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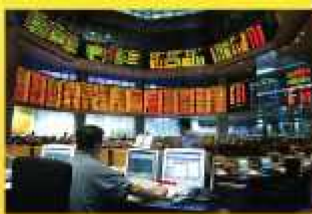

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SABAH HOTEL INDUSTRY AND CAPITAL EXPENDITURE DECISIONS: A PROPOSAL FOR AN EMPIRICAL RESEARCH

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ABSTRACT

Consistent with the government's latest initiative to strengthen the hospitality industry, this study highlights the current issues and practices of capital expenditure decisions in Sabah hotel industry. The focus on Sabah is crucial since the state represent a major tourists' attraction for its unique culture and natural beauty. Strategic investment in capital expenditure is linked to long term capacity building and sustainability of the industry. McConnell and Muscarelle (1985) provide evidence that firm performance is affected by capital expenditure decisions. Existing studies which examine factors that influence capital expenditure level include Nair (1979), Berndt et al., (1980), Larcker (1983), Fazzari dan Athey (1987), Fazzari et al., (1988), Waegelein (1988), Gaver (1992), Griner and Gordon (1995), Sartono (2001), and Mansor and Hamidi (2008). The main objective of this paper is to review the existing literature of capital expenditure issues in the hotel industry. An empirical future research is proposed which will involve both qualitative and quantitative methods. A survey questionnaire will be developed based on personal interviews of Chief Executive Officers and/or Chief Financial Officer of participating hotels in Kota Kinabalu City. Participants for the final survey will include finance managers or accountants of sampled hotels in the state of Sabah.

Key Words: Hospitality Industry; Tourism Industry, Capital Expenditure Decisions; Capacity Building; Investment; Performance.

INTRODUCTION

Sabah tourism industry is still at its infancy and represents one of the highest potential growth sectors in the Malaysian economy. However for the past five years, the industry has recorded an annual growth of 25 percent. Total arrivals of just over 400,000 in 1998 significantly increased five-fold to 2.48 million (60 percent domestic, 40 percent international) in 2007, which accounted for the yield surpassing the RM3.2 billion estimated for 2007 and the average per capita tourism receipt for international tourists is RM2,500 (domestic RM1,500) and average length of stay was eight nights, nine days (domestic four nights, five days) (Sabah Tourism Board, 2008).

Vis-a-vis with this positive scenario is the emergence of its accommodation industry. Table 1 depicts the number of registered hotels and total number of rooms, whereby Sabah recorded the top number of hotel room inventory in Malaysia. According to Sabah Tourism Board (2008), the occupancy rate Statewide averaged 75 percent and over 80 percent are for four-star and five-star hotels. By 2010, 6,000 rooms would be in demand, especially with regard to five-star beach resort hotels. A total of 4,000 rooms, presently under construction, are scheduled for completion in 2009.This room total ranges from five to one star ratings and one to three orchids rating as in Table 2. This growth is expected to continue and this reflects the need to improve the overall performance and competitiveness of the accommodation sector, where it is still in the early stage of its lifecycle.

TABLE 1: Registered Hotel in Malaysia as of September 2009

State	Total	Rooms Total
Sabah	218	13819

Source: Ministry of Tourism, Malaysia

TABLE 2: Hotel Rating in Sabah as of September 2009

Star Rating					Total	Apartment			Total	Orchid Rating				Total	Total
5	4	3	2	1		5	4	3		3	2	1	Not Qualify		
5	6	32	29	22	94	0	0	1	1	26	32	36	4	98	193

Source: Ministry of Tourism, Malaysia

Similar to other components of the tourism industry, hotel businesses are negatively affected by the reduction in tourists' arrivals during the time of economic down turn. However, the low sales period are usually accompanied by a growth in hotel up-grading and capacity building activities in anticipation of future demand growth when the economy recovers.

During the recent years, the industry has invested large amount of expenditures to improve guest amenities and services including flat screen televisions, high speed internet access and redesigns of guest rooms, lobbies and restaurants. These expenditures are long-term in nature and commit large amount of financial resources at risk. With limited resources, hotel managers are under pressure to prioritize and balance between investment and returns with the objective of increasing stakeholders' value. The challenge is to ensure that every capital expenditure decision does not lead to operational inefficiencies. Failure to invest in capital expenditure may result in loss of market share due to inability to offer the desired level of service quality at attractive prices. Wall (1982) states that within the hospitality and tourism industry, both the behavioral component and the quality of the environment (biophysical) are recognized by consumers. It is crucial to identify the optimal capacity or capacity threshold (Saveriades, 2000) which represents the required critical level to support the service activities.

