Financial challenges in the Indian hospitality industry

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Abstract

Purpose – The purpose of this paper is to provide a practitioners' perspective on financial challenges prevalent in the Indian hospitality industry. The paper also makes an attempt to give useful insights into possible solutions to the issues raised.

Design/methodology/approach – The study assimilates data from senior finance professionals from a spectrum of hotels in India. The study involves the collection of primary data through structured interviews.

Findings – The study highlights that some of the financial challenges faced by the Indian hospitality industry include high financing costs, multiplicity of taxes charged, licensing and legal issues, working capital issues and eroding margins. The study also gives some useful insights to the possible solutions to the challenges identified.

Research limitations/implications – This paper provides some very useful qualitative analysis of the contemporary challenges and their possible solutions prevalent in the Indian hospitality sector. The findings will be useful for hoteliers, policy makers and researchers to deliberate on the issues raised. However, it does not involve any quantitative analysis.

Originality/value – This study makes a sincere attempt to bring forth some real life issues, challenges and solutions which would be a good value addition to the existing literature.

Keywords Hospitality, Finance, Challenges, Hospitality services, Hospitality management, India

Paper type Research paper

Introduction

Throughout the 1980s the hospitality industry has been slowly evolving from one that was highly fragmented and dispersed to one that is becoming more consolidated (Teare, 1989; Olsen, 1991). However, the economic downturn and the banking sector turmoil have once again affected the global hospitality industry. Almost no aspect of the industry has escaped unscathed. In this new decade, there are many views on what lies ahead and how the recovery will unfold. The industry is finding new and creative ways to enhance revenues, cut costs and position themselves for future growth (Ernst & Young, 2010). As the executives in the hospitality industry continue to face the new wave of challenges the authors of this paper will provide fundamental insights into today's ever changing global economy and will provide a practitioners perspective on the financial issues or challenges that are a concern to the Indian hospitality industry. Since there are a few issues that are prevalent worldwide (Duncan, 2005) this paper provides insights and suggestions to address some of those challenges. The issues considered for the study are the ones that were raised by practitioners during a roundtable discussion hosted by IIMT during the Fifth International Conference on Services Management, May 2011 in Gurgaon, India. This paper primarily focuses on challenges in the Indian context and proposes possible solutions for deployment.

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Literature review

Many eminent researchers have reviewed hospitality research articles over the past decades that highlight the key issues (Harris and Brown, 1998; Olsen and Roper, 1998; Baloglu and Assante, 1999; Olsen, 2004; Rivera and Upchurch, 2008; Jang and Park, 2010). But little work has been done to review the financial studies (Jang and Park, 2010). Baloglu and Assante (1999) categorized 1,073 hospitality papers published during 1990-1996 into six categories namely:

(1) Marketing.

(2) Finance.

(3) Strategy.

(4) Operations.

(5) Research and development.

(6) Human resources.

Interestingly, the most widely studied subject in hospitality research was found to be human resources management.

Across the world, researchers delineated the scope of finance which broadly includes:

- Profitability, asset management, forecasting, valuation of assets, financial statements, their analysis (Baloglu and Assante, 1999).
- Managerial finance, financial management, financial services, corporate finance (Khan and Jain, 2005).
- Investments (Groppelli and Nikbakht, 2006).

According to the recent Ernst & Young global client survey on Capital Confidence Barometer in October 2010, the strategic decision to manage capital today yields a competitive edge for the firm tomorrow. Generally, companies finance their operations through debt or equity. Capital structure theories argue that firms should raise debt financing to an optimum level, as huge debt leads to financial distress (Titman and Wessles, 1988; Sunder and Myers, 1999; Myers, 2001). The lodging industry is a capital intensive industry and the value of the property is adversely affected by huge debt, especially in weak market conditions. Also, firms that raise finance at floating rates are better off than those that adopt fixed rate floated debt (Ernst & Young, 2010).

Jang *et al.* (2008) investigated the shifts in financing behavior of hotel companies listed in the USA during three time periods – slump 1990-1992, expansion 1996-1998 and recovery 2002-2004. The author found that, out of 78.8 per cent of total long term assets, plant, property and equipment (PPE) contributed 61.2 per cent, and this was financed by 49 per cent of long term loan and 28.9 per cent shareholders' equity. This depicts the interdependency of the investing and financing functions. The results also showed that the financing behaviors of hotel companies do not remain the same during all three different economic phases. In 1990-1992, the short-term interest rates were declining with very high long-term interest rates. The author suggested that managers should not stick to one leverage ratio. They must, instead, explore opportunities for financing long-term assets with short-term finance. Tress (2002) supported the notion that private sector lenders were becoming more cautious in the decade ending in 2000.

