Economic and marketing fundamentals of hotel chains

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Introduction

Hotel chains are major players in the global hotel market. From both business practice and theoretical perspectives, hotel chains exist as enterprises only if they are more competitive than independent hotels and contribute to increased financial performance of the individual properties that constitute them. If hotels chains are less competitive than individual hotels in attracting guests and generating revenues, and membership in a chain does not lead to improved financial performance of its members, then it does not make economic sense for any independent hotel to be affiliated to a hotel chain. In this regard, this chapter builds on the discussion from Chapter 1 and elaborates the economic and marketing fundamentals that determine the existence and development of hotel chains (Ivanov and Zhechev, 2011), namely:

- brand recognition and significant role of the brand in choice of hotel by guests;
- high sunk costs;
- service standardisation;
- economies of scale;
- economies of scope;
- financial benefits of chain affiliation for the individual hotel surpass the affiliation-related costs

Figure 2.1 depicts the six economic and marketing fundamentals (in italic) and their impact on chains’ and individual hotels’ revenues, costs and financial performance. The financial performance of the chain and the member hotels depends on the difference between their revenue and costs. The brand recognition of the chain leads to decreased perceived risk for the affiliated hotel’s customers and its greater market visibility which increase the number of guests, overnights and prices, ultimately resulting in higher revenues for the hotel. The chain incurs expenses to develop and promote its brand, which take the form of sunk costs and are one of the barriers to entry into the industry. The individual hotel incurs expenses to be part of the chain, some of which are considered revenues for the chain – franchise/management/
membership fees. When financial benefits from the chain affiliation are greater than the costs associated with it, the hotel becomes/remains affiliated. When the number of hotels in the chain’s network increases, the chain experiences economies of scale and economies of scope that contribute to cost savings for the chain. Ultimately, the service standardisation influences the expenses of the individual member hotel and brand recognition of the chain. Each of these economic and marketing fundamentals is elaborated in detail in the next section of this chapter.

### Economic and marketing fundamentals of hotel chains

#### Brand recognition and significant role of the brand in choice of hotel by guests

The common brand is one of the determining characteristics of hotel chains – hotels in the chain share a common brand which is recognisable by the potential guests (see Chapter 1). Business practice and prior research (Yesawich, 1996) reveal that the brand of the hotel and its popularity play a significant role in customers’ choice of a hotel. The chain brand effect on a hotel’s financial performance may be evaluated in several directions:

1. **Decreased perceived risk of the choice of a hotel.** Brand familiarity decreases their perceived risk in the decision-making process (Keller, 2013: 436; Lin, 2013), thus when travelling to a new destination many tourists show preferences for the secure choice of chain hotels.
2. **Greater market visibility of the hotel.** The hotel is included in the reservation system of the chain and, through the chain’s centralised contracts, in global distribution systems (GDSs) (Amadeus, Sabre, Travelport), online travel agencies (OTAs) (e.g. Booking.com, Travelocity, Expedia), tour operators and travel agents. The hotel is also included in regular marketing communication campaigns of the chain directed towards distributors (push strategy) and direct customers (pull strategy), and in the loyalty programme of the chain. In all cases, these actions lead to greater chances that the hotel is booked by the customers or the distributors.

3. **Increased average daily rate (ADR).** Affiliation to a chain results in a ‘brand premium’ in the price level of the hotel. Ivanov (2014), in his research about the factors influencing the prices of hotels in Sofia (the capital of Bulgaria), finds that while chain affiliation does not influence weekday prices of the hotels, it has a positive and statistically significant impact on weekend price, i.e. the ‘brand premium’ has a more tangible effect during periods of low demand.

4. **Increased number of guests.** The chain’s brand net impact on the number of guests depends on the balance between the decreased perceived risk and increased market visibility from one side, and the higher price level, from the other. The decreased perceived risk of the guests and increased market visibility of the chain-affiliated hotel improve a hotel’s competitiveness and it attracts more guests, while the higher price level makes the hotel less price competitive and dissuades some guests from making a booking at the hotel. Considering that the brand development usually generates more inelastic customer response to price increases and more elastic response to price decreases (Kotler and Keller, 2006: 277), we may say that there is a high probability when a hotel is affiliated to a hotel chain that the effect of the decreased perceived risk and increased market visibility on the number of guests is greater than the effect of the increased price level, and the net impact is increased (although probably only slightly) number of guests.

