The emerging strategic and financial issues in the Indian hospitality industry

An overview

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Abstract

Purpose – The paper aims to provide an overview of the facts and trends relating to the Indian hospitality industry. It also seeks to identify the key strategic and financial issues that hoteliers are currently facing and to introduce the theme issue.

Design/methodology/approach – The paper draws facts and emerging trends from various official reports and collates key issues as highlighted by the theme issue contributors. All the papers in the theme issue identify salient points after rounds of discussions with practitioners.

Findings – Some of the key emerging areas are risk management, cost management, land management and policies, revenue management, growth challenges and innovative practices arising from an extended inflationary period.

Practical implications – With domestic hoteliers in an expansion mode and foreign operators' intention of investing in India, the paper is of interest to hoteliers and policy makers interested in knowing about emerging and topical issues relating to this market.

Originality/value – There are relatively few prior studies relating to the strategic and financial issues affecting the hospitality industry in India – particularly in the context of practitioner involvement. The theme issue involves senior practitioners in the review from the outset and this approach offers a significant contribution to applied research in this field.

Keywords Strategy, Financial issues, Indian hospitality industry, Cost management, Risk management, Revenue management, India, Hospitality services, Strategic planning

Paper type General review

Introduction

The hospitality industry is one of the most sensitive industries globally in terms of its responsiveness and vulnerability to changes in the market. In fact, it is often more adversely affected by natural disasters, economic fluctuations and civil unrest than almost any other industry.

The current macroeconomic scenario is quite challenging, given the ongoing European sovereign debt crisis, high interest rates, inflation and weak corporate performance. Additionally, there have been other recent and traumatic events such as the earthquake in Japan during March 2011, civil disturbances in the Arab countries and floods in Thailand in October 2011.Growth in arrivals in Africa and the Middle East was slow in 2011 whereas arrivals to Europe, Asia, the Pacific and Americas were much stronger. South Asia and South East Asia also experienced grown in intra-regional demand during the period (ICRA, 2012).

India, too, has experienced tough market conditions in the recent past. However, in the long term, it is expected to become more profitable on account of several factors

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such as an upwardly-rising middle-class, rising affluence, consumerism and several initiatives by policy makers and the government to facilitate growth in the hospitality industry. There are challenges for the industry but with a strong focus on growth, the long-term scenario appears to be quite promising.

Some key facts and trends about the Indian hospitality industry

The hospitality industry reported an aggregated growth of 11 percent in revenues for the nine-month period ending December 2011, as compared to the same period in 2010-2011 and no significant change was observed in the operating profits (ICRA, 2012). In fact, the industry recorded a loss of Rs. 14.4 crores as against Rs. 108.3 crores profit during the previous year (1 billion = 100 crores). As a result, the interest coverage ratio (OPBITA/ Interest and finance charges) slipped from 2.32 to 1.75 in a12-month period and interest costs are one of the primary reasons for losses/ lower profits. In summary, the profitability status has not been very encouraging.

In terms of room occupancy the hospitality industry fared better. According to HVS (2011), the room supply grew by nearly 15 percent in 2010/2011, growth in demand out-paced supply and nationwide occupancy grew by 1.7 percent during the 2009-2010 period. However, the average rates recorded a slight drop (1.4 percent) over that of the previous year due to the focus on improving occupancies. The nationwide RevPar improved marginally (0.3 percent), overall.

Looking forwards, the future of tourism in India is expected to be bright and market optimism should provide a good impetus for growth – especially in the Indian hospitality industry. The World Travel & Tourism Council (WTTC, 2011) offer the following estimates: The direct contribution of Travel and Tourism to GDP is expected to be INR 1,570.5 bn (1.9 percent of total GDP) in 2011, rising by 8.1 percent pa to INR 3,414.8 bn in 2012 (at constant 2011 prices). The total contribution of Travel and Tourism to GDP, including its wider economic impacts, is forecast to rise by 8.8 percent pa from INR 3680.4 bn (4.5 percent of GDP) in 2011 to INR 8523.1 bn (4.9 percent) buy 2021.

Despite the current recession and rising costs, the long-term growth story of India – one of the BRIC nations – is strong as India is a prominent destination for investment by both domestic and international companies. As Jim O'Neil, a senior economist at Goldman Sachs points out in his newly published book "The Growth Map", the aggregate GDP of the BRIC countries (before South Africa joined in late 2010) has close to quadrupled since 2001, from around three trillion US dollars to between 11-12 trillion US dollars in 2010". Looking forwards, the GDP of BRIC countries is expected to reflect higher growth than in other world regions. In this context, the future looks bright as Indian hotels – now in revival mode – seek to identify the most effective cost management, profit maximization and growth strategies for the future.

