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The Financial and Economic Performance of Hotels in Spanish Beach Tourist Destinations

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Abstract

This paper analyzes the differences in financial structure, size and profitability of hotels located in three main Spanish coastal areas: Costa Brava, Costa Dorada and Costa del Sol. The study focuses on the analysis of the financial statements of a sample of approximately 100 hotels, finding key differences in hotels' performance in these three regional clusters of the hospitality industry. The three areas show significant differences in terms of hotel size, financial structure and economic performance. The hotels located in Costa del Sol are much bigger than the hotels located in the other areas but this also implies higher levels of debt and accordingly higher interest payments with a negative effect on the profits level. Hotels in Costa Dorada have a size that allows benefiting from economies of scale, with reasonable interest payments. This size combined with higher occupancy rates are the main reasons for the better economic performance of this area compared with the other two. Finally, we found that there exist exit barriers due to the specificity of the assets involved in the hotel sector.

Keywords: Hotel profitability, Indebtedness, Size, Spanish tourism.

Introduction

After a period of economic growth lasting from 1995 to 2007, the Spanish economy has suffered a severe economic recession with a deep economic impact, felt mainly in the labour market, with the unemployment rate climbing to over 20%. In this situation characterized by credit contraction and the closing down of many small and medium sized businesses, the tourism sector has been one of the most resilient sectors. Tourism accounts for nearly 12% of Spanish GDP, being one of the few sectors with a positive flow in terms of creating employment. In 2013, 60.7 million people visited Spain, with the share of international tourists reaching a new record. Additionally, the positive surplus in the external tourism balance has increased to 25.44% from 2007 to 2013.

The Spanish Statistics Office (INE 2014) has identified 44 geographical areas where tourism is the key economic activity. Many of these areas are located on the coast and a great number of tourists come to Spain in order to enjoy the excellent weather conditions and services provided at the Spanish beach destinations. If the Canary and Balearic Islands are individually considered, thus excluded from the analysis of tourism in Spain's mainland, and we only analyse the Iberian Peninsula, some of the most relevant areas in terms of the international tourist arrivals, are: Costa Brava (Girona, north of the Catalonian region), Costa Dorada (Tarragona, south of the Catalonian region) and Costa del Sol (Málaga, south of Spain) (Table 1). The main objective of this research paper is to provide valuable insight into the performance of the hotel sector in these three areas. We will also examine whether these three areas apply the same business model or whether there are significant differences in terms of profitability. If this is the case, the aim is to understand the main variables that explain the differences in profitability.

The three selected areas have some common characteristics: Tourism is their main economic activity, there is a high level of seasonality and the supply of the lodging industry grew exponentially in the period between 1960 and 2007. In these areas, there also exists a tendency towards higher quality hotels. However, the three areas are different in terms of the hotel industry's market structure. One notable variable is the size of the hotels. Size could be measured in many different ways but in the present study, we have use the average number of rooms per hotel as a proxy for hotel size in each area. Hotels in Costa del Sol (Málaga) have an average size of 180.94 rooms per hotel, which is similar to those located in Costa Dorada (198.50). The latter is higher than the average hotel size in Costa Brava found to be equal to 112.55 rooms per hotel. According to the relevant academic literature, a higher size could be associated to increased profitability due to the presence of economies of scale. In the Spanish case, the differences in profitability among the three areas could be attributed to the fact that Costa Brava's hilly terrain makes it more difficult to build large facilities while most of the current lodging supply was built in the 1960's. On the contrary, in the other two areas supply expansion came about when the demand was consolidated and growing.

Table 1. *Main Spanish Tourist Destinations according to the Number of International Tourists*

Tourist area	**International tourists**
Balearics: Majorca	5,813,672
Catalonia: Barcelona	5,550,877
Balearics: Palma – Calvía	2,601,721
Canaries: Tenerife	2,572,247
Andalucia: Costa Del Sol (Málaga)	2,425,150
Canaries: Tenerife South (Tenerife)	2,157,380
Catalonia: Costa Brava	1,762,699
Canaries: Gran Canaria	1,736,549
Canaries: Gran Canaria South (Las Palmas)	1,565,096
Catalonia: Barcelona Coast	1,501,839
Valencian Community: Costa Blanca	1,466,980
Canaries: Fuerteventura	1,228,637
Balearics: Ibiza-Formentera	1,214,350
Catalonia: Costa Dorada	1,013,562
Canaries: Lanzarote	1,010,593
Andalucia: Costa de la Luz de Cádiz	530,198
Balearics: Menorca	393,695

Source: Authors using data from INE (2014).

