The election of the organizational form in hotel companies

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Abstract

The aim of this paper is to explain the economic reasons for the complex variety of mechanisms of governance observed in the hotel industry. First, we focus on the allocation of property rights of key assets to propose an ordered typology of governance forms in the industry. This ranges from owned hotels, the organizational form which offers the hotel company the greatest control over assets, to franchising which offers least control. We also consider joint ventures, building/business leasing and management contracts as intermediate forms. Second, we take Transaction Cost Economics and Resource Based theories to analyze factors determining the choice of a particular mechanism of governance for each hotel. The literature predicts that wholly-owned hotels help to solve the hold-up problem, reducing quality coordination costs and enhancing the transmission of tacit knowledge and that they reduce the need for high-powered incentives. Our results on a sample of 712 hotels seem to support all the arguments except for the influence of the cost of coordinating quality. The latter topic remains open for future research.

Keywords

Hotel industry, modal choice, mechanisms of governance, management service contract

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1. Introduction

Organizational form in the hotel industry seems puzzling. As guests in hotels, we are not usually aware that only a minority of outlets are fully and directly owned by hotel chain companies. In 2003, the six largest Spanish hotel chains only owned 40.1 % of the 464 outlets in Spain.[1] The other establishments were linked to chains by a large variety of contractual figures such as franchises (3%), management contracts (12.5 %), leasing contracts (38.6 %) and minority joint ventures (5.8 %). The aim of this paper is to explain the economic reasons for the wide range of organizational forms used by hotel chains to manage the establishments bearing their brand.

The mechanisms of governance observed are far from being the classic, pure forms (market / hierarchy), and are best classified as hybrid forms.[2] Transaction Cost Economics (TCE), and especially the works by Oliver Williamson, offer a suitable theoretical framework for analysis of modal choice, especially from the strictly organizational point of view.[3] Williamson (1991) argues that market and hierarchy are pure but extreme forms and that between them there is a continuum of organizational solutions. The choice of one or another depends on their capacity for minimizing transaction costs. Similarly, the Resource-Based View (RBV) also offers arguments that have been applied to the choice of mechanism of governance, as a complement rather than an alternative to TCE (Williamson, 1999, and Poppo and Zenger, 1998)

However, little research has been done into the typology of the hybrid forms, which continues to be an important scientific challenge (Menard, 2004). In the words of this author, "The typology of the hybrid forms has not been well established" (p. 160). Based on the approach adopted by Contractor and Kundu (1998a), we note that the fundamental difference between the different types of organization (or contract) used by hotel establishments lies in the different ownership rights (or control exerted) over the assets needed to produce the service. We therefore propose a classification of the mechanisms of governance based on this criterion which we consider should assist in understanding of the hybrid forms.

We chose the hotel sector because it offers an ideal framework for studying mechanisms of governance. On the one hand, since tourism is one of the most important industries in Spain,[4] the main hotel companies operating in Spain are large, professionalized and competitive on a global level. This offers a guarantee that the business practices they follow do not differ substantially from those used by other world leaders and are probably efficient. Also, this sector displays a large variety of organizational forms which are difficult to note in any other

[1] According to Hostelmarket (2004), the hotel chains that had the largest number of outlets in 2003 were Sol Meliá, NH, Riu, Husa, AC and Hoteltur.

[2] See a recent review of this literature in Menard (2004).

[3] In referring to organizational matters, we omit part of the arguments used to explain the choice of mechanism of governance when related to the firm's strategic behavior. For this type of analysis, see Gulati (1998) and Anderson and Gatignon (2004).

[4] In 2004, Spain was in second place within Europe following France for total incoming foreign tourists (European Travel Commission, 2006, p. 11). It was also the favorite destination for European tourists in 2005, with 13% of total travellers (ahead of France with 11%) (European Travel Commission, 2006, p. 23).

sector. The aspect of greatest interest to researchers to date has been how hotel chains choose the mechanism of governance for growth in foreign countries[5] whereas our objective is to analyze the reasons for choosing the organizational form irrespective of the market characteristics. We decided to exclude establishments in foreign countries in order to ensure that the market variables were constant (thus avoiding the need to consider the influence of the political, economic and regulatory situation of the destination country).

The paper is structured as follows. After this introduction, the second section describes a theoretical typology for the way hotel establishments are linked to the chain, based on control over the assets that are fundamental for the hotel activity. The third section gives the theoretical framework and proposes the hypotheses. The fourth section describes the sample of hotels, the sources of information and the methodology used. The fifth section describes and discusses the main results. Some brief conclusions follow, with some comments on the limitations of the study.

2. Hotel sector, asset ownership and mechanisms of governance

The purpose of the hotel business is to offer accommodation in exchange for payment. This basic service sometimes goes together with others such as catering, leisure activities, business services, etc. The system is that the customer, probably attracted by the brand, contacts a hotel either directly or indirectly via its booking center. These two types of asset (brand and booking center) are essential to the business. The brand or, rather, the brand value, offers the consumer a guarantee that the hotel will meet its commitments regarding quality of service and enables the consumer to expect a certain level of service.[6] The booking center is a basic coordination mechanism and one of the most important points of sale (if not the most important, especially with the development of Internet booking). Although, strictly speaking, this is not an intangible asset, more important than its physical value is its value as a means for establishing

[5] Altinay and Miles (2006), Brown, Dev and Zhou (2003), Cazorla Papis and Perez Medina (2002), Chen and Dimou (2005), Cho (2004), Contractor and Kundu (1998a and b), Dev and Brown (1991), Dev, Brown, and Lee, (2000), Dev, Erramilli and Agarwal, (2002), Endo (2006), Fladmoe-Lindquist and Jacque (1995), Johnson and Vanetti (2005), Kehoe, (1996), Lewis, Chambers and Chacko (1995), Malley (1997), Pine and Phillips (2005), Pla Barber and León Darder (2004), Ramón Rodríguez (2002a and b) and Wong, Luk and Li (2005).

[6] We refer to the arguments given by Klein and Leffler (1981) on the value of the brand or reputation for safeguarding commercial relations. The brand owner offers the service promised in order to prevent dissatisfied customers from damaging the brand and, consequently, the value of investments to develop it. Specific studies on brand value in the hotel sector include those by Bailey and Ball (2006) and Kim and Kim (2005).

communication with customers and for providing information on them and on their preferences.