The theme issue

This theme issue focuses on the strategic question: What are the emerging strategic and financial issues in the Indian hospitality industry?

The issue contains multiple perspectives on various strategic and financial developments from the shared perspectives of both academic researchers and senior practitioners. The articles touch on topics like land acquisition; cost management;

deployment of costing techniques for more effective cost management, assessment of risk and the management of costs in the context of food and beverage offerings. The context is Indian and the data was collected in consultation with practitioners and policy makers. In some cases, practitioners have co-authored with academics and this helps in drawing out experience and practical perspectives about the current and future realities.

Emerging strategic and financial issues:

The following five themes have emerged as key issues affecting the Indian hospitality industry in recent times:

(1) *Strategic growth challenges and issues in setting up of a hotel:* The most common complaint of hoteliers involved in setting-up a hotel relates to the regulatory environment. A very pertinent issue here is that most hotels in India currently have real estate status and not infrastructure status and because of this, the cost of financing is very high. If the Government grants infrastructure status, the biggest advantage is that the banking sector is able to lend to hotels at a modest rate of interest (3-4 percent) as compared to the very high rate of interest (12-13 percent) charged to hoteliers with real estate status. This change in status has long been sought by hoteliers in India. The Government has responded in its 2011-2012 budget, but only for 3 star or higher category hotels based outside cities with populations of more than one million people (Business Standard, 2012). Kamlesh Barot, President of The Federation of Hotel & Restaurant Associations of India (FH&RAI) comments that the Government's response on the infrastructure status issue is so limited that it covers only 5 percent of the total hotel market. FH&RAI is an apex body of the hotel and restaurant associations and is the third largest hotel and restaurant association in the world. It provides an interface between hoteliers and the Government, policy makers and other stake holders and is advocating that the entire hotel sector should receive infrastructure status. In so doing, it would enable Indian hotels to compete with foreign hoteliers in terms of rates (Economic Times, 2012). Further, the tenure of bank loans in India is often shorter and it is common to find that monthly repayments are subject to regular increases. External commercial borrowings (ECBs) are also regulated and many of the problems associated with hotel financing could be resolved if the entire hotel sector was accorded infrastructure status.

The average development cycle for India in the premium hotel segment is around 0.5-1 year longer than for the general Asia Pacific region. Despite this fact, the top ten global brands have a presence in India using different multiple brands and pricing approaches (ICRA, 2012). They are: InterContinental Hotels Group; Wyndham Hotels; Marriott International; Hilton Worldwide; Accor Group; Choice Hotels International; Best Western International; Starwood Hotels; Carlson Group; and Hyatt Hotels Corporation. The presence of all these groups clearly illustrates the interest of the biggest global hotel companies in making investments in India.

Jauhari (2012) reviewed the strategic growth challenges in the context of the hotel industry in India and there are a number of issues that need to be explored. Land prices, the cost of project funding, licenses for various approvals, decision-making processes, talent management, technology, branding and customer management through deployment of social media among others. These are all areas that require debate and also policy interventions. For example, what would be the components of a new strategic leadership approach; what would be the formats needed to expand franchising and other forms of business development? These and other questions need to be explored.

(2) *Risk management:* Risk is inevitable in the case of the hospitality industry. Conventionally, the restaurant industry, with small profit margins and high failure rates, is believed to be a risky business (Bell, 2002). A study conducted by American Express (2003) highlighted that nine out of ten new restaurant openings go bankrupt during their first year of operation. For an industry that is prone to risks both from the internal and external environment, it is important for hotels to develop systems to manage risk. Given the nature of the industry, the impact of external risk such as natural disaster or terrorist activity is much more prominent than for most other industries. Any negative sentiment or fear arising from terrorist activities, natural calamities or an economic downturn has a negative impact on travel and tourism because it is rarely a necessity. The impact is immediate and often lasts for long periods of time. This not only affects short-term profits but it may also have a longer-term impact on the stock returns – the wealth maximization objective.

In view of the above, it is of interest to hoteliers to better understand the risks that affect the hospitality industry especially in relation to pressing questions: Are these internal or external? Are these strategic or operational? Are there any suitable measures to evaluate the magnitude of risks involved? Which are the most pertinent risks and what measures are the hoteliers taking to minimize the adverse effects of these risks? Are there risk mitigation practices that the hospitality industry has already adopted and successfully implemented?