To date, accounting research focusing on hotel management sector is very limited. Examples of the few exceptional studies are Brignal et. al. (1991), Collier and Gregory (1995a), Collier and Gregory (1995b) and Guilding (2003). According to Chenhall (2003) and Chenhall (2007), the importance of service industry to research activities is growing especially in the tourism and hospitality sectors. In general, studies of capital expenditure in the hotel industry can be grouped into two main areas. The first covers the techniques applied in analyzing the potential capital investment including the net present value, internal rate of return, payback and residual value. The second area of research focuses on the size or amount of investment in capital expenditure to ensure that companies to remain competitive.
The challenge in managing hotel capital expenditures is that they are many grey areas and subjectivity and thus, deserves a systematic study. Consequently, this topic area has not received the attention it deserves especially in developing countries. The present paper reviews the existing literature of capital expenditure issues and proposes an empirical future research. The future study has the following objectives (i) to document the profiles of Sabah hotels including ownership pattern; (ii) to examine the practice of capital expenditure management; (ii) to determine the preferred methods of capital investment analysis; and (iv) to suggest the determinants of capital expenditure decisions in the hotel industry.

The remainder of the paper is organized as follows. Section two provides a review of the existing literature on hotel industry and capital expenditure decisions. Section three discusses the determinants of capital expenditure and the predicted direction of relationships. The proposed research methodology is described in section four and this is followed by a conclusion in section five.

LITERATURE REVIEW

Griner and Gordon (1995) describe capital expenditure as the amount of investment incurred to acquire property, plant and equipment. Sartono (2001) further expands the definition of capital expenditure to include investment made to support organizational development. Collier and Gregory (1995) adopt a field study approach to examine capital budgeting practices in the hotel sector. Their study is partly motivated by the fact that hotel business is highly capital-intensive. Hotels generally incur large expenditures and these are classified into two broad categories. The first group is termed revenue expenses for which their associated benefits are realized within a year. These expenses are also known as period costs. The period costs are deducted from the annual revenue in the same accounting period when the expenses occurred. Thus, revenue expenditure reduces the taxable income for the year. The second group of expenditure is classified as capital expenditure and their benefits extend over a period beyond one year (William and Raymond, 1997). They include expenditures incurred to purchase long term assets such as land, buildings and equipment or commonly referred to as Property, Plant and Equipment (PPE).

In the public sector, Beverly (1996) examines the accounting aspect of capital expenditures. Paula (1994) highlights the importance of standardizing data on capital expenditures to increase the value of real-estates. Peggy and Mark (1995) study the appropriate level of annual capital expenditures. Kerstein and Sungsoo (1995) investigate whether capital expenditures provide a reliable source of information to project future earnings. According to the International Society of Hospitality Consultants (2000), the variation in capital expenditure classification is due mainly to the flexibility in its definition. For example, KPMG (1999) excludes new hotels built or acquired in its definition of capital expenditure. Only items which are recorded in the balance sheet as fixed asset expenditure are included as capital expenditures. On the other hand, the International Society of Hospitality Consultants (2000) study reports that capital expenditure also includes capital improvement costs that prolong the economic life span of an asset.

At the micro level, capital expenditure affects strategic planning (Bromiley, 1986), production decisions (Nicholson, 1992) and firm performance (McConnell and Muscarelle, 1985). Existing studies which examine issues related to capital expenditure include Kuh and Meyer (1957), Dusenberry (1958), Jorgenson (1963), Kuh (1963), Jorgenson and Siebert (1968), Grabowski and Mueller (1972), and Elliot (1973). According to Brignall (1997), approximately 75 percent of hotel total costs are committed and fixed in nature. The cost per square meter of hotel rooms can reach £1300 or £13.6 million in total for a 150-room hotel (Ransley and Ingram, 2001). Comparing small to large firms, Barclay and Smith (1995) show that the latter are able to commit and afford higher fixed costs of debt and thus, carries higher debt level. In addition, Sheel (1994) states that these large firms also enjoy lower costs of debt since their large size is associated with low likelihood of bankruptcy.

Hotel owners generally hire managers or a management company to operate their business. Under the agency theory framework, the operating company represents an agent and the owner acts as the principal. The relationship of the two parties is agreed upon and legalized in the hotel management contract. Under such an arrangement, the agent is usually the party who proposes the capital spending for the hotel while the principal approves or rejects the proposal. The latter assumes the duty to fund the required expenditure and bear the risks associated with the investment. Guilding (2003) highlights the capital budgeting conflicts due to the hotel ownership structure.