There are three main economic players in the hotel business – the manager, the operator and the owner. We define the "manager" of a hotel establishment as the person or legal entity provided by the brand and the booking center (such as the Sol Meliá chain). The manager is usually responsible for managing the establishment and strategically organizing the business, except in franchised hotels which are managed directly by the franchisee, but indirectly (or remotely) by the franchiser who is the owner of the brand and of the booking center.

Subsequently, the customer enters into contact with the hotel "operator" on the date agreed for the service (for example, the actual Sol Meliá chain or a separate company such as 30 Palma S.A. —Grupo Palomo)[7]. This is the company that produces the service, maintains the rights to use of all the assets (except those retained by the manager over the assets provided by the former) and, after paying the owners of the other production factors used, keeps the residual revenue. The operator's know-how, therefore, is the basic asset during this stage. This relates to the establishment's organizational routines and allows proper functioning of the production system by carrying out functions such as supplies, personnel management, financial control, supervision, etc. Although these skills are to a large extent the same throughout the hotel sector, there is always some degree of adaptation for each specific establishment.

The operator will not necessarily be the owner of all the assets, but must have the right to use them. So, with regard to the actual real estate (buildings, land and other property used for the hotel activity), there is a third figure, that of the "owner". This is the entity that holds the ownership title to the property and may assign it by leasing it to the operator. It may also be that the operator is not the legal owner of the hotel business but only holds a temporary right to use on the basis of a lease contract for the activity or the business. For example, in 2003, the Tryp Diana hotel in Madrid, managed and operated by the Sol Meliá chain, was leased as a business to the Hoteles Grupo Diana Company. In such cases, it often occurs that the productive goods and chattels - such as furniture, linen, crockery, decor and kitchen equipment (and even workers) - may be included in the lease contract. As a result, the three roles – manager, operator and owner – may be held by one, two or three different people or legal entities.

Hotel chains can use several types of contract to organize their network of establishments –franchise, management contract, leasing contract, joint venture and direct management. There are also mixed or co-operating forms that do not fit perfectly into any of these categories but combine them. Table 1 shows the link existing between the type of contract (or mechanism of governance) and the degree of control exercised by the chain over the basic assets of the hotel business.

Firstly, direct management of fully-owned establishments means that the chain obtains control of all the assets used in the production of the hotel service via ownership. It therefore employs all the staff and owns the brand, the booking center, the intangible assets, the goods and chattels and the real estate property. The distinguishing characteristic of direct management is

[7] In 2003, 30 Palma S.A. (Grupo Palomo) was operating three hotels belonging to the Sol Meliá group: Meliá Avenida de América, Tryp Guadalajara and Tryp Leganés (Hostelmarket, 2003, p. 87).

that the chain can obtain maximum control and, therefore, coordination of the assets needed to produce the service (Holmström and Milgrom, 1994 and Baker and Hubbard, 2003). A variant of full ownership, which is more legal than economic, is when the hotel is owned by a subsidiary in which the chain operating the establishment has a majority stake. In this case, even if the chain does not have direct control over all the assets, it does have indirect control so, from an economic point of view, the situation is similar to that of direct management because there is effective control over the operator's assets. As a result, we have joined these two categories by placing them in the same column under the heading "owned hotel". Independent hotels that do not belong to chains would also fall within this category.

But the situation changes when the chain holds a minority stake in the owner or operator company. In such cases, real control over the assets depends on the stake and on the type of shareholder. There may be financial or real estate partners who do not participate in management of the establishment, leaving this completely in the hands of the hotel chain. Or the partner may be a local hotel company operating the establishment, in which case the chain would, at the most, only manage the hotel. We have called this category "minority joint venture" (but will broadly refer to it as "joint venture").

A third possibility is for the chain, either directly or through a subsidiary, to lease a property or business from an independent owner to carry out its own hotel activity in it. In such cases, the owner may be a company or an individual involved in real estate activity or may simply have a strategically located property. In this case, the chain has full control over all the hotel business assets with the exception of the actual building and any related assets belonging to the owner. The chain may also gain access to use of the assets by leasing a working hotel, including not only the building but also the staff, furniture and operating know-how. The chain complements these assets with its own know-how and, especially, by carrying out strategic management and including the hotel in the chain and the booking center, as well as through other tangible assets belonging to the brand (linen, crockery, uniforms, etc.). In such cases, the chain is both operator and manager of the hotel but is not the owner. In both these situations, control over the assets is limited by the scope of the lease contract (building or business), because the residual decision-making rights over some assets belong to their owner. We have called this category "leasing contract"

The fourth possibility is when the chain is only the manager but neither the operator nor the owner. This means that the chain signs an agreement, normally known as a management contract (Eyster, 1998), with the operator so that one of its managers can run the establishment bringing to it, in addition to personal experience and management skills, the chain's brand name and the booking center. This means the operator is different to the manager. The latter, that is, the chain only owns the booking center and maintains control over the brand but it cannot be as strict as in the previous cases because the manager is not always able to transmit the necessary brand values to all the workers who remain on the payroll of the operator. The control exerted over other assets, such as goods and chattels and operating know-how, is limited by the contract because residual control is left to the operator. We have called this category "management service contract".

The fifth contractual situation, which is unusual in Spain but common in other countries such as France and the USA, is the franchise. In this case, the chain finds a partner (the franchisee) who sets up his own establishment but follows the guidelines of the chain and adopts its brand.

The main difference regarding the management contract is that it is the operator who is delegated by the franchisor to carry out the role of manager.[8] In this case, therefore, the real "remote" manager, that is, the hotel chain, only has direct control over the booking center with some control over the brand. Indirectly, the chain's influence is likely to be greater depending on the obligations and rights included in the franchise contract.[9] We refer to this category as "franchising agreement".

Finally, there may also be hybrid contractual forms in which control over assets works differently. For example, it may be that a company operating a hotel under a management contract with a chain is partly owned by the chain. Under such circumstances, the chain's control over the establishment is based on both ownership and contractual forms.