5. **Increased number of overnights.** This is a result of the larger number of guests staying at the hotel.

The combined effect of the increased number of guests, overnights and price level is the higher level of revenues and improved performance metrics of the chain-affiliated hotel. In recent research, for instance, Enz, Canina and van der Rest (2015) found that chain-affiliated hotels gained higher levels of occupancy and lower RevPAR losses than independent hotels when pricing below competitors. Furthermore, independent hotels were not able to yield as substantial RevPAR gains from pricing at higher levels than their competitors when compared to chain-affiliated hotels. Therefore, affiliation to a chain improves the performance of the hotel compared to its competitors. However, the brand will contribute positively to the financial performance of the hotel if it has a strong, recognisable and positive image among customers and distributors. Therefore, hoteliers have stimuli to affiliate their properties to chains with popular brands and positive image considering their target market segments. When more hotels join the chain, its revenues coming from franchise/management/membership fees increase and the financial performance of the chain improves. As a consequence chains invest heavily in the recognition, image and identity of their brands, which leads us to the second fundamental concept behind hotel chain development – sunk costs.

**High sunk costs**

Sunk costs are already incurred costs of the firm that are irrecoverable (Carmichael and MacLeod, 2003). Usually they are associated with the marketing and research and development
costs (Sutton, 1995: 11). In the field of hotel chains, investments in the development and the improvement of the chain’s reservation system and in the brand image are the two most important sunk costs. The image and, less so, the reservation system are unique selling propositions of the chain to its potential members (independent hotels would save costs for designing trustworthy own websites with reliable booking engines and developing a strong image, because the chains have already done so). The more expenses the chains make to strengthen their own image and improve their reservation systems, the higher the financial threshold a new chain needs to overcome to develop a recognisable brand. Therefore, sunk costs may be considered as an entry barrier to the industry because they decrease the potential profits of new entrants (Schmalensee, 2004).

The rise of the OTAs in last two decades partially offsets the importance of the sunk costs for the hotel industry. Until the end of the 1990s, hotel chains were one of the most important pathways to increased market visibility of hotels, alongside GDSs and tour operators, due to their popular brands and online reservation systems. With the exponential growth of the OTAs in recent years, it became easy for the independent hotels to improve their market visibility without the need to join hotel chains. Selling through OTAs also eliminates the necessity for the hotels to adhere to strict chain requirements and service standards that decrease the operational flexibility and independence of the hoteliers. Actually, one might speculate that OTAs serve as substitutes of hotel chains in delivering one of the core benefits sought by hoteliers when they affiliate their properties to chains – the greater market visibility of the hotel. Furthermore, the OTAs’ brands, secure reservation systems, convenient payment choices (credit card, PayPal, on-the-spot payment directly to the hotel) and hotel ratings based on customer evaluations, decrease the perceived risk for the customers as well. Therefore, the OTAs may be considered as substitutes of the hotel chains for the customers as well as regarding their decreased perceived risk. However, the OTAs, unlike the hotel chains, do not impose or control the service quality standards of hotels included in their reservation systems, and thus they cannot provide guarantees to their customers regarding the service experience and satisfaction they would receive when staying at the hotels booked via them. On the contrary, some hotel chains, like Hampton Inn, even provide 100 per cent satisfaction guarantees to their guests (http://hamptoninn3.hilton.com/en/about/satisfaction.html) who receive a full refund if not satisfied with the service, which is possible only if the chain has control over the service operations and quality standards applied in the hotel.

Service standardisation

Customers expect to receive the same product quality, regardless of which hotel of the chain they stay at. This is possible only if the chain properties apply the same or similar service procedures, use the same or similar room amenities, etc., i.e. when the hotel service is standardised to a certain degree. Service standardisation means that the chain develops a service operations manual, which stipulates the service delivery procedures to be applied in every member of the chain. Of course, as discussed in Chapter 1, the standardisation aims to provide consistent service among the chain members, but specific service elements and hotel product design might be to a large degree adapted to the local conditions.