Early studies which examine the importance of ownership structure in business decisions include Haugen and Senbet (1981), Walkling and Long (1984), Benston (1985) and Morck et al. (1988). According to Haugen and Senbet (1981), managers having ownership in options have the incentive to make decisions which are consistent with stockholder's interest. Morck et al. (1988) provides evidence of positive correlation between ownership and companies financial performances. Similarly, Wu and Wang (2005) conclude that increase in ownership corresponds with increasing firm value. The empirical findings of Jensen et al. (1992) suggest an inter-dependency among ownership, debt level, and dividend policy in. In relation to merger and acquisition, Walkling and Long (1984), Benston (1985), Agrawal and Mendelker (1987), and Sicherman and Pettway (1987) also provide an evidence that ownership influence the levels and the characteristics of the merger activity and acquisition that a company conducted.

Within the pecking order theory, internal financing such as retained earnings is generally preferred over external debt or equity. The theory proposes that for financing activities, companies usually choose to issue debt after internal funds are exhausted. Issuing new shares is the least preferred. Myers and Majluf (1984) attribute this sequence of financing to information asymmetry where managers' knowledge about the companies is greater than that of the average investor. External funding is associated with a signal of profit reduction and thus, results in low stock prices. Issuing new stock instead of debts may suggest that managers perceive over pricing of companies' stocks. Consequently, the announcement of a stock issue is associated with a negative stock price reaction.

According to Davis and Heineke (2005), the perceived quality of service decreases as physical capacity utilization increases which usually lead to queuing. On the other hand, excess capacity results in waste and discounted prices to stimulate demand (Davis and Heineke, 2005). Inadequate capacity, on the other hand, can impair the visitor experience through degradation of facilities, overuse of natural resources, crowding, and increased waiting time. It can allow opportunities for competitors to enter the market and can overtax the workforce, leading to employee burnout and increased turnover. Fortunately, firms can borrow a number of ideas from other industries to facilitate better matching of supply to demand in their particular enterprise.

PROPOSED DETERMINANTS OF HOTEL CAPITAL EXPENDITURE

Hotel Ownership Structure

In the hotel industry, the practice of classifying capital investment as either revenue or capital varies and subjects to various interpretations of CE itself (Schmidgall, et.al., 1997). One of the factors relate to the structure of hotel ownership. It is common for hotel owners to hire management companies to operate their hotels. In return, the companies are rewarded which may produce conflict between owners and management company. The former has the incentive to maximize the expenditure as revenue expenses rather than capital expenditures in order to minimize taxable income. In contrast, capitalizing the expenditure is of interest to management since it increases net operating income (NOI) which usually forms the basis for management fee.

As in most developing economies, private and family-owned hotels are not uncommon in Sabah. For these hotels, the owner-manager usually provides the needed capital and this is sometimes supplemented by external bank borrowing. In recent years, however, hotel ownership by foreign investors has become an emerging trend. This is probably due to the need for fast capital expansion as a result of industry growth. Other explanations for the changing trend in ownership structure include increase capital mobility, low capital costs and rate of increase in market value of hotel assets versus office and residential properties. At present, the relationship between hotel ownership and capital expenditure decisions is not well understood and thus, becomes one of the objectives of this study.

Growth Opportunity

In the hotel industry, growth opportunity determines the level of capacity building. In Sabah, a 25 percent annual growth has been registered for the last five years and is expected to continue Dalbor and Upneja (2004) documented substantially high fixed asset level in the lodging industry. Their study provides evidence for a positive relationship between growth opportunities and debt utilization. They argue that unlike other industries, the company growth in this industry depends mostly on investments in fixed assets. Growth opportunity is reflected in expected future earnings. The relative value of growth opportunity can be estimated using the market-to-book ratio. Market value reflects market's expectation on the current net worth and all future earnings. In this study, the market-to-book ratio is adopted to capture the relative value of the growth opportunities viewed by the market. Growth opportunity is predicted to be positively related to hotel capital expenditure.

Star Rating and Service Quality

The philosophy and approach to operations management in the hotel sector is guided by the desired level of service quality. This factor is captured in the hotel star rating system. The star rating system signifies that hotels are independently branded with respect to their quality. Customers' satisfaction has been shown to be positively related to service quality (e.g., Cronin et. al, 2000; Green and Chakrabatry, 2007). High customer satisfaction, in turn, will result in customer loyalty (McCain et. al., 2005). High quality or high star rating hotel is thus, expected to invest more in capital expenditure to support their high quality service quality and delivery. In this labor-intensive industry, inefficient capital expenditure management will reduce service delivery and quality and result in reduction in a hotel's image and, star rating. Thus, a positive relationship between hotel star rating and capital expenditure is predicted in the proposed study.