Table 1: Mechanisms of Governance and Control over Assets

	MEANS TO CONTROL ASSETS				
	EQUITY		***NON EQUITY***		
KEY ASSETS	Fully owned and majority joint ventures (owned)	Minority Joint Venture	Leasing contract	Management service contract	Franchising
Real estate property	++	+/++	-	-	-
Goods and chattels	++	+/++	++/+	+	-
Know-how	++	+/++	++/+	+	+/-
Booking center	++	++	++	++	++
Brand	++	+/++	++	+/++	+
Ranking[10]	**1** (10)	**2** (8)	**3** (7)	**4** (5.5)	**5** (3.5)

Key: ++ = total control of asset; + = partial control of asset; - = no control

3. Choice of mechanism of governance

Williamson (1991) argues that the choice of mechanism of governance should be in line with the characteristics or attributes of the transactions in order to save on transaction costs. It could, moreover, be argued that the choice of mechanism of governance will depend on the problems or contractual hazards faced by the parties because not all the mechanisms serve to resolve all

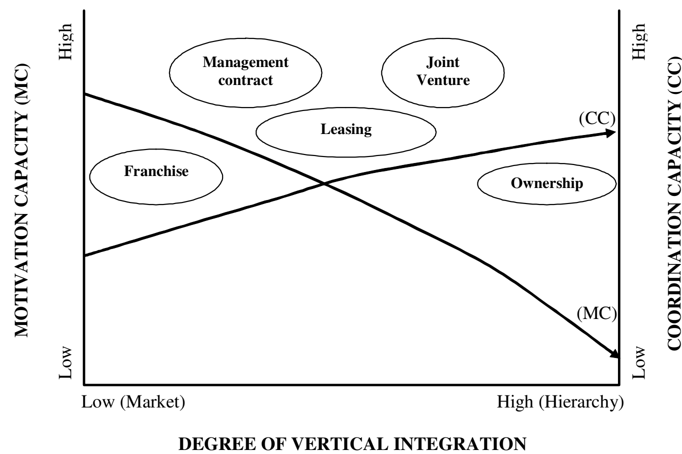
[8] Franchisees may own or rent the property.

[9] See Blair and Lafontaine (2005) for a summary of the problems of franchising and possible contractual solutions.

[10] Last row in Table 1 establishes a ranking of the degree of control over assets in each contractual form. In brackets appears a measure of the degree of control. This measure has been calculated adding the number of "+" in the column. When the symbol is +/++ the weight considered is 1.5 and 0.5 when is +/-.

problems equally efficiently. Such risks will depend not only on the characteristics of the transactions but also on the actual technology of the transaction and the institutional environment in which it takes place. Williamson (1991) also systematizes the analysis of mechanisms of governance, arguing that there is a continuum of intermediate or hybrid solutions between the two extreme or pure mechanisms – market and enterprise (*hierarchy*).[11] Figure 1 shows the range of possible governance solutions for the hotel sector as described in the above section as well as their situation on the market-enterprise spectrum.

Figure 1: Mechanisms of Governance, Coordination and Motivation Capacity



An enterprise-based solution, that is, one based on the ownership of all the establishments by a single owner, has the advantage that it facilitates the coordination of complex activities and the design of work stations (Milgrom and Roberts, 1992, Holmström and Milgrom, 1994 and Holmström 1999), unifying service quality and standardizing the corporate image. However, this solution is not so good at motivating those involved (Williamson, 1991). Although it is possible to motivate participants, for example, by linking the manager's remuneration to performance, wages do not usually vary much because labor regulations tend to complicate such contracts. The usual solution is a contract with low-intensity incentives comprising a set amount and a variable amount linked to the establishment's results. Such mechanisms are not so effective at motivating value-creating activities as other high-powered incentives, which are normally closer to market-based solutions. Moreover, in their seminal work, Grossman and Hart (1986) argue that asset ownership offers the owners residual control rights which give them power and therefore incentives to create value. This means that the limits of the enterprise and of the mechanisms of governance will depend on optimal allocation of such

[11] Many studies have covered the subject of hybrid forms. See Menard (2004) for a review of this literature.

control rights. Also, that the contractual figures under observation should allocate residual control rights to the players that have the greatest capacity for creating value.

If we take the basic argument that mechanisms of governance are chosen for their capacity for resolving organizational problems, we can establish certain hypotheses which will allow us, firstly, to validate the classification of mechanisms of governance for the hotel sector and, secondly, to reach our main objective of finding the reasons why a specific mechanism of governance is chosen for a specific hotel. These hypotheses will establish links amongst the different assets over which the chain has control in each contract category with certain characteristics of the hotel establishments that affect the contractual hazards. Thus, in order to achieve our objective, we have to find significant differences between the relevant characteristics of the hotel establishments managed under the different contractual forms, and these differences should allow us to also ascertain the main reasons for the choice of mechanism of governance.

One of the most important contractual hazards is hold-up.[12] This problem arises when one party is forced to accept conditions which it would prefer not to accept in order to not completely lose its investment in a specific asset. Although it would be unusual for a complete investment to be lost, it does happen that a large proportion of an investment in a specific asset may be expropriated, leading to serious losses for the asset owner. The cause of this problem is the actual, specific, expropriated asset because it has much less value in any other alternative use than in its current use. If the conditions change, the contract which previously was optimal for the parties may no longer be so, at least for one of them and the other party will try to take advantage of the situation. The solution, therefore, will be to ensure that the two parties have the same interests so that neither of them can gain an advantage even if the conditions change. This happens at least when the two parties are the same, that is, when they both fall under the same owner. As a result, our first hypothesis (H1) is that:

> ***H1**: The more specific an asset the greater the propensity to find a solution involving ownership.*

Several earlier works on the hotel sector have argued that the assets usually analyzed (building, equipment, reservations, global brand…) do not have the same degree of specificity to the chain (Dev, Brown and Lee, 2000; Contractor and Kundu, 1998a). So the investment in developing a brand is completely specific to the characteristics of the chain (Bailey and Ball, 2006), as are the booking and customer access system. To re-use these assets in a different contractual relationship (another hotel chain) would probably lead to a large loss of value in the asset.