Elgonemy (2002) suggests that the financing of lodging properties requires creativity, flexibility and tenacity. As per the study, the main concern for the hotel companies is to deleverage and hold cash wherever feasible.

Bob (2003) pointed out that investment banking houses are filling the gap by offering more innovative hybrid securities that are specific to the lodging industry. The author highlighted the emergence of Real Estate Investment Trusts (REITs) in selected European countries as an alternative source of funding lodging industries. However, the author concluded that REITs would be successful only if supported by Pan-European statutes in terms of their conception, management and treatment of taxation. Singh and Schmidgall (2000) listed alternative sources of financing different segments of hotels using Delphi methodology. The list of lenders included an investment bank, pension fund, life insurance companies, money centered banks, regional banks, conduit, finance companies, community bank and thrift institutions. Bob (2003) supported this finding by concluding that insurance and pension fund managers are becoming more inclined to invest in hotels. Other prevalent sources of funding the lodging industry include mezzanine financing, private equity and other entrepreneurial sources (Elgonemy, 2002; Tress, 2002).

According to the Ernst & Young (2011) Report on private equity, there are 2,560 private equity firms across the globe. The report also detailed the availability of private equity finance and suggested that it is $231billion in the USA, $142 billion in Europe, and $56billion in Asia and the rest of the world. Private equity, as a source of finance, is preferred over Initial Public Offerings (IPOs) used by the hospitality industry in the USA (Lockyer, 2006). Whiley (2008) investigated the private equity scenario during economic downturns and concluded that recession provides an opportunity for investment as property prices go decline. Also, a large number of opportunities are available during recession when other financial institutions and banks curb leverage and tighten their norms. However, some practitioners are of the view that only less geared value businesses with huge cash flows, attract private equity fund managers (Adam, 2007). Liu (2010) detailed the ownership structure of Sunstone Hotel in the USA. The hotel was formed in 1985 and became a publicly traded REIT in 1995. In 1999, a private equity firm named Westbrook Partners acquired Sunstone Hotel and in October 2004, the hotel came up with the new equity issue. The performance of the hotel over the different scenarios improved. The author suggested that the effect of ownership structures on the performance of the hotels during different economic scenarios is an area which should be further explored.

In the context of changing ownership structures and the modalities of the external environment, the hospitality industry faces a greater degree of operational risk ("26th Annual New York University International Hospitality Industry Investment Conference", cited in Chang and Zeng, 2011; Birt *et al.*, 2006). Hotel values change over time worldwide. For example, there was negative growth in the value per room for a typical US hotel in the year 2008 and 2009, which stabilized in 2010. Such a scenario mandates better dispersion of information aimed at reducing information asymmetry among prospective investors (Botosan and Stanford, 2005). Financial reporting is one of the measures for dispersing information to reduce information asymmetry. According to the existing accounting norms, cross country transactions require the complete interpretation of financial statements. Typically this includes adjustment for different accounting standards, currency conversion, examining different financial terminologies, and in-depth analysis of operating characteristics of companies. However, the International Financial Reporting Standards (IFRS) provides a standard set of financial disclosure methods that would help in synchronizing the transactions beyond the geographical boundaries of the world. IFRS convergence would specifically affect lease accounting in the lodging industry context (Ernst & Young, 2011). Here the distinction between capital and operating leases is eliminated which, in turn, increases the leverage ratios and other financial and performance indicators. This is an important topic that needs further review before convergence of accounting standards can take place.

The hospitality industry also faces huge operating risks due to changes in the external environment like economic cycles and terrorism. Also, most hotel costs are fixed (Makrigiannakis and Soteriades, 2007).

Thus, we see a number of studies conducted worldwide on financial issues such as financing, capital budgeting, valuation, cost structures, adaptation of IFRS and taxation aspects amongst others. In view of this, it is more useful to explore the key financial challenges faced by Indian hoteliers in the current scenario.

Objectives of the study

The objective of this study is to identify the key financial challenges affecting the Indian hospitality industry. This paper will also try to consolidate practitioner opinions about possible solutions to the problems and challenges they are facing. The discussion focused on the following:

- The financial challenges that the Indian hospitality industry faces.
- The possible solutions to the problems identified.

