



# Impact of location on profitability in the Spanish hotel sector



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## HIGHLIGHTS

- We use dynamic panel data models to explain impact of location on profitability.
- The results confirm the theoretical proposals of the SCP.
- We confirm the existence of economies of scale.
- Unobservable characteristics have a significant impact on profitability.

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## ABSTRACT

This paper analyzes the impact of market structure on hotel profitability in a sample of 8992 Spanish hotels in 2005–2011, using variables relating to the hotel and tourist destination in addition to structure–conduct–performance (SCP) and Chicago School frameworks simultaneously. The results show that profitability depends largely on the market structure and the level of demand of the tourist destination and we confirm the SCP proposals. Regarding characteristics of each hotel, there are unobservable characteristics which influence on profitability and we identify the existence of economies of scale.

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## 1. Introduction

Most investment decisions in the hotel sector are of a strategic nature and are difficult to change in the short term. An example is the location of the hotel which influences, for example, demand level, opportunities for complementary services and market structure (Bull, 1994; Lundberg, Krishnamoorthy, & Stavenga, 1995). Consequently, it is necessary to study the characteristics of a location that can affect the hotel business because the profitability of a hotel depends on more than its characteristics. In addition, a location study could identify the most profitable tourist destinations to create a new hotel. In particular, it is important to

understand know the characteristics of a tourist destination that affect the hotel business. The manager should know them to adapt strategy and improve the profitability of the hotel.

Focusing on market structure, there are two theoretical approaches to considering its influence on the profitability of a company. First, the structure–conduct–performance (SCP) framework, proposed by the Industrial Organization, argues a positive relationship between market concentration and profitability obtained through corporate collusion (Bain, 1951, 1956; Weiss, 1974). Moreover, the Chicago School also argues a positive relationship but its justification is different because it is based on the greater efficiency of large companies and not collusive behaviour (Demsetz, 1973; Williamson, 1975, 1985). In this context, there are no previous studies in the hotel industry that simultaneously consider the argument underpinning the SCP framework and that of the Chicago School. However, Davies (1999) indicated the need to incorporate variables related to the location in their study of the

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SCP in the UK hotel sector. Likewise, Pan (2005) also stressed the importance of including the efficiency of the hotel in his research about hotels in Taiwan as a future line of work, which is associated with the Chicago School. Thus, although we can say that the previous literature emphasises the importance of including both theoretical approaches in the analysis, there is no empirical study that has, to date, carried this out.

In addition, the academic literature focused on testing the SCP framework has not obtained unanimous results concerning the existence of the impact of market concentration on profitability. In our opinion, this may be because such studies do not consider the postulation of the Chicago School that it is important to include efficiency in the analysis. In addition, we propose that it is also necessary to include other factors related to the tourist destination and hotel and not only market concentration and efficiency.

This paper studies the impact of location on hotel profitability in a sample of 8992 Spanish hotels in the period 2005–2011, using variables relating to the hotel and tourist destination. For the hotel, we include the level of efficiency, market power and indebtedness level. Regarding the tourist destination, we use the demand level, market structure and entry barriers. Focusing on the market structure, the objective is to study whether the theoretical proposals of the SCP and Chicago School are met when we analyse its effect on profitability.

This paper makes three contributions to the literature. First, this study provides the first empirical evidence of the SCP and the Chicago School in the hotel sector simultaneously considering the characteristics of hotels and tourist destinations. Therefore, we study the impact of location on profitability using a broader and more comprehensive framework. In fact, previous studies have analysed very specific locations, using small data samples and limited information concerning hotel and tourist destination characteristics (Davies, 1999; Pan, 2005; Tung, Lin, & Wang, 2010). Including a broader range of information related to these characteristics in the study model, as we do in this paper, can reduce bias and increase the efficiency of estimations. Moreover, the results allow the isolation and quantification of the effect of the destination on profitability, which is important for good management of the competitive strategy of the hotel.