In practice, we observe different levels of standardisation – from full description of all service procedures to more general service guidelines depending on the type of affiliation used by the chain. Franchising (Chapter 12), for example, is usually associated with a very high degree of standardisation not only of service delivery process, but the building design as well. At the other extreme, marketing consortia (Chapter 14) are more lax and set mostly
general service guidelines which member hotels need to fulfil. The more standardised the service operations, the easier to control the hotel product quality and train new employees, but the more difficult it is to take managerial decisions in situations not elaborated in it. The opposite is also true – less detailed service manuals provide hotel employees with the opportunity to take creative decisions in atypical situations but hinder the training of new employees and service quality control. Therefore, service standardisation should look for an optimal balance between the chain managers’ desire for greater control of hotels’ operations and service quality and the necessity for flexible managerial decisions by hoteliers depending on the situation. Furthermore, the level of standardisation would depend on the specific market conditions. Hotel chains that operate in one national market could standardise their product and service procedures to a greater extent, compared to chains that operate in markets with diverse economic, social and cultural conditions that need to apply ‘glocalisation’ strategies and adapt some of their procedures to local situations.

The development of technology has made it possible to standardise and automate the service delivery process to a very high degree. This is especially true for budget hotel chains with limited services. For example, Formula1 hotel chain has standard modular rooms which facilitate the construction of the hotel building, housekeeping and maintenance. Furthermore, the chain transfers the check-in process to the responsibilities of the guest – entry to the hotel room is possible by an access code provided through an ‘automatic rooms dispenser’ machine (the terminology used by the chain). As an extreme example of standardisation of all physical features and the service processes we may mention the capsule hotels in Japan.

Finally, standardisation of the service process and the hotel product influences the management of human resources in hotel chains. The hotel business is notorious for attempting to cut costs by using a large number of low skilled, part-time and seasonal employees and interns, many of whom have limited knowledge, skills and work experience. In this regard, service standardisation and elaborate service operations manuals facilitate the training of new employees, staff rotation and the implementation of service quality control procedures.

**Economies of scale**

Economies of scale (the decreased costs per unit as production volume grows) are considered one of the major driving forces behind the development of a hotel chain (Contractor and Kundu, 1998; Holloway, Humphreys and Davidson, 2009: 315). In the field of hotel chains they are a self-nurturing process – the more extensive the chain’s network, the more the properties among which it distributes its fixed costs for marketing, administrative personnel, development and maintenance of the reservation system, etc. This decreases the fixed costs of the chain per one member hotel, which are calculated either as an absolute amount of money or as a percentage of the expenses (or revenues) of individual properties in the chain’s network. Lower fixed costs per member hotel create conditions for a decrease in the chain affiliation fees leading to its competitive advantage over other chains in attracting individual hotels as members in its network, thus further increasing the number of properties affiliated to the chain. In addition, in the case of contracts for centralised supplies (e.g. linen, toiletries, room furniture, etc.), the greater number of hotels in the chain increases its bargaining power with suppliers due to the higher purchase volume, leading to lower prices for the centralised supplies. Therefore, the chain has economic stimuli to affiliate as many properties to its network as possible.

The economies of scale depend to a great extent on the level of standardisation of the hotel chain’s product and the service operations procedures among its members. High level
of standardisation implies the use of the same supplies, room amenities, kitchen equipment, hotel facilities, etc., which leads to higher purchase volumes by the chain and lower prices. The necessity to adapt the product to local conditions decreases the purchase volume per item and the opportunities for lower prices. The importance of the economies of scale has been eroded in recent years by several factors. First, new technologies, like 3D printing for example, allow significant cost savings for many products produced even in extremely small quantities (Petrick and Simpson, 2013), i.e. the chain does not need to purchase very large quantities to receive low prices. Second, in the field of services, customers look for coherent service quality (Clarke, 2000: 27), and not for exactly the same physical features (of the hotel product). Therefore, the chain has to adapt the physical features of its product to local market conditions (e.g. kitchen/restaurant/room design), which decreases its opportunities to utilise the economies of scale via large volume purchases of the same items. Third, despite the massive introduction of various technologies in hotels (magnet cards for access control, in-room tablets, etc.) that increase the productivity of the hotels, human resources continue to play the major role in the service process, especially in mid- and upscale hotels, and put limits on productivity growth through economies of scale. Moreover, all these technological innovations are available to both independent and chain-affiliated hotels, thus further offsetting any competitive advantages created by the economies of scale for chain-affiliated hotels.