Methodology

The methodology used in this study is exploratory in nature. An exploratory study is a valuable means of finding out "What is happening; to seek new insights; to ask questions and assess phenomena in a new light" (Saunders, 2009). Some of the most common research methods used in the social sciences are surveys and interviews (Saunders, 2009). Not surprisingly, the most widely used data collection technique in survey strategy is the questionnaire or the tailored design method (Dillman's, 2007; Saunders, 2009). For this study, the data has been collected over a three week period in June 2011. As mentioned earlier, the aim is to provide practitioner perspectives on the key financial challenges and in so doing, most of the data for this study has been collected from senior level managers of hotels based in India. Inputs were received from two eminent speakers in the roundtable discussion hosted by IIMT during the Fifth International Conference on Services Management in May 2011, Gurgaon, India. In order to survey other respondents the authors used a self-administered questionnaire and structured interviews from a judgmental sample of ten senior level professionals from the Indian Hospitality industry operated by global hotel chains in four and five star categories. This design of the interview also enabled the authors to ensure consistency in the data collection from one respondent to the next. The use of open-ended questions also encouraged respondents to provide an exhaustive and developmental answer (Saunders, 2009). Where it was felt appropriate, the authors sought clarification and further detail on certain questions.

Sample/participants

The sample for this study included corporate managers, consultants and professors associated with the hospitality industry.

Two participants were eminent speakers at the round table discussion held at IIMT, May 2011. These were Mr. Akshay Kulkarni, Executive Director – Residential Services (India) and Hospitality Services (South Asia), Cushman & Wakefield and Prof. Daniel Mount, from the School of Hospitality Management, Pennsylvania State University, USA.

Interviews were conducted with the following senior level professionals:

- Mr Amit Kapur, Director Business Development for Radisson Blu, Delhi.
- Mr Javed Ali, Vice President and General Manager, Radisson Blu, Delhi.
- Mr Alok Dagga, Financial Controller, Radisson Blu, Delhi.
- Mr Prasenjit Guha Thakurta, General Manager (Revenue Management, E-Commerce and Online Distribution). The Pride Hotels Pune.
- Mr Devendra, General Manager – Finance, The Pride Hotels.
- Mr Amitava Guha Thakurta, General Manager ITC Fortune Hotel Kolkata.
- Mr Alam Khan, Revenue Manager Sarovar Hotels, Delhi.
- Mr Raju Louzado, General Manager, Fortune Hotels, Bengaluru.
- Mr Prasad S. Bal, Lead – Hotel Distribution & E-Commerce, Sabre Hospitality Solutions India.
- Mr Amel Joe, Revenue Manager Hyatt Regency Pune.

Most of respondents were within the age group of 35-50 years and many of them had been associated with the hospitality industry for 20-25 years.

Findings

There are a few issues that have emerged as key challenges affecting the Indian hospitality industry. The key issues are high financing costs, taxation and legal aspects, working capital issues and eroding margins.

High financing costs

Hotels are considered as "real estate" rather than infrastructure projects due to the regulatory norms in India. In fact tourism in many states in the country does not have Industry status. As hotels are capital-intensive projects, they are dependent on banks for the financing of their projects. However, tough lending norms by Indian banks have led to a higher risk bracket. This has precipitated lending rates for hotels at much higher percentage rates than their prime lending rates (PLR). In turn, this has resulted in high cost of debt for hotel development. Elgonemy (2002) pointed that the hotel business has always been perceived as high risk by lenders. Fund raising through external commercial borrowings is difficult as it is regulated. With few options available for financing, the financing costs are higher. In India, the tenure of the loans is short, which impacts the debt repayment capacity of hoteliers.

Further, at present, although there are various regulatory bodies, they are scattered, regionally based and rather un-structured. There is in fact, very little effort to make the hotel industry more structured, with a proper regulatory body. India does not have a singular hospitality charter which is aimed at helping a steady investor to invest in the Indian hospitality sector. Most investments come in-house, from real estate companies. This impedes international finance from penetrating India, a development which could have enhanced the Indian market and added on to the National GOP.

Taxation policies and legal aspects

It is felt that that there is a multiplicity of taxes charged in the hospitality industry in India. The luxury tax is computed on rack rates and the operations of hotels are still being governed by certain archaic laws. A plethora of licenses are required with multiple agencies responsible for approvals. Inadvertently, the approval process could take a period of 6-12 months making it lengthy. Further, it is also felt that there is a lack of fiscal incentives for hoteliers to invest in this capital-intensive industry.