But the buildings are not specific to a single chain. They are, however, specific for hotel activity but, considering that there is a large number of chains that could use the assets and that the hotel could also work independently, the problem of specificity is not so great. The other assets in Table 1 show an intermediate situation. The know-how related to daily management, supervision and quality control might be used in other establishments belonging to the same chain and even to different chains. If, as argued by Schemenner (1988), hotels could be considered as similar to service factories, that know-how would to a great extent be

[12] Klein, Crawford and Alchian (1978) and Williamson (1979).

standardized within the sector. Obviously, the operating procedures of two different chains are not identical but nor are they radically different. Finally, the goods and chattels might be personalized with logotypes or by the type of decoration. But the most costly of these, such as kitchen equipment and furniture, are not usually personalized so they could be re-used. And the rest of them (linen, crockery, etc.) are not too costly and usually have short depreciation periods.

A second important contractual risk is that of moral hazard.[13] This is a type of post-contractual opportunism that aims to reduce effort, taking advantage of the great costs of observing and/or verifying such behavior for the other party. Agency theory has linked the solution of this problem to the introduction of a system of incentives that aligns the interests of the parties.[14] The company, as argued above, does not seem to offer such powerful incentives as other solutions which are more similar to the market. Therefore, a second general hypothesis is:

H2: *The more likely the problem of moral hazard, the more likely it is that we shall observe solutions that are closer to the market.*

This hypothesis can be divided into several sub-hypotheses depending on the actual type of reduction of effort. In our case, the manager of a hotel establishment is not only the link between the establishment and the chain but is also responsible for control of quality and costs, financial equilibrium, staff supervision, etc.

Hotel activity can be classified, within services, as a "service factory" (Schemenner, 1988). This means that management of a hotel or a chain of hotels has to meet certain challenges and one of the main ones is to offer the right quality of service, especially ensuring that it is the same in all the establishments bearing the same brand. This standardization is essential for developing and consolidating the brand and affects not only organizational routines but also tangible elements such as logotypes, decoration, uniforms, style, colors, etc.

A conflict may arise between the manager of an outlet and those responsible for the chain (Dev, Brown and Lee, 2000), because the latter are as interested in how a specific establishment helps develop the brand through standardization and the quality of service offered as in more operational aspects such as the profit raised by it. This is because they are usually linked to the chain by contracts with high-powered incentives to avoid moral hazard in their management effort. Franchising and management service contracts are paradigmatic examples of hotel manager behavior. The problem, as stated in studies on franchising, is that, since all the franchisee's remuneration is directly linked to the financial results of the specific establishment, he will only aim to improve short-term results (for example, by reducing quality and costs), even if this means his opportunistic behavior may damage the chain's brand (Caves and Murphy, 1976 and Michael, 2000, 2002). Moreover, it may require a great effort on the part of the manager to meet certain service quality standards (Ramón Rodríguez, 2002), which

[13] This problem is described by Simon (1951), Pauly (1968) and Williamson (1985), amongst others.
[14] See Spence and Zeckhauser (1971), Ross (1973), Jensen and Meckling (1976) and Hart and Holmström (1987), amongst many others.

are often designed to improve the image of the whole network rather than that of a single establishment.
This empirical prediction can also be reached through another argument based on Resource-Based View.[15] When know-how is costly to transmit, the chain is compelled to exploit it internally in order to make its assets fully profitable. In terms of the Resource-Based View applied to the hotel sector, the resources are not easy to replicate (Dev, Erramilli and Agarwal, 2002). Moreover, it seems reasonable to assume that know-how is more important and, perhaps, more costly to transmit in higher-category hotels that offer additional, more refined services (Chen and Dimou, 2005; Pla Barber and Leon Darder, 2004).

***H2A**: Establishments in which quality is more important (as in higher-category, luxury establishments) are more likely to adopt mechanisms of governance that do not offer very high-powered incentives and that are closer to integration.*

In spite of these two arguments, the empirical results are not very clear. On the one hand, some studies are not altogether conclusive about the link between the importance placed on quality control and the trend towards franchising (Contractor and Kundu, 1998b). On the other hand, the problem of coordinating establishments when they do not form part of the company (hierarchy) and the possible drop in quality (especially with regard to standardization or conformity) may be mitigated by establishing additional, or even overlapping, mechanisms for coordination which, in combination with the greater motivating power of mechanisms of governance offering higher-powered incentives, will lead to high-quality results. In the latter case, it is essential to analyze any additional mechanisms for safeguarding quality that are introduced because they may resolve the problems of coordination introduced by the high-powered incentives. Fernández-Barcala, González-Díaz and Raynaud (2006) find some evidence that companies grouped according to geographical indicators in the agrifood sector, this being a mechanism of governance that is based on high-powered incentives, offer greater quality (in terms of the price premium that consumers are prepared to pay for their products) than other companies that are more vertically integrated and have lower-powered incentives.
Hotel size is also related to the importance of the tacit knowledge and know-how required to manage it (Pla Barber and Leon Darder, 2004). Large hotels are more complex to manage and require a better-qualified manager who is capable of heading a large, specialized human team. Also, large establishments represent a substantial percentage of the chain's revenue so it is important that they should be controlled not only for financial reasons but also because they tend to act as flagships for the brand, acting as a point of reference for both customers and staff. Either of these arguments leads us to think that integration will resolve such problems better than other organizational solutions. In the first case because, when activities are very complex and it is impossible to predict the result, links via the market will be very imperfect, leading to a high degree of conflict among the parties. A company can resolve this situation better by taking on absolutely all the risks involved in the complexity. This is a way of solving the conflict arising from attempts made by the parties to pass on any losses to the other party. In the second case, in order to avoid the need for a great supervision and control effort, the

[15] On Resource-Based View, see Penrose (1959), Wernerfelt (1984) and Barney (1991).

chain prefers to integrate the establishment in order to reduce the manager's interest in keeping part of the profits. Also, with integration, it is easier to coordinate resources and to make a hotel a reference point than if it belongs to another company and the chain is just managing it.
In addition to the above arguments, we can state that it is more likely for larger establishments to be more specific because only a limited number of firms have sufficient know-how to manage them and, therefore, attract customers. If we use arguments taken from studies on franchising, it is difficult to find partners who will be prepared to invest large, specific sums (Brickley and Dark, 1987; Kehoe, 1996; Ramón Rodríguez, 2002). For this reason, large hotels are more likely to be integrated.[16] The second sub-hypothesis (H2b), therefore, is that:

***H2B**: Chains will tend to retain ownership-based control over larger establishments.*

Finally, the possibility of moral hazard is also directly related to the intensity and functionality of the mechanisms established by the chain for supervision and control. It can be said that managing a hotel chain requires a dual technology in that there some activities that can be centralized while others have to be carried out in a variety of locations, that is, wherever they are consumed. The former include marketing, accounting and finance, bookings, etc., all of which are subject to large economies of scale and are therefore often concentrated in a single location.[17] The latter include activities related to actual accommodation, catering and other services rendered in the presence of the customer (this being the characteristic that prevents them from being centralized). The nature of such services means that they are carried out in different locations so they do not enjoy the advantages of concentration (economies of scale and standardization). This dispersion leads to a problem of moral hazard –an agency problem– because of the cost of observing the effort made (for example, regarding quality of service) in establishments that may be far from the head office.[18] Since it is difficult to measure the effort made, it is very costly to control whoever is in charge and this increases the possibility of moral hazard. In fact, distance itself may reduce control and supervision because of the cost involved, and this will increase the possibility of moral hazard in all aspects of the effort made by the person in charge of the establishment.
Establishments in isolated locations or far from the network are more costly to supervise for the following reasons: supervisors have to be sent specially to the location, supervision is not permanent, there are no references from other hotels, etc. In such cases, the parties may choose to introduce organizational methods that offer high-powered incentives for the hotel managers, such as management contracts or franchises (Brickley and Dark, 1987; Lafontaine, 1992;

[16] In their study on internationalization in the hotel industry, Contractor and Kundu (1998a, 1998b) conclude that larger size does not lead to organizational forms characterized by greater control through ownership. However, they refer to the size of the hotel chain whereas we refer to the size of the actual hotel.
[17] Although with computerization the booking centre does not necessarily have to be centralized in a single location, it is in fact centralized digitally via a single IT program.
[18] Rubin (1978) refers to this problem to explain why not all hotels are owned by the company and franchise contracts are used. This is also a clear problem of opportunism as described by Williamson (1985). For the case of hotels, see for example Dev, Brown and Lee (2000).

Kehoe, 1996). Conversely, if in a single geographical area there are several establishments, supervision is easier and less costly as a single person can supervise several establishments and comparison is feasible (Fladmoe-Lindquist and Jacque, 1995). In such cases, it is not necessary to adopt solutions offering such high-powered incentives. We can therefore establish a third sub-hypothesis (H2c):

> ***H2C****: The greater the concentration of a chain in a specific geographical area, the greater the predominance of contractual mechanisms based on ownership or direct operation by the chain.*

4. Empirical analysis

4.1 Description of the sample

The above hypotheses were tested on a sample of 744 hotel establishments. The majority –464 establishments– belong to the six main hotel chains operating hotels in Spain. In 2003, these chains maintained a total of 170,893 rooms in 866 establishments worldwide, with 50.32% of the rooms and 56.69% of the establishments being located in Spain (Hostelmarket, 2004). All the typical mechanisms of governance were represented: *1)* fully-owned or majority-owned (40.18% of establishments); *2)* minority joint venture (5.77%); *3)* building or business leasing (38.57%); *4)* management contract (12.47%) and *5)* franchising (3%). The remaining 280 establishments in the sample were chosen by random sampling of independent hotels. These were defined as establishments that do not form a chain with others, with a chain being defined as a company with 2 or more establishments (Turespaña, 2004, 2005). The random sample was taken from the Guide to Hotels in Spain (professional edition) for 2004. Most of these independent establishments were operated by their owners (98.21%), with joint ventures and leasing very much in the minority, at just 1.08% and 0.72% respectively. Table 2 shows descriptive statistics of the sample and Table 3 defines the variables.
The sample only included hotel establishments located in Spain, for two reasons. Firstly, the chains provide limited information on hotel establishments in foreign countries and, for some variables, it is impossible to obtain. Also the influence of the country in the choice of mechanism of governance for entry has been amply studied and tested in the literature (see footnote 5). The same cannot be said about internal or domestic governance. This sampling controls the effect on the choice of mechanism of governance of the peculiarities (regulation, economic and political stability, sector organization) of a specific country (market).

Table 2. Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
Governance form	712	3.17697	1.14964	0	4
_5gd	712	0.00983	0.09873	0	1
_5s	712	0.04354	0.20421	0	1
_4s	712	0.39888	0.49001	0	1
_2o3	712	0.54494	0.49833	0	1
Total services	685	18.76788	5.23234	0	37
Quality label	684	0.03070	0.17263	0	1
Average price	585	125.28340	68.88697	0	550
Spatial concentration	712	6.67135	9.43950	0	28
Rooms	660	132.59390	117.60830	4	916
Guests	656	251.44970	224.19100	8	1,736
Beach	685	0,37226	0,48376	0	1
Mountain area	685	0,04525	0,20801	0	1
Downtown	685	0,58248	0,49351	0	1
Historical building	685	0,13576	0,34279	0	1
Sol	712	0.22191	0.41582	0	1
Husa	712	0.08427	0.27799	0	1
Nh	712	0.12079	0.32611	0	1
Riu	712	0.07022	0.25571	0	1
Ac	712	0.06461	0.24600	0	1
Hoteltur	712	0.04635	0.21039	0	1
Independent	712	0.39185	0.48851	0	1

The information on the hotel establishments was obtained initially from the Hostelmarket Census of Hotels and Apartments for January 2004 and the Hostelmarket Annual Reports for 2003 and 2004. These give information on the owner of the building, the operating and/or managing company and the operating regime as classified by Hostelmarket: managed establishment, establishment operated through a subsidiary, fully-owned establishment, operated establishment, leased establishment and fully-owned operated establishment. Since this classification differs from our theory-based proposal (see Table 1), it was necessary to recode these variables by identifying the chains' "direct" mechanisms (a stake in the capital) and sometimes the "indirect" mechanisms (such as common administrators) for controlling the companies that own or manage certain establishments. This was done taking data from the chains' reports, also the SABI data base (System for the Analysis of Balance Sheet on the Iberian Peninsula) and the web sites of the chains studied (www.solmelia.com; www.nh-hotels.com; www.riu.com; www.hotetur.com; www.husa.es; www.ac-hotels.com) for each of the establishments and from Turespaña (www.tourspain.es).