Hotel Pricing

Pricing issues in the service industry can be very challenging and requires continuous monitoring of both internal and external environment. Smith (1995) classifies pricing into three main sets of information. The first relates to production costs and profits, the second set on information focuses on competitors while the third group concentrates on customers. Hotel pricing is highly sensitive to capacity utilization and cost considerations. Pricing is not only multidimensional but also complicated due to the fact that different pricing information can result in different pricing objectives. In other words, pricing decisions is non-standardized and subject to circumstances. Within this context, it is crucial for hotel managers who are in-charge of setting prices to understand the relationship between capital structure and hotel. Managers have to ensure that hotel businesses achieve satisfactory return on the capital investments through the pricing structure. They have the duty to formulate pricing policy that is consistent with the overall corporate strategy and goals. Hotels which invest highly in capital expenditure are more likely to experience higher fixed costs than those with less capital expenditure. Accordingly, it is proposed that hotel pricing is positively related to capital expenditure.

RESEARCH METHODOLOGY

The proposed study involves both qualitative and quantitative techniques. For the purpose of developing the survey questionnaire, semi-structured interviews of the Chief Executive Officer and/or Chief Financial Officer of selected hotels in Kota Kinabalu City will be conducted. The use of semi-structure interviews allow issues to be addressed and understood in details (Veal, 1997). Kota Kinabalu is chosen since it is the capital city of Sabah and also provides relative ease of access to the researchers. At the same time, being the main gateway to Sabah, Kota Kinabalu has the most concentration of hotels in Sabah.

Interviewees will be selected from three to five star hotels and the interviews will focus on gathering information relating to the general practices in capital expenditure decisions. According to Ryan et. al. (1992), there are five types of field study or interviews namely, descriptive, illustrative, experimental, exploratory, and explanatory. The proposed field study falls into the exploratory type since the interviews will focus on determining issues related to capital investment decisions.

The interview method has been proven to be more advantageous that the phone or mail interviews. Chisnall (1997) highlights the advantages as high response rates, completeness in responses and less ambiguity on the part of the respondents. All interviews will be recorded and to be attended by three researchers. The interviews are designed to be open-ended. The initial question will invite the interviewee to relate their operational guidelines and policies in handling capital expenditure decisions. Comments on any challenges and shortcomings experienced by the interviewee will also be addressed.

The interviewees will also be asked to share their opinion on the implications of their current practices on the hotel owners.

The participants will be on voluntary basis. The potential interviewees will be selected by sending a request to conduct the interview to the selected hotels. A specific form will be sent to these hotels accompanied by a cover letter. The letter will briefly explain the objectives of the study and its significance. The reply slip will be attached and the respondents will be requested to indicate their preferred date and time for the interview. The test parameters and hypotheses will be finalized based on the outcome of the interviews. Furthermore, before using the questionnaire for data collection, a pretest will be conducted in the Kota Kinabalu area to ensure the appropriateness and increase the validity of the final questionnaires.

For the survey part, a systematic sampling procedure will be utilized to determine the list of participating hotels. The official directory of hotels in Sabah produced by the Ministry of Tourism will be the basis for sample selection. These hotels range from three to five star ratings and include accommodation types such as business hotels, beach resorts, island resorts, and budget hotels. The survey will be sent to the Accounting/Finance Managers or their equivalent.

The questionnaire will be divided into 2 major parts. Part I addresses the descriptive statistics of the hotel such as their ownership concentration, number of employees, annual revenue, number of rooms and average capacity utilization. Based on the ownership structure, hotel ownership is generally classified into several major groups such as single-family-owned firms, state-owned firms, foreigner-controlled firms, and others. The second part covers statements correspond to the factors which influence capital expenditure decisions. A five point Likert scale will be adopted for the survey questionnaire.

Follow-up telephone calls will be made after 2 weeks to determine if the respondents have completed and returned the questionnaires. Otherwise, a new set of questionnaire will be mailed and/or an appointment will be set for a face-to-face interaction (for hotels within reasonable distance from Kota Kinabalu). The completed responses will be analyzed and a multiple regression analysis will be employed based on the outcome of the field work.

CONCLUSION

The main objective of this paper is to highlight existing research on operational issues and practices of capital expenditure decisions in the hotel industry. Capital expenditure decisions carry strategic implications on long term hotel capacity and performance. This study offers opportunities for further research even though several limitations are unavoidable. It addresses issues related to capital expenditure and presents a proposal for a new empirical research to determine the current practices of capital expenditure decisions in developing economies. Such a preliminary research is essential for the continuous improvement of both the strategic planning and implementation processes in any industry.

The findings of the proposed research shall provide a platform for further understanding of the financing aspect and can be expanded to a broader context at the national and regional levels. The universality of the capital expenditure phenomenon along with the exploratory nature of the proposed study could provide useful insights for hotel industry in other developing countries. Certainly, the proposed research if conducted in other countries would improve our understanding of the determinants of capital expenditures in the case of hotel businesses. Moreover, future research could be replicated and lead to a more detail analysis of how other sectors in service industries deal with the strategic issues of capital investment decisions. Extending the proposed study to include other capital expenditure issues could lead to a more thorough understanding of the concepts discussed in the present study.

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