The second hotel industry indicator we include in our analysis is the occupancy rate. The occupancy rate is a key variable in explaining profitability as it depends on two factors: the net margin per room related to the value added to the customer and the effective use of the hotel's assets. Average occupancy rate is higher in Costa del Sol, being higher than 50% (50.49% in 2012) while hotels in Costa Dorada (49.42% in 2012) and Costa Brava (45.69% in 2012) have an average occupancy rate of below 50%. One of the main challenges that most beach hotels face is reducing the level of seasonality. A high level of seasonality implies the need to adjust the number of employees throughout the year and also leads to facility underuse. In the context of this analysis, seasonality is measured using the standard deviation of the occupancy rate. Hotels in Costa del Sol have the lowest occupancy rate (15.52%), which could be explained by the specificities of their location in the south of Spain, meaning that good weather conditions are enjoyed for a larger proportion of the year. Costa Dorada, located to the south of Barcelona, also enjoys good weather conditions for a longer period than the Costa Brava, being in the north of Barcelona and close to France. However, seasonality is higher in Costa Dorada (25.42%) than in Costa Brava (18.03 %), which may be attributed to the more extensive touristic services provided in the Catalan destination, including gastronomy and hiking.

There also exist some differences in terms of the evolution of supply over the last five years. Costa Brava and Costa del Sol nowadays have a similar number of hotels as they had in 2007, whereas there has been a significant reduction of approximately 19.5% in the number of hotels in Costa Dorada in the period between 2007 and 2012. Table 2 shows the evolutions taking place in the Spanish tourism sector in terms of the number of hotels for the three areas.

Table 2. *Number of Companies, 2007-2012 Evolution*

Touristic area	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Costa del Sol	433	414	431	426	430	449
Costa Brava	661	666	652	658	675	665
Costa Dorada	313	311	326	334	262	252

Source: Authors using data from INE (2014).

After the data analysis presented above, the following research question arises naturally: Do the hotel companies in these three areas apply different business models? Are the differences in profitability or gross margin significant enough to imply the existence of three different models despite the fact that all hotels fall into the category of beach destinations?

Based on data drawn from financial statements of the 2007-12 period, we attempt to substantiate a well-grounded answer to the above question.

The structure of the paper is as follows. The next section summarizes the literature review on the performance and the activities of the hotel sector; mainly, the key findings regarding coast destinations and the importance of differentiation as well as heterogeneity in the lodging industry are presented. In the following sections, we describe the methodology employed in our study and present the main results and findings on the key differences in the three areas under study. Finally, the conclusions and some ideas about future research are discussed in detail.

Literature Review

Tourism is a key industry in Spain, in terms of its share in GDP but also of its contribution to new employment. Tourism includes many different and interconnected activities, with the lodging sector clearly being of great significance. Many papers have been published recently regarding various aspects of the hotel sector, including the Spanish one. However, there is still much research to carry out on the activities and performance of the hotel sector in the coast destinations.

Chung and Kalnins (2001) conducted a research on the lodging industry in Texas, looking at the importance of the agglomeration effect on the hotel industry. The fact of being close to other similar hotels could be associated to positive externalities; according to this paper, the agglomeration positive effects are clearer for small independent hotels than hotels belonging to a chain. The choice of the location is a strategic decision, and what matters for a small hotel could be different that compared to the considerations made when deciding the optimal location in the case of medium firms or hotels affiliated to a chain. Yang et al. (2014) provide a complete review of the main models on the decision of the hotels' location, considering theoretical, empirical and operational models and also, suggesting interesting directions for future research. Peiró-Signes et al. (2014) studied the importance of clusters in the hotel sector, based on the US hotel sector. The benefits of being in an area of high hotel concentration and many suppliers depend on the star category of the hotel, its location and management structure. Alvarez Gil et al. (2001) studied the relation between environmental practices and some key variables: size, affiliation to a chain and the age of the facilities. The size, the type of management (independent versus chain's affiliation), the location and the quality of the services provided are the main variables explaining performance, according to most of the relevant literature. Campa (2004) analyzed the financial structure, management and accounting systems in a sample of Spanish hotels. Similar to the research conducted in other countries, he found that the Spanish hotel sector is characterized by the importance of the fixed assets, mainly financed through banks' loans and having a cost structure with more fixed cost weighting than variable cost, making the occupancy rate a key indicator in explaining economic performance.