Second, we analyse the Spanish hotel sector because, unlike markets examined in previous studies (Davies, 1999; Pan, 2005), it has heterogeneous tourist destinations, allowing investigation of the impact of market structure on profitability in different contexts. Furthermore, tourism is very important in Spain and the country has a significant position in the global tourist context. For example, with an area of over 500,000 km<sup>2</sup> and a coastline of over 8000 km,<sup>1</sup> Spain is first in Europe for international tourist arrivals and second in the world in revenue, surpassed only by the United States (UNWTO, 2013).

Finally, the third contribution of this research concerns its methodology. We use dynamic panel data models through generalised method of moments (GMM) to control endogeneity problems. These problems arise in testing the SCP framework empirically (Demsetz, 1974). Other studies have applied static panel data but, according to Arellano and Bover (1995) and Arellano (2003), dynamic panel data also consider unobservable heterogeneity, which has to be included in the model to avoid bias. The importance of econometric improvements was pointed out by Davies (1999).

The paper is structured as follows. Following this introduction, Section 2 presents the conceptual framework. Section 3 presents

the theoretical model and Section 4 the data and the variables included in the study. The results obtained are explained in Section 5. The paper concludes with Section 6.

## 2. Literature review

Location affects the profitability of hotels because their services can only be consumed in a particular place and a given point in time (Bull, 1994; Dolnicar & Otter, 2003; Sainaghi, 2011; Suh & McAvoy, 2005; Yang & Lee, 1997). Moreover, the location determines the competitive position of the hotel over its competitors. Therefore, the market structure associated with a particular location may influence hotels' profitability.

The relationship between market structure and profitability has been addressed theoretically from two different perspectives that support the existence of a positive relationship, but with different theoretical support. On the one hand, the structure–conduct–performance (SCP) paradigm developed by Mason (1939, 1949) and Bain (1951, 1956) argues that markets in which there is a high market concentration (few suppliers) create a climate conducive to collusion activities between firms. The collusion among firms has a positive effect on their profitability. Therefore, according to the SCP perspective, a location with high market concentration could be related positively to profitability (Pan, 2005; Porter, 2008). In addition to competing among themselves within a specific location, hotels also compete against other locations. Hotels located in the same tourist destination can collaborate to attract more customers to it, potentially fostering their profitability in the long term (Crouch, 2011; Novelli, Schimtz, & Spencer, 2006; Shaw & Williams, 2009). This supports the hypothesis of the existence of incentives for collusion and reinforces the precepts of the SCP framework. Being a member of an industry with high market concentration, which favours collusive behaviours, will increase the margins of a company and hence its profitability.

However, the Chicago School questions the SCP perspective and suggests that the market structure is determined by the criterion of corporate survival. According to this theoretical approach, only the most efficient companies survive, so a market structure with a high concentration is due to a process of improvement aimed at enhancing efficiency (Demsetz, 1973; Williamson, 1975, 1985). Thus, efficiency is the key factor that can increase profitability and not collusion. In particular, only if the market has entry barriers is it possible to increase profitability through collusion (Stigler, 1968). This is justified on the basis that if there are no barriers to entry, the location will be a contestable market and incumbent firms would behave as in a normal competitive situation, with no market power, regardless of market structure (Baumol, Panzar, & Willig, 1982). This potential effect of entry barriers is consistent with several studies such as those of Yang and Wong (2012), Capone and Boix (2008), Gooroochurn and Hanley (2005), Maulet (2006), Capone (2006) and Michael (2003).

Despite prior theoretical considerations, the effect of market structure on profitability is unclear (Davies, 1999; Pan, 2005; Tung et al., 2010). In our opinion, this may be due to the omission of relevant variables, such as business efficiency and factors related to the tourist destination and hotel. Here, we highlight two papers focused on the hospitality industry, Pan (2005) and Davies (1999), which test the relationship between market concentration and profitability. However, they differ significantly in their methodology and the characteristics of the sample analysed. Davies (1999) discusses the UK hotel sector with a sample of 36 hotels for the period 1989–1994 and finds inconclusive results concerning market structure and profitability. Pan (2005) analyses the hotel industry in Taiwan, which has particular characteristics because

<sup>1</sup> Data obtained from the General Direction of the National Geographical Institute for 2008.

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