Finally, the Official Hotel Guides for 2004 and 2005 (professional edition) give detailed information on the specific characteristics, services and prices of the hotels. The web sites of the different chains studied (www.solmelia.com; www.nh-hotels.com; www.riu.com; www.hotetur.com; www.husa.es; www.ac-hotels.com), of each of the establishments and Turespaña (www.tourspain.es) were also used to complete the information.

Table 3. Variable definitions

Variable	Definition
Governance form	0= Franchise 1= Management contract 2= Rent of business or real estate property 3 = Joint venture 4 = Total or majority ownership
_5gd	1 for a grand deluxe hotel
_5s	1 for a 5-star hotel
_4s	1 for a 4-star hotel
_2o3	1 for a 3 or 2-star hotel
Sol	1 for a hotel belonging to the Sol Meliá chain
Husa	1 for a hotel belonging to the HUSA chain
Nh	1 for a hotel belonging to the NH chain
Riu	1 for a hotel belonging to the RIU chain
Ac	1 for a hotel belonging to the AC chain
Hoteltur	1 for a hotel belonging to the Hoteltur chain
Independent	1 for a hotel that does not belong to a chain
Historical building	1 for a hotel located in a historical building
Beach	1 for a beach hotel
Mountain area	1 for a hotel in a mountainous area
Downtown	1 for a downtown hotel
Quality label	1 for a hotel that has received the Q for quality
Total services	Number of different services (swimming-pool, sauna, gymnasium, restaurant, etc.) offered by the establishment according to classification in the Guide to Hotels in Spain for 2004 (professional edition)
Average price	Average price for a room in euros
Spatial concentration	Number of hotels belonging to the chain in the province

Altogether, 712 establishments were classified, and these formed the basis for the econometric analyses. The hotel establishments were allocated to the theoretical categories proposed according to the following criteria (Table 4 summarizes the classification that results from the whole process):

1. Fully owned and majority joint ventures (Owned): When the chain or hotel company owns at least 50% of the building and of the operating company.
2. Minority joint venture (Joint venture): When the chain owns less than 50% of the building and the operating company. When ownership is shared equally (50% each), the hotel is assigned to this or the previous category depending on who appears as the "*Ultimate Owner*" in the SABI data base.
3. Leasing: When the chain does not own shares in the building and operation is carried out directly by the chain or a company in which the chain is the majority shareholder.

4. Management contract: When the chain does not hold shares in either the building or the operating company. What the chain does is to manage the hotel on behalf of the operator by appointing the manager.
5. Franchising agreement: When the chain does not hold shares in either the building or the operating company and when one of the sources consulted states that there is a franchising contract.[19]

Table 4. Mechanism of Governance in the Sample

Governance form	Observations	Percentage of total
Franchise (y=0)	13	1.83%
Management contract (y=1)	57	8.01%
Business or building lease (y=2)	169	23.74%
Joint venture (y=3)	25	3.51%
Fully or majority-owned (y=4)	448	62.92%
Total	712	

4.2 Methodology and estimation

Last row in Table 1 shows the varying degrees of control exerted by the hotel brand owner over the assets according to the chosen mechanism of governance. This table ranges from maximum control of assets with full or majority ownership down to the minimum control offered by franchising. This suggests that the dependent variable in our econometric model is multinomial and ordered. Then, we proceed with the ordered logit model following Greene (1993, pp. 672-676) and the Stata reference manual (pp.: 95-104, vol. 3). This is built around a latent regression:

$$y^* = \boldsymbol{\beta}'\mathbf{x} + \varepsilon$$

Where y^* is unobserved. However, we observe:

$$y = 0 \text{ if } y^* \leq k_1,$$
$$y = 1 \text{ if } k_1 < y^* \leq k_2,$$
$$y = 2 \text{ if } k_2 < y^* \leq k_3,$$
$$y = 3 \text{ if } k_3 < y^* \leq k_4,$$
$$y = 4 \text{ if } k_4 \leq y^*$$

Considering the logistical distribution, the probabilities of observing an outcome i is:

[19] The latest issues of the *Hostelmarket* journals were also consulted, especially to determine which hotels are operated as franchises because this contractual form does not figure split from management contracts in the Hostelmarket Annual Reports.

$$\Pr(\text{outcome}_j = i) = \Pr(k_{i-1} < \beta_1 x_{1j} + \beta_2 x_{2j} + \ldots + \beta_k x_{kj} + \varepsilon_j \leq k_i) = \frac{1}{1+e^{(-k_i+\beta' x)}} - \frac{1}{1+e^{(-k_{i-1}+\beta' x)}}$$

where we have k regressors, ε_j is logistically distributed, k_0 is taken as $-\infty$ and k_I as $+\infty$, with I being the number of possible outcomes. We can then estimate this model using the method of maximum likelihood.

5. Results and discussion

The results of the estimation are given in Tables 5 to 7. The calculations were made using the STATA 8.0 statistical program. The first hypothesis, referring to the influence of asset specificity on the choice of mechanism of governance, was initially tested on the basis of location of the establishment as this is the only specific feature that can be tested directly. It might be argued that the refurbishment of historical buildings to convert them into hotels is more specific than other locations because of the difficulty of re-use. We introduced this variable (Historical building) into our econometric model but did not obtain statistically significant results, as shown in Table 5.[20]
Similar results were obtained for other locations, such as beach, mountains or downtown, and this leads us to think that the difficulty of re-using the building does not seem relevant, perhaps because it is not very costly to reconvert a hotel from one brand to another and at present there are many brands competing in all market segments (beach, downtown, etc.). It is also difficult to directly test the relevance of asset specificity because of the lack of proper estimators.
However, we do consider that asset specificity may be relevant in the choice of the mechanism of governance. Table 1 shows assets ordered line by line from lesser to greater specificity (from buildings to brand) with the mechanisms governance ordered in columns from left to right starting with those that are closest to integration (from ownership to franchise). If the lines and columns are compared, we note that the rights to the assets that are most specific to the hotel company, brand and booking center are practically never assigned to another company. If we accept that a franchise is a lease of the brand and is therefore the only asset that would be assigned in the market, Table 4 shows that 699 of the 712 (98%) establishments for which we have data maintain direct control (ownership) over the most specific assets. This supports the first hypothesis that the more specific the investment, the greater the likelihood of solutions close to integration. In other words, all the mechanisms of governance observed are designed in such a way that the hotel company retains the ownership rights over the most specific assets. This regularity supports our theoretical argument although we cannot test it statistically.