(3) *Revenue management:* Given the nature of the service experience in the hospitality industry and the fact that these services are often perishable, they need to be sold within a given time frame if their value is to be realized. Further, different segments of customers are willing to pay different prices and in these complex situations, the hospitality industry must continuously develop its revenue management techniques.

Hoteliers may benefit by understanding how routine practices such as overbooking is managed across different hotel segments for different groups of customers across the world. Further, it would be helpful to understand how social media is impacting revenue management techniques. It is challenging to measure the impact of revenue management techniques in direct relation to profits but successful case studies are needed to better understand this and other best practice approaches.

(4) *Cost management:* As the majority of hotel costs are fixed (Makrigiannakis and Soteriades, 2007). It is important to explore what hotel operators do – and could do – to minimize their costs. For example, can they really decrease fixed costs (as most fixed costs are largely related to the period rather than the product)? As

noted earlier, if the Indian Government grants infrastructure status, tariff rates could come down by 3 percent as suggested by the FH&RAI (Economic Times, 2012). Hotels are using sophisticated accounting mechanisms to improve the costing of their products and services and hence, better pricing may be possible. As competitive margins are thin, it may be wise for managers to correctly allocate and appropriate costs, rather than focusing on reducing overall costs. Any fierce competitive environment brings about change in organizations (Avci *et al.*, 2011) and activity-based costing (ABC) is fast emerging as an effective cost management and pricing tool. ABC is more accurate in terms of cost allocation though it is expensive to operationalize (Drury, 2002). Additional measures can also be taken such as the deployment of data envelopment analysis (DEA) to better understand costs and improve the efficiency levels of hotels (Sanjeev, 2007).

As far as the non-operating costs are concerned, one of the biggest costs for the Indian hotel industry is the interest cost. It can be argued that financing costs or interest expenses are challenging in any industry, but the situation in India is worse as compared to other countries. This is because the regulatory norms in India treat the hospitality industry as a real estate industry rather than an infrastructure-based industry. Consequently, the risk weights assigned by the lenders to the hospitality industry are high, thereby increasing the borrowing costs of hotels. Elgonemy (2002) has elucidated that the risk associated with the hotel business has been perceived to be high by lenders as banks often charge a much higher rate than their PLR. In part, this is because there are few options for hoteliers to raise finance at competitive prices (Sanjeev *et al.*, 2012). In this context, it is of particular interest to find out what the industry is doing about both operating and non-operating costs.

(5) *Impact of inflation on profit margins:* All industries are hit by inflation. But it is even more pertinent in the case of budget hotels as they operate on thin margins and any such adverse impact gives rise to debate as to whether hotels should absorb the rise in inflation to stay competitive or pass on the cost to customers to retain profit margins. Inflation, year-on-year, as measured by the Wholesale Price Index (WPI) has remained at high levels and shown an upward trajectory since December 2009. Inflation was at 9.8 percent in August 2011, much elevated above the five-year historic average of 6.5 percent (2006/07-2010/11) (HVS, 2011). A report by HVS suggests that the ever-rising prices of manufactured products, food grains and oil has contributed towards persistently high inflation. This means that current levels of high inflation may have a negative effect on the profit margins of existing hotels. In this context, it is useful to understand how an extended period of inflation affects hotel operations. For example, are there any practices or strategies that hoteliers or restaurateurs have adopted that have led managers to focus on cost reduction and re-visit pricing strategies? Have difficult times, due to rising food inflation, prompted any new innovative practices? How has the industry reacted to inflation in terms of managing costs without compromising on quality?

Summary

Globally, there have been various factors such as natural calamities, the euro crisis and civil unrest that have impacted the hospitality industry. India too has faced hard times but with its growth focus, innovative practices, and support from the Government in relation to certain policy frameworks, the future looks promising. As demand has increased, domestic hotel companies are in an expansion mode. Many global players have already entered, or are planning to make huge investments in India, and so this is a good moment to review the key strategic and financial issues that affect the Indian hospitality industry. As there has been limited research in the areas of strategy and finance for the hospitality industry the emerging issues investigated in this theme issue include: the challenges that hoteliers face in setting up a hotel, risk management, revenue management strategies, cost management and fighting inflation to minimize the impact on profit margins. There is a growing awareness amongst hoteliers for the need to understand these issues in depth so that they can adopt the appropriate measures to enhance growth and profitability.

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