The hotel sector is generally characterized by volatile demand, depending on many factors, some of them economical, related to the prices, exchange rates, substitutes and complementary prices but also geo-political factors and the fear of terrorist attacks, as the political instability could be really important in understanding demand changes. According to Lockyer (2005), in his study on New Zealand hotels, four variables are the basic ones in terms of the customers' hotel choice: the hotel's location, price, facilities and cleanliness. Similar results were found for the Japanese hotel sector by Kim and Kamoto (2006).

Sainaghi (2011) focused in the main elements driving the formation of the Revenue per Available Room ratio (RevPAR); one of the most significant specific hotel ratios in terms of performance. His research was based on a sample of 72 hotels located in Milan. Again size and location were found to be among the most significant variables in terms of explaining performance behaviour.

The academic literature so far has emphasized in the importance of hotel's location and variables affecting consumers' choices. However, many scholars have recently adopted a different approach in the study of the hotel sector based on the analysis of the importance of management. Claver-Cortés et al. (2008), using a sample of 301 three-to-five stars Spanish hotels, analyzed the relations between management and economic performance in the context of the Total Quality approach. Hotels with a stronger Total Quality Management commitment also demonstrate better economic performance. Pereira-Moliner et al. (2012) goes a further step forward at looking at the relation between Total Quality Management, Environmental Management and the positive impact of managers' and employees' strong commitment on the company's economic performance. Similar conclusions were also reached by Tari et al. (2010) and Wang et al. (2012), with the paper of the latter also including the analysis of how market orientation combined with a Total Quality Management approach has positive effects on the economic performance but also in terms of building a close relationship with customers. In the service sector, employees' loyalty and commitment is also important on explaining better performance, as shown in Yee et al. (2010)

The present study takes into account the previous academic literature and the scholars' research in order to get some insight regarding the hotel sector structure in the three main coast areas of the Iberian Peninsula. Finally, the main aim of the study is to explain the differences in economic performance and financial structure depending on the geographical area.

Methodology

The analysis of the hotel industry for the three coast destinations has been carried out using data from the official financial statements, comprising the period from 2007 to 2012. We have mainly used data from the balance sheets in order to gain insight into the size of the companies, their financial structure as well as their level of debt and wealth, in addition to their main investments. From the Profit and Loss statements, we collected data on sales, gross profit, net profit, the importance of interest payments and the level of profitability, considering the values for Return on Assets (ROA) and Return on Equity (ROE).

The data have been extracted from SABI (Sistema de Análisis de Balances Ibéricos "Analysis System for Iberian Balances"), a database where one can obtain the official annual financial statements for more than 1.4 million Spanish companies. SABI, commonly used by scholars interested in the financial situation of Spanish companies, allows the user to filter the incoming information according to different criteria. In the context of the present study, two main criteria were used. The first criterion is the declaration regarding the main activity; only companies whose principal activity is declared as "hotel" were considered. The second criterion was the companies' location; the ones selected had their registered offices and activity in towns located in the three coastal areas the paper focuses on. Companies were removed from the sample if any inconsistency was found in their financial statements. The final sample comprises 99 hotels, 33 hotels from Costa Brava, 32 from Costa Dorada and 34 from Costa del Sol. Almost 80% of the hotels are rated with three or four stars. The sample may be somewhat biased in favour of the small and medium independent hotels. The reason for this is that hotels belonging to international groups usually have their registered offices outside of the places where the hotel is actually located; specifically in Spain, they tend to be registered in the large cities such as Madrid or Barcelona.