[20] Tests were carried out with other models and other variables but the results did not improve. For the sake of simplicity, these results are not given but they can be obtained on request from the authors.

Table 5. Ordered Logit Estimations I

Variable	H1a	H1b	H1c	H1d
Quality label	-0.33136 (0.72235)	-0.32064 (0.72027)	-0.31187 (0.72337)	-0.27490 (0.72263)
Guests	0.00217*** (0.00056)	0.00202** (0.00063)	0.00215*** (0.00056)	0.00208*** (0.00055)
Independent	4.72512*** (0.51009)	4.69602*** (0.50880)	4.70048*** (0.51167)	4.70479*** (0.50904)
Historical building	0.17930 (0.27156)			
Beach		0.09753 (0.24123)		
High mountain			0.45949 (0.52522)	
Downtown				-0.15601 (0.19843)
k_1	-2.73412 (0.31852)	-2.77161 (0.31218)	-2.75466 (0.31424)	-2.88849 (0.35143)
k_2	-1.11235 (0.20836)	-1.15030 (0.20004)	-1.13249 (0.20230)	-1.26609 (0.24807)
k_3	0.88375 (0.20885)	0.84389 (0.19907)	0.86388 (0.20238)	0.73235 (0.23990)
k_4	1.14888 (0.20805)	1.10900 (0.19836)	1.12908 (0.20139)	0.99780 (0.23679)
N	628	628	628	628
log L	-496.93804	-497.05835	-496.85765	-496.84282
$\chi 2$	87.34813***	86.12033***	88.24819***	86.07589***
Pseudo R^2	0.23010	0.22991	0.23022	0.23024

Key: coefficients/ (standard errors). All estimations consider the Huber/White/sandwich estimator of variance. * p<0.05; ** p<0.01; *** p<0.001

It must, however, be pointed out that franchising in the Spanish hotel sector is different to English-speaking countries and even to France where this formula is much more common for hotel establishments. The explanation given by Hostelmarket (1999) is that there seems to be a shortage of both franchisees who are prepared to make the necessary investments and franchisers prepared to train managers and assign their brands. According to Hostelmarket (1999), potential franchisers consider it difficult to control quality standards and fear tension with franchisees during this process; and franchisees are reluctant to pay the substantial fees for the use of brands and the high costs of adaptation and fear the strict quality controls carried out by the franchiser. Other explanations, which are perhaps based more on theory and empirical results than on the success of franchising, are that: *a*) hotels, especially those of higher category and larger size, are much more complicated to manage than the traditional franchise flagship - it is too risky to leave this business in the hands of a not very professional manager who, at most, will have undergone 6 months of training; *b*) small investors interested in the hotel sector prefer management or leasing contracts to franchises because there is no

need to participate directly in management of the establishment (which is carried out by the hotel company assigning the brand). Finally, there is an empirical feature of franchising which is that the larger the investment to be made by the franchisee, the more difficult it is to find them (Brickley and Dark 1987, Lafontaine 1992). If the amount of the investment is too large (and normally too specific), the risk taken by the franchisee is large. The only chain using this formula in our sample (Sol Meliá) has resolved all these problems mainly through multi-franchising (several establishments to a single franchisee). It thus assigns its brands to a small number of franchisees with whom it maintains a close relationship. This may be the solution adopted by chains in the other countries mentioned above for using franchising successfully in the hotel sector.

The second group of hypotheses refers to how the mechanism of governance should be chosen in order to resolve the various problems of moral hazard that arise in this business. The results for the first of the sub-hypotheses (H2A), which states that hotels offering higher quality will mostly be integrated, are given in Table 6.

Unlike the previous case, several estimators can be used for this effect. Firstly, there is the establishment category, granted by a government body (national or regional) in line with evaluation of the premises and the services rendered in it. This category is measured by the number of stars, from a minimum of 1 star for establishments with less quality to a maximum of 5 for top-quality establishments. Also, a special category within 5-star establishments called "Grand deluxe" is used to identify the best hotels within the top category. We did not include 1-star hotels in our study because the large companies are scarcely involved in this segment and they are of limited economic relevance because they find it hard to compete with hostels and guest houses. We introduced three dummy variables, taking a joint category for 2 and 3-star hotels (we only have 20 2-star hotels in our sample).

The results do not show any statistically significant link as shown in the first column of Table 6. Similar results were obtained for other potential quality measures such as whether the establishment has the "Q for quality", the number of services offered and the average price of a double room. In this case, we introduced a variable for control by the chain as different companies may have different quality policies. The variable omitted to avoid colliniarity is Sol. AC and Riu obtain significant positive parameters which can be interpreted as a tendency of these chains towards integration (ownership) in comparison with the Sol-Meliá chain.

These results are not conclusive about the importance of quality in the mechanism of governance. The literature offers two opposing arguments so we do not know if the lack of significance is due to the two effects being relevant and countering each other or simply because neither is relevant. However, all the coefficients estimated, some of which are very close to the values for which they are traditionally considered significant, are negative. This seems to mean that we are closer to a search for quality using different mechanisms to the traditional one of integration, probably in order to offer higher-powered incentives to the manager. This would require the introduction of additional safeguards to avoid the unfavorable effects generated by high-powered incentives on quality. Finally, an alternative explanation is that we have always used design quality measures rather than conformance quality. The latter is probably more suitable for reflecting the effect of the mechanism of governance on the quality of the service rendered. This requires further study.

The second sub-hypothesis (H2B) suggests that larger-sized establishments tend to be integrated. This was checked by measuring the size of establishments by the number of places (guests). The results obtained, which were statistically significant, are also given in Table 6.

The larger hotels are either fully or majority-owned, and smaller ones are leased or franchised. These results support most of the theoretical arguments and suggest that the high costs of transferring specific know-how and the large investment and risk taken on by potential franchisees may promote integration for large establishments.

