asset ratio, fee-income ratio, degree of franchising, and capital intensity – complement prior studies that only use two measures – fixed-asset ratio and fee-income ratio – by providing a more comprehensive and fine-grained view of ALFO and its implications. While prior research only focuses on the impact individual ALFO measures have on profitability, risk, or firm

value, our study emphasizes the relationship between an overall ALFO measure obtained from principal component analysis and capital structure.

To that end, our study contributes to the literature by identifying an industry-specific variable in explaining leverage behavior of hospitality firms. Using panel data analysis, we provide additional time-series evidence for the effect of traditional capital structure determinants in the hospitality industry when the existing evidence is predominantly cross sectional. From a practical standpoint, knowing the determinants of capital structure is especially important for the hospitality industry because of the high failure rates associated with high debt levels. The findings may benefit practitioners, investors, and bankers alike in making decisions regarding ALFO adoption/adjustment, investment portfolios evaluation, and lending and borrowing.

2. Literature review

2.1. Capital structure determinants and theories

Existing finance literature has identified several major determinants of capital structure including impact of taxes, costs of financial distress, and the agency costs and benefits of debt and equity. Scholars have also proposed two major theories in explaining capital structure decisions, i.e., the trade-off theory and the pecking order theory. Using a natural experimental design, Faccio and Xu (2015) find that both corporate and personal taxes affect capital structure choices. Since interest expenses are tax deductible, firms use more debt when firm-specific marginal tax rates are higher (Graham, 1996). However, heavy debt financing also incurs direct and indirect costs of financial distress, estimated as 10%–20% of firm value (Andrade & Kaplan, 1998). To balance the corporate tax benefits and costs of financial distress associated with debt, the trade-off theory postulates that firms will borrow up to the point where the marginal benefit of tax on additional debt is equal to the possible costs of financial distress. In other words, there exists an optimal capital structure that maximizes firm value.

In a broad sense, the trade-off theory also includes agency costs and benefits. From an agency perspective, owner-managers have the incentive to exchange low-risk investments for high-risk investments that benefit shareholders at the expense of bondholders (i.e., asset substitution; Jensen & Meckling, 1976). The presence of debt may also lead to underinvestment when a debt burden is so large that a firm cannot borrow more money to finance profitable projects (i.e., debt overhang; Myers, 1977). Despite the costs, debt has benefits that lower the agency cost of outside equity (Jensen & Meckling, 1976) and partially solve the agency problem of free cash flow (Jensen, 1986).

A competing theory to the trade-off theory is the pecking order theory, which states that due to information asymmetry between managers and shareholders, equity is more expensive than debt. As a result, firms should finance their new investments first with internal funds, then with risk-free debt, followed by risky debt, and lastly with equity (Myers & Majluf, 1984). A salient implication of this theory is that an optimal capital structure does not exist.

A number of studies have examined the determinants of capital structure in the hospitality industry. Dalbor and Upneja (2002) examine the factors affecting the long-term debt (LTD) decisions of U.S. publicly-traded restaurant firms. Dalbor and Upneja (2004) investigate the relationship between growth opportunities and LTD in the U.S. lodging industry, whereas Upneja and Dalbor (2009) test major capital structure theories in the U.S. casino industry. These studies indicate that the effect of some debt determinants like growth opportunities may vary among different sectors within the hospitality industry.

2.2. ALFO and its implications

Traditionally, hospitality firms have heavy fixed costs arising from capital investment in land and building and from depreciation and

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