The beach hotel sector can be characterized as similar to the theoretical model of monopolistic competition although there are some differences; mainly the existence of entry and exit barriers. The industry has a large number of companies involved, none of which has a market share large enough to be considered market leader. They also exhibit some degree of differentiation. The studies conducted so far on this subject, by Peiró-Signes et al. (2014), Lockyer (2005) and Sainaghi (2011) just to mention a few, agree that differentiation is a key factor in this market. The main differentiation variables are the hotel location and the quality of the services and facilities provided.

Being based on a sample consisting of 99 hotels, the present analysis main attempt is to analyze some key aspects in the definition of the sector's structure and the companies' performance using the tools of the financial statement analysis. The statistical indicators used were average values and standard deviations of the selected variables.

Size is proxied by the total value of assets. The financial structure is studied through the ratio of debt and its composition in short and long term liabilities. One important finding is the proof of the existence of an important percentage of companies in Costa del Sol with negative equity value. Economic performance is measured using the distribution of gross margin values, the average values for ROE and ROA. Given the importance of the debt levels as determinants of profit, the average interest rate paid by the companies is also studied.

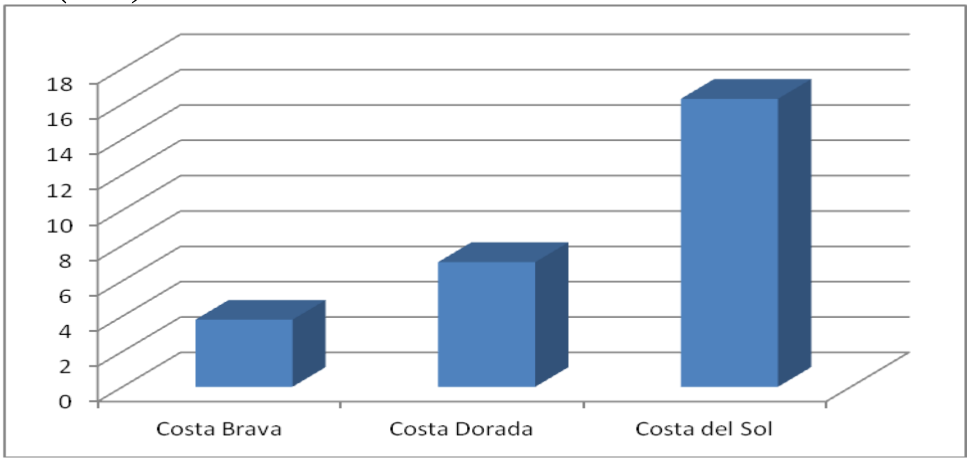
Most of the data relates to 2012 values; the last reports available in the official annual financial statements.

Main Results

According to the official data, the size of the hotel sector can be measured by the ratio of number of rooms per hotel. As previously mentioned, the Costa del Sol hotels are significantly larger, according to the average value of the total assets. Hotels located in Costa Brava are smaller with the average value of their total assets being equal to 3.8 million Euros. The Costa Dorada hotels are worth almost twice as much; their average value calculated at the 7.06 level. Finally, the hotels in Costa del Sol have an average value of 16.3 million Euros (Figure 1). This very significant difference can be explained considering the specific timing of the expansion in the lodging industry in each coast and the ease of building new hotels on the terrain of each coast.

Large hotels usually have more facilities to offer to their customers and also take advantage of economies of scale. However, the financial structure required to be able to exploit such scale economies also varies. Considering that interest payments are usually a fixed cost, the large hotels find themselves more vulnerable to demand shocks that lead to lower revenues but almost the same fixed cost. According to findings of other scholars, a high proportion of the assets is fixed, with the building and its facilities being the main hotel assets (Campa 2004). According to our data, most of the companies own the hotel building and it is uncommon for the company to be renting and using a building without being the owner. The average value for the fixed assets shows no significant difference among the three coasts and accounts for almost 80% of the total asset value.

Figure 1. *Average Asset Value for Hotels on the Three Coasts, in million Euros (2012)*



Source: Authors using data from SABI database.