Economies of scope

Economies of scope are cost advantages that stem from the variety of the products that companies produce (Panzar and Willig, 1981). In the context of hotel chains, the economies of scope are derived from the different macro-, micro- and internal environments every hotel in the chain operates in. This provides the chain with the opportunity to ‘learn’ and develop its operations and service standards in different economic, social and cultural settings. Moreover, the knowledge gained in one market by one hotel could be transferred, under certain conditions, to other hotels in the chain and improve their efficiency, which is not achievable by the independent properties. The knowledge generated by the hotel managers and employees may take two forms – tacit and codified knowledge (Brown et al., 2003; Cooper, 2006). Tacit knowledge is the knowledge gained by hotel managers and employees through their work experience and is not written. Codified knowledge is written and is expressed in the form of service operations manuals, written procedures, internal memos, reports and other documents within the organisation. The codified knowledge is more easily shared among the member hotels than the tacit knowledge as member hotels receive the service operations manuals and various reports from the chain’s (regional) headquarters. Tacit knowledge obtained in one hotel is shared with other chain member hotels through various ways: rotation of the managers and other employees among chain members (in the case of affiliation via management contract, full or partial ownership), training sessions on which trainers and trainees share their experience and decisions taken in various situations, formal and informal conversations between managers of member hotels during annual meetings or other special events organised by the chain, etc. Tacit knowledge may be transformed into codified knowledge by including the best practices developed by some member hotels in the chain’s service operations manual and making them part of its standard procedures and compulsory for all other chain members. Therefore, by operating in different environments the chain has greater opportunities to learn and improve its services than independent hotels do.

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Financial benefits of chain affiliation for the individual hotel surpass the affiliation-related costs

An independent hotel will join a hotel chain only if the financial benefits from the chain affiliation surpass its affiliation-related costs. As already discussed, chain affiliation increases the revenues of the hotel via the chain brand effect (see Figure 2.1). However, affiliation to a chain entails not only higher revenues but expenses as well. For example, hotels need to pay a royalty fee for the use of the brand, management/franchise/membership fee (depending on the type of affiliation contract), use particular types and brands of supplies, that might be more expensive than unbranded ones, have more employees and pay larger insurance premiums to fulfill their chain’s requirements, and prepare monthly/quarterly/annual reports, etc., thus leading to higher initial and operational expenses for the affiliated hotel, compared to the independent one. If the financial benefits for the individual hotel from the membership in the chain are higher than the expenses for maintaining the membership, the individual hotel has incentives to be a chain member. This membership will be maintained as long as it is more profitable for the hotel to be affiliated rather than independent. Nevertheless, it is very difficult to measure the role of the chain affiliation in the increase of a hotel’s performance metrics (sales, ADR, RevPAR, GOPPAR): Is the higher performance of the hotel a consequence of its sales staff’s increased efforts or a result of the greater market visibility and brand recognition of the hotel due to its chain affiliation? When hotels receive bookings from the chain’s proprietary reservation system and the distribution channels associated with the chain (i.e. those channels, in which the hotel appears thanks to the affiliation to the chain), their managers and owners see the direct contribution of the chain affiliation to the financial performance of the hotel. However, one cannot be definitely sure whether the guest chose the hotel due to the chain’s brand and whether they would have selected it if it were independent (Cho, 2005: 132). This uncertainty in the contribution of chain affiliation to the financial performance of the member hotel makes hotel owners and managers quite sensitive towards the fee they have to pay to the chain. Paying franchise/management/membership fees only for the direct contribution of the chain to the financial performance of the hotels, stimulates the chain to improve the financial performance of its members and tangibilises the benefits chain hotels receive from their affiliation to the chain. The marketing consortium Magnuson hotels (http://magnusonworldwide.com/independents/), for example, ties its fees to the actual reservations produced by the chain.

Concluding thoughts

This chapter analysed the economic and marketing fundamentals behind the emergence and development of the hotel chains as business enterprises. We claim that the hotel chains will exist as enterprises if only they are more competitive than independent hotels and contribute to increased financial performance of the individual properties that are part of their network. Our analysis revealed that from managerial perspective, brand recognition, economies of scope and financial benefits surpassing the costs of the affiliation seem to be the most important forces that will continue to support the establishment of new and the expansion of existing hotel chains. Recent technological developments have eroded the importance of economies of scale and the sunk costs so that we may witness the successful development of small boutique hotel chains with only a few or tens of hotels and with various levels of service standardisation. Such chains may be developed either by newly established companies or as new brands of the existing hotel corporations.
References