In the USA there are relatively few tax related issues that impact the hospitality industry significantly. Reservations made at the retail rate by Online Travel Companies (OTCs), are paid at wholesale rates as are occupancy taxes. As a result, there has been a loss of tax revenue with the onset of OTCs in the USA as the margin of difference is kept by OTCs as service charge fees. The hospitality industry in the USA has been concerned that city councils will respond by raising occupancy taxes and several lawsuits have been filed, some of which have been won by city councils and as an outcome, the OTCs responded by de-listing the entire city. In contrast, some law suits have been won by the OTCs and there is a potential for many thousands of lawsuits to follow in the future. In order to address this problem, the OTCs are asking for a federal response.

Working capital issues

There are some issues related to the working capital levels in the hospitality industry that affect the day to day operations of the business. Generally, there is an expectation of a long credit period resulting in the generation of negative working capital and this adds additional burden to interest costs. A policy of negative working capital may prove to be detrimental, as by design, the hospitality industry is highly geared and thus, requires high levels of liquidity. As noted by a hotel's solution provider:

> [...] hoteliers process payments in a range of 40-60 days and they do so because hotel accounts carry large balances and they want to earn interest for the above mentioned period.

Eroding margins

With competition increasing, it is becoming increasingly difficult to maintain high margins. There are certain cost increases that are difficult to absorb and so some costs are being transferred to customers. Some of the issues affecting revenues and costs are as follows:

- There has been an increase in competition specifically for corporate clients who put more and more emphasis on lower rates and better services.
- There has been a decrease in average room revenue (ARR) due to the growing number of hotels/rooms.
- The impact of Indian taxation has increased the cost burden that must be met by guests.

- Terrorism acts as a brake on hospitality industry growth in some developing countries, including India.
- Natural disasters have a direct bearing on the hospitality industry. For example, Japan has had to cope with the aftermath of an earthquake and a tsunami.
- The increase in procurement costs for food and beverages and other materials, is not always proportional to the increase in rates that are charged to the guests.

As noted earlier, the online travel companies (OTCs) have impacted the US hotel industry in a big way. One major issue in this regard is that if 25 per cent of reservations come through OTCs and commission is 20 per cent, the hotel industry loses 5 per cent of revenues. It is estimated that from 2008 to 2011, hotel companies in the USA lost nearly $8 billion due to this kind of development.

Thus we find that there are several financial challenges faced by the global as well as the Indian hospitality industry today. A few of these are at the policy level and some of at the local level. Additionally, there are internal financial challenges that require specific responses by managers in different locations.

Solutions to the identified challenges

There are a number of possible solutions arising from the the hoteliers that were interviewed in relation to this study. The participants felt that if their suggestions were to be implemented, that they would go some way towards addressing the financial challenges that the hospitality industry is facing today. Some of the possible solutions require government intervention and others can be directly implemented by the hoteliers themselves.

The following initiatives could be undertaken in response to the financing issues:

- Hotels should be granted infrastructure status by Governments so that it is easier to access cheaper debt both from domestic and international markets.
- External commercial borrowings (ECBs) should be made more accessible by making regulations more flexible. This is especially true in the Indian context.
- Hoteliers should explore alternative sources of finance. The Ernst & Young (2011) report: *Global Hospitality Insights* suggests that companies should seek alternative sources of financing as most hotel companies during the 2008 recession were severely affected as they were geared with low cost risk funding.
- The availability of mezzanine finance products should be increased. According to Ernst & Young (2010) the worst affected hotels are the ones that raised debt finance during the peak market values of 2006-2007. The hotels that used mezzanine financing found themselves in a more difficult situation.

Actions in the sphere of taxation and legal regulation may also help in addressing some of the financial challenges. Suggestions are as follows:

- The Indian Ministry of Tourism should encourage the Finance Ministry to rationalize local taxation guidelines in favour of this sector. Hotels should be granted infrastructure status under Sec 80-IA of Income Tax (IT) Act. The benefits of relevant sections in the IT Act should be extended to all parts of India.

- A single uniform luxury tax, based on the actual room tariff only, should be imposed across all Indian states. Also, tax rates on rooms, food and beverages, and liquor should be uniform across the country.
- Incentives, in the form of tax breaks, should be given to reinvested capital in the hotel industry. Special incentives should be given for budget hotels across the country to alleviate funding issues.
- Transparency for the entire license / approval process should be increased, with minimum documentation.
- Restrictions on franchisors operating in India should be eased.
- The regulatory framework needs to be modernized with modifications to the rules and regulations.
- Once hotels are given industry status, concessions in electricity and energy charges should be available.