Two ratios are analysed in order to understand the financial structure of the companies. The first one is the debt ratio, defined as the total debt divided by the total asset value. According to the well-known financial principles, there is a relationship between debt level, default risk and the interest rate applied. Hotels with a higher debt ratio should have a higher interest rate in order to compensate the lender for the increased risk taken. Our data suggest that this principle is in operation in the hotel sector on the Spanish coast. The highest debt ratio is 76.08% and corresponds to the average value of hotels located in Costa del Sol. This higher rate of debt is related to the need for higher investments, considering that the average size of hotels in Costa del Sol is almost 6 times that observed in Costa Brava. The Costa Dorada hotels' average debt ratio is 62.3%, and the lowest ratio is demonstrated by the smallest hotels in Costa Brava, with a debt ratio of 53.02%, nearly 20 points lower than that of the Costa del Sol hotels. The average interest rate is calculated by dividing the interest expenditure, reflected in the last Profit and Loss statement (2012), by the total value of the debt. Debt which does not accrue financial costs, such as accounts payable or taxes payable, is excluded from this measure. As expected, the higher interest rate corresponds to the hotels in Costa del Sol, where companies pay an average rate of 5.75%, whereas the Costa Dorada hotels' interest rate is 4.32% and the Costa Brava's just 3.70%. The difference between the highest and the lowest rate is 205 base points which may have an important impact on the final profitability of the companies. Table 2 summarizes these findings on financial structure and interest rates.

Table 2. *Debt Ratio and Interest Rate (Average Values)*

	Debt ratio	Interest rate
Costa Brava	53.02%	3.70%
Costa Dorada	62.30%	4.32%
Costa del Sol	76.08%	5.75%

Source: Authors using data from SABI database.

The importance of differentiation and the heterogeneity of lodging industry become clear once we consider gross margins. The gross margin is the primary profitability indicator and it is the revenues minus the operational costs, defined as a percentage of sales. At the three coasts considered, hotels show a great disparity of values, with some companies accruing losses on an annual basis, while others enjoy profit margins of over 20%. Nevertheless, some differences between the geographic areas become quite clear when analyzing the data. If we consider the percentage of hotels having larger operational costs than revenues, the percentage of such companies, showing yearly losses, is 43.3% in Costa del Sol, but only 18.2% in Costa Dorada and around 30% in Costa Brava. Similarly, the share of hotels with a gross margin of above 20% is 24.4% in Costa Dorada but only 10% in Costa del Sol. The data reflect a superior economic performance of hotels in Costa Dorada compared to those in Costa del Sol. A question that immediately arises after analyzing these results is whether the negative results are a consequence of extraordinary circumstances or whether they reflect structural differences. However, the companies with negative results fail to break even despite the vigorous international tourist demand emerging over the last three years. An analysis of previous Profit and Loss statements shows that many companies experiencing losses have suffered for a few years. In fact, one indicator used in our analysis is the percentage of firms in bankruptcy, i.e. having negative equity values. In the majority of the cases, bankruptcy is a result of loss accumulation after several years of bad economic performance. 23% of the Costa del Sol hotels are technically bankrupt compared to a share of 6% in Costa Dorada and 5.3% in Costa Brava. The results obtained allow us to conclude that this sector exhibits exit barriers, considering the specificity of the assets. Firms experiencing negative returns are forced to stay in the market because they cannot sell their business for an amount they consider acceptable. They feel forced to remain in the market despite the opportunity cost of a negative return on investment. Even though they have negative results, in many cases, they have enough cash flow to cover payments and losses are similar to the value of the asset depreciation, so companies can survive in the market while they lose value on an annual basis. Table 3 shows the distribution of gross margins in the three geographic areas considered in this research.