Table 6. Ordered Logit Estimations II

Variable	H2Aa / H2Ba	H2Ab / H2Bb	H2Ac / H2Bc	H2Ad / H2Bd
Quality label			-0.12775 (0.76975)	
Services lump sum		-0.00739 (0.02343)		
Average price				-0.00013 (0.00175)
_5gd	-0.13411 (0.88678)			
_5s	-0.09235 (0.55502)			
_4s	-0.33281 (0.20401)			
Independent	4.92217*** (0.56922)	4.93298*** (0.57027)	4.96225*** (0.56770)	4.87358*** (0.58192)
Guests	0.00220*** (0.00065)	0.00220** (0.00068)	0.00219** (0.00068)	0.00230** (0.00073)
Husa	-0.35495 (0.32163)	-0.33339 (0.32398)	-0.33449 (0.32268)	-0.31485 (0.34204)
Nh	-0.11774 (0.28941)	-0.06877 (0.28528)	-0.07539 (0.28382)	-0.09627 (0.29366)
Riu	1.24907* (0.48813)	1.19198* (0.48743)	1.35486** (0.49044)	0.90647 (0.68073)
AC	2.22040*** (0.46236)	2.15546*** (0.45021)	2.15910*** (0.44828)	2.19750*** (0.48836)
Hoteltur	-0.52463 (0.28680)	-0.40307 (0.28559)	-0.38471 (0.28048)	-0.43548 (0.29711)
k_1	-2.93117 (0.47430)	-2.87047 (0.57348)	-2.73360 (0.45371)	-2.76727 (0.53216)
k_2	-1.27796 (0.35426)	-1.21815 (0.49373)	-1.09915 (0.33336)	-1.10747 (0.42401)
k_3	0.85954 (0.34105)	0.90943 (0.50652)	1.05266 (0.32038)	1.02776 (0.41555)
k_4	1.16276 (0.33991)	1.21037 (0.51049)	1.35620 (0.31877)	1.32766 (0.41240)
N	656	629	629	583
Log L	-476.07429	-476.73112	-472.96809	-440.91974
$\chi 2$	127.85035***	124.13602***	123.89760***	111.08874***
Pseudo R^2	0.27911	0.26442	0.26776	0.26709

Key: coefficients/ (standard errors). All estimations consider the Huber/White/sandwich estimator of variance. * p<0.05; ** p<0.01; *** p<0.001

Table 7. Ordered Logit Estimations III

Variable	H2Ca	H2Cb
_5gd	-1.10530 (0.66854)	-0.00455 (0.90384)
_5s	-0.84972 (0.49732)	0.02297 (0.58761)
_4s	-1.04631*** (0.19041)	-0.23663 (0.21777)
Spatial concentration	-0.03782*** (0.01055)	0.02761* (0.01184)
Guests	0.00016 (0.00040)	0.00226*** (0.00068)
Husa	-2.24209*** (0.26952)	-0.18810 (0.34165)
Nh	-1.83413*** (0.26900)	-0.06329 (0.30450)
Riu	0.41145 (0.48395)	1.16576* (0.50017)
AC	0.35477 (0.42470)	2.49291*** (0.48428)
Hoteltur	-1.69806*** (0.30901)	-0.79054* (0.31782)
k_1	-5.68277 (0.39837)	-2.55898 (0.49994)
k_2	-4.06212 (0.26363)	-0.94957 (0.39454)
k_3	-2.07969 (0.16521)	1.28931 (0.38430)
k_4	-1.84509 (0.15549)	1.61535 (0.38241)
N	656	377
log L	-564.78687	-437.48508
$\chi 2$	174.54899***	65.30275***
Pseudo R^2	0.14478	0.08601

Key: coefficients/ (standard errors). All estimations consider the Huber/White/sandwich estimator of variance. * p<0.05; ** p<0.01; *** p<0.001

The third sub-proposition H2C suggests that the presence of several hotels in a single area facilitates control and means that they are more likely to be managed under formulae allowing the chain to retain greater control. This proposition was tested by examining the "Spatial concentration" variable which reflects the number of hotels owned by the company in a single province. The problem with this variable is that it correlates perfectly with the Independent variable. This is because all independent hotels have no other establishments either in the same province or anywhere else, so they also show zero in the Spatial concentration variable. In order to avoid this bias, we have eliminated the Independent variable from Table 7 as well as all observations in the sample for independent hotels. The result is a positive, statistically significant coefficient, meaning that when a chain has more than one hotel in an area it is likely

to hold at least a majority stake in them. The hypothesis therefore seems to support the theoretical model.

6. Conclusions and limitations

This study aims to find an economic explanation for the choice of mechanisms of governance in hotel chains. It first analyses how the allocation of property rights generated by each type of governance leads to more or less control for the hotel chain over the assets that are key to producing the service. We then order the mechanisms of governance from ownership, in which control of the basic assets needed to produce the service is fully retained by the hotel chain, down to franchising in which the chain only retains partial control of some of the assets (know-how, brand and booking center). In between, we study intermediate asset control situations (joint ventures, business/building leasing and management contracts).
Secondly, the study analyses how the mechanism of governance is chosen for each outlet. Our argument is that hotel companies will choose the mechanism that best resolves the contractual hazards resulting from their obtaining rights to use the production factors needed to offer the hotel service. We test the importance of asset specificity, the costs of the coordination required for offering good quality, the costs of transmitting know-how and the problems of moral hazard for the establishment manager.
The results obtained seem to indicate that the assets that are most specific to the hotel chain are more likely to be integrated than less specific ones. However, unexpectedly, the location of the establishment does not seem to be relevant with regard to hold-up problems because of the existence of a dynamic hotel property market and the large number of brands that are competing in all the market segments (beach, downtown, etc.). The most robust results indicate that bigger establishments are usually owned and operated by the brands, which we interpret as being due to the difficulties of finding owners or operators who are prepared to make such large investments and of transmitting the know-how needed for successfully managing such establishment. Another important finding is that network monitoring costs are essential and that the more dispersed the chain's establishments are, the more likely it is that formulas apart from ownership will be used. Finally, our empirical results do not allow us to ascertain whether the chosen mechanism of governance will affect service quality. Various hypotheses can be suggested to explain this result but testing them will have to be left to a further extension of this study because for the time being there is insufficient information. It will be necessary to find a measure to distinguish conformance quality from design quality and therefore to estimate it. Otherwise, it would be necessary to study what type of additional safeguard mechanisms can be introduced to guarantee quality in establishments that maintain more market-oriented mechanisms but focus on the top-quality segment of the hotel industry.

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