To address the working capital issues, it is suggested that the average credit period should be not more than 30 days. It is important that hotels can maintain a good level of liquidity – especially if they have a high interest burden.

There are several steps that could be taken to stabilize eroding margins in the hospitality industry. These are as follows:

- Salary structures needs to be revised or restructured to better manage costs. However adjustments need to be made in relation to rates of pay in related service industries so as to ensure that manpower is not lost because of more attractive rates of pay in other service industries.
- It is important that corporate clients are sensitized to the general price index so that corporate rates can be benchmarked against the index and increased (or decreased) as appropriate.
- Operating policies should seek to match input costs and sale values or prices so as to maintain existing profitability levels.

Implications for managers and policy makers

The hospitality industry in India and beyond faces an array of financial challenges but if handled well many of these can be resolved by innovative and dynamic decision making. In India, further assistance could arise from a few straightforward regulatory steps taken by the Government.

There is clear evidence that financing issues are among the key challenges faced by the industry today. As this industry involves huge capital investment, much of it is backed by the debt component with associated risks. It is clear that executives should take steps to explore alternative sources of finance and consider floating rate rather than fixed rates of interest. As noted earlier, firms that raised finance at floating rates are generally better off than those with fixed rate debt (Ernst & Young, 2010). It is also suggested that mangers should explore opportunities for financing long-term assets with short-term finance.

The industry should consider the benefits of innovative hybrid securities. For example, Bob (2003) has cited the emergence of Real Estate Investment Trusts (REITs) in selected European countries as an alternative source of funding for the hotel industry. He notes that that insurance and pension funds are becoming more inclined to invest in property securities such as hotels. Thus, managers should explore these funds as alternatives to regular financing. Other prevalent sources of funding include mezzanine financing, private equity and other entrepreneurial sources. In the USA, private equity, as a source of finance is preferred over the Initial Public Offerings (IPOs) (Lockyer, 2006). However, some studies suggest that only less geared businesses with huge cash flows attract private equity fund managers (Adam, 2007). Thus, it might be interesting to evaluate how much liquidity should be maintained as higher liquidity will attract more funding by the private equity players.

In order to achieve better cost management practice, input costs and sales value could be matched to maintain existing profitability levels. A number of costs in a hotel are fixed – such as deprecation, amortization, management fees, property taxes, insurance, rent, interests and income taxes. Thus hotel face the risk of high operating leverage. It might be useful for mangers to explore how fixed costs can be reduced or restructured so that a component of the same can be converted to variable costs. This will reduce the risk of the operating leverage.

As far as taxation and legal aspects are concerned, there is much that hoteliers can do but the regulators and the policy makers can surely take steps that will ease out some of the challenges for this industry. At present, the hotel industry is considered to be a real estate industry rather than an infrastructure project-based industry. Thus, a lot of benefits that are applicable to infrastructure projects are not extended to the hospitality sector. For example, in India, the debt extended to the hospitality industry is provided at the rates applicable to the real estate industry which is much higher compared to those charged to infrastructure industry projects. The regulators could quite easily develop norms for external commercial borrowing (ECBs) to facilitate availability and lower cost of finance. Furthermore, the policy makers could have just one uniform luxury tax based on the actual room tariff across all states. Also a uniform tax rate on rooms, food and beverages, and liquor should be applicable. Tax breaks should be given to promote reinvestment of capital in the industry. Finally, the regulatory framework could be modernized by streamlining the license / approvals process.

The above implications may be useful for hotel managers and policy makers in order to address some of the key financial challenges facing the hospitality industry.

Conclusion

This paper has made an exploratory attempt to highlight challenges that the Indian hospitality industry is facing in current times. Financing (high financing costs and difficulty in raising finance) has emerged as one of the key issues that needs to be addressed. In a scenario where raising funds has become more difficult and expensive, hoteliers are looking for alternative financing options. This not only helps them to generate liquidity but also enables them to raise capital at an optimal cost. Taxation and legal aspects are another important area where the Government and other regulatory bodies need to focus. Some other pertinent issues are: falling top lines and margins in the era of competition and economic fluctuations and other unforeseen scenarios such as economic downturns, terrorist attacks and tsunami.

The proposed reforms and initiatives led by the Indian Government would provide a conducive environment for the growth of the hospitality industry. This would be seen as a welcome move and would greatly help in curbing the problems related to taxes and other legal aspects. Better management of finance and costs will also solve some of the financial challenges faced by the Indian hospitality industry now and in the future.

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