Table 3. *Gross Margin Distribution, 2012*

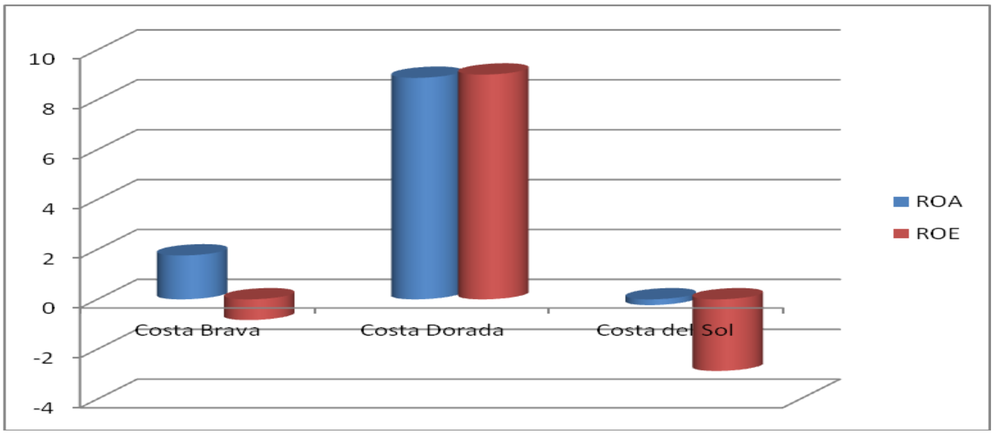
	Costa Brava	**Costa Dorada**	**Costa del Sol**
Negative gross margin	28.6%	18.2%	43.3%
Gross margin 0% - 5%	22.9%	24.2%	30.3%
Gross margin 5%-10%	14.3%	15.2%	3.3%
Gross margin 10%-20%	22.9%	18.2%	13.3%
Gross margin >20%	11.4%	24.2%	10%

Note: Data from 2012 Profit and Loss Accounts.
Source: Authors using data from SABI database.

Investment decisions are taken according to two basic criteria: the level of risk the investor is expected to accept, and the expected rate of return. Accordingly, the last part of our analysis focuses on the study of ROA, defined as earnings before interest and tax divided by the total assets value, and ROE, defined as the net profit divided by equities. The value of ROA can be compared to the interest rate paid by the company; if the ROA value exceeds the interest rate the company pays, debt is used to leverage economic performance, but if ROA is below the interest rate, the debt is eroding the shareholder's value. If we consider hotels in Costa del Sol, showing the lowest returns, 65% of firms pay interest rates above the ROA levels, so the debt is a burden for them. In Costa Dorada, where hotels exhibit the best economic performance, only 35% of firms are paying interest rates above the ROA.

The ROE allows shareholders to compare the return on their investment with other alternatives. ROE should be above the opportunity cost otherwise the investment destroys value, at least in the short term. The average ROE is 9.01% in Costa Dorada, showing that many firms in this area have positive results. In Costa del Sol, the average value is -2.87% which leads us to expect further market restructuring with a reduction in the number of companies. Hotels in Costa Brava show an average ROE which reflects a return close to the break-even point (-0.83%). Figure 2 shows the average values for ROA and ROE discussed above.

Figure 2. *Return on Assets (ROA) and Return on Equity (ROE), Average Values 2012*



Source: Authors using data from SABI database.

Conclusions

Tourism is a key sector for the Spanish economy. One of the main industries related to tourism activity is the lodging industry. This research has studied the market structure of the hotel industry in three of the most important areas of the Spanish coast, Costa del Sol, located in the south of Spain near

Malaga, Costa Brava, in the north of Barcelona and near the French border and Costa Dorada, in the south of Barcelona.

The methodology used is mainly the analysis of the financial statements, while this analysis shows significant differences among the geographic areas. The size of the hotels, measured in different ways, (number of rooms per hotel or total assets) was found to be larger in Costa del Sol, with hotels being around 6 times bigger than those located in Costa Brava. The Costa del Sol hotels have higher debt ratios as a result of the larger investment made, with these higher ratios leading to a risk premium in the interest rates, making debt more expensive for them.

The large distribution of the values for the variables considered in this paper across the three geographic areas proves the existence of a high degree of heterogeneity in this sector, which is consistent with its high level of differentiation. The returns on investment measure shows better performance for hotels located in Costa Dorada; not only is the average value higher, but also, according to the gross profit distribution, more hotels belong to the top ranges. The market structure of the hotels in Costa del Sol shows the existence of exit barriers, with the companies experiencing negative returns for several years still choosing to operate, due to the difficulty of selling their specific assets at the prices their shareholders would accept.

To conclude, there are some interesting future research lines. The first is to extend the analysis to the Balearic and Canary Islands, where the tourism sector is the main contributor in terms of national GDP and employment. The second direction for future research would be to study the value added through the different activities and services provided by hotels and ascertain what the key activities for hotels located in beach destinations are.

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