HOTEL GOVERNANCE STRUCTURE AND ALLIANCES IN THE TOURISM INDUSTRY

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ABSTRACT

Usually within an industry firms have similar organizational forms. The service sector, and in particular the hotel business, includes different forms of governance. Given several choices, ranging from full ownership to a partial equity position, to various contractual modes, such as management contracts and franchise agreements, the key question is: What determines the optimum choice of the organizational mode? The theory developed in this paper combines concepts from Transaction Cost Theory (TCE) and Resource-based Theory (RBT) to answer this question. The paper then tests these concepts to explain the incidence of these modes in the hotel business. The governance structure is shown to be determined by both TCE and RBT variables.  

We will, also, examine how the governance structure chosen affects the firm’s strategy. We will focus on the ability of the units of the global hotel chains to create alliances with the other players of the tourism industry, given their governance structure.

1. INTRODUCTION

In the new management landscape, where interfirm collaborations are becoming more and more common among the different tourism companies, hotel chains have made various different choices regarding their governance structure. Management today involves the art of selective strategy: knowing where to compete and where to cooperate. A firm collection of businesses will involve some with a high level of ownership or control, while others will be run by some form of contractual alliances such as franchising and management service contracts. Our aim is to answer two main questions for the practice of management of the tourism companies: (1) when is one governance structure chosen over another, and (2) how does the governance structure chosen affect the firm’s strategy.

This study focuses on the hotel business, which is particularly suitable for an investigation of the governance form question, since non equity forms are at least as widespread as equity ownership. Today competitive advantage can equally well be derived from interfirm cooperation in non equity-
based agreements such as management service contracts. This is especially true in the service sector, in particular for the hotel chains, where the capital-intensive elements (such as real estate) can be separated from the knowledge-based or managerial expertise elements of competitiveness.

There is a considerable literature on some governance form such as full ownership and franchising, but less on the conditions that can influence the selection of the organizational mode and on which type of mode is best under which circumstances. The aim of this paper is to provide a unified framework of analysis of a spectrum of modal choices in the hotel industry, including relatively neglected modes such as management service contracts.

Moreover, we will examine how the governance structure affects the firm’s strategy and whether the strategies pursued, focusing on strategic alliances, are consonant with the unit’s governance form. In facts, there are very few studies today that have examined both the structural question of the units, the strategies that they can pursue, and the fit between the two.

The paper proceeds in the following manner: the next section develops the Transaction Cost Economics and Resource-Based Theory arguments. This is followed by a survey of the main organizational forms in the hotel business. The third section covers the issue of aligning strategy and governance structure. The fourth section presents the methodology used and discusses the data to demonstrate the hypothesis. The paper concludes by examining the implications of the empirical findings for management practice and for further theory development.

2. THEORETICAL BACKGROUND

The hotel business product has the common attributes of the tourism product, in the first place intangibility and heterogeneity. The hotel product is an experience. Intangibility creates a greater perceived risk for the customer, who has to rely on the promise of satisfaction without the opportunity to return the purchase. Moreover, heterogeneity implies the lack of uniformity, for the procedural and convivial dimensions of the service. The challenge for the hotel firm is maintaining control of quality and standards, and being sure that both are consistent throughout the firm. Quality assurance is especially important in the service sector and in businesses in which individual units cater to non-repeat customers, as in the tourism industry. Hotel firm have identifiable brand names that help to assure the customer of uniform product quality. As a result, the major problem facing companies with valuable brand names is controlling the actions of agents throughout the organization to assure the continued value of the trademark. Management control is a complex and multidimensional concept. Contractor and Kundu (1998b) broke the overall administrative control into four dimensions: 1. daily operational and quality control in each hotel property; 2. control over the physical asset or over the real estate; 3. control over tacit expertise embedded in the routines of the firm; 4. control over the codified assets, such as global reservation systems and the firm’s recognized brand name.

Past studies have relied on a single theoretical paradigm to explain governance form. This paper combines concepts from two main theories: Transaction Cost Economics and Resource-Based Theory. The choice is based on the consideration that the global hotel chains are more than a collection of organizations and of discrete transactions. The global hotel chains have an overall long-term strategy. Their objective is not merely the minimization of transaction costs but the maximization of profits based on a long-term strategy. Moreover, the maximization of long-term global profits is not merely a matter of maximum rent extraction from a particular market in which a hotel is positioned, but building the capabilities and knowledge of the company as a whole (Hedlund and Rolander, 1990; Winter, 1987). Modal choice decision is, therefore, fundamental to create long-term value (Zajac and Olsen, 1993) and to enhance the performance of the chain overall (Bradach, 1999).

2.1 Transaction Cost Theory

Transaction cost deals with asset specificity, bounded rationality, free-rider problem and opportunism.
As an economic approach to organization, transaction cost theory attempts to explain why sometimes institutional structures, others markets, may be a more efficient means of governing economic activities. The literature accepts the dichotomy of market and hierarchy as the primary alternative for exchanges along with the assumption that opportunism dominates the behaviour of the parties to the exchange (Chen and Chen, 2003). The principal focus is on one transaction or negotiation (one market entry) at a time. The choice of the governance form is that which minimizes transaction costs (Williamson, 1979). This implies the argument that the firm will prefer hierarchy, and therefore ownership, because it affords a higher degree of control, when the market for knowledge transfer “fails” (Dunning, 1988). Thus, market failure is the primary antecedent of the firm’s decision to integrate and assume greater control.

From the transaction cost perspective, the most important determinant of market failure is the presence of transaction specific assets. The theory is based on the idea that firms, in their growth process, will exploit the competitive advantage they have developed. In transaction cost words, the competitive advantage is linked to the transaction specific assets, which are nonredeployable physical and human investments that are specialized and unique to the task. In the hotel business the main transaction specific investment is the hotel known and distinct brand. The more the brand, and the image and total quality of the product/service it represents, is at risk of opportunism, the greater will be the danger for the firm that potential partners may steal its transaction specific asset. Thus, the firm will choose equity ownership, because it affords a higher degree of control over technology, assets and operations.

On the other hand, avoiding contractual organizational forms altogether entails a substantial capital investment, which typically constrains the company’s ability to expand rapidly. The transaction cost literatures focused on the difficulties of negotiating an agreement that could effectively substitute for an extension of a company’s own organization (Williamson, 1979). These include selecting the right partner especially in foreign nations (Geringer, 1991). The transaction cost literature details the problems of being able to specify in a contract the contingencies that may befall a business relationship; the reluctance to make investments that are specific, or dedicated, to a contract (Eramilli and Rao, 1993; Fladmoe and Laurent, 1995); possible “opportunism” or “shirking” by business partners (Williamson, 1979); and the consequent costs of monitoring the other company’s activities and behaviour (Mathewson and Winter, 1985).

Transaction cost theory recognizes vulnerability in strategic alliances when the cooperation involves relation specific assets, assuming uncertainty and bounded rationality (Williamson, 1985). Economic rents are associated with relation specific assets and when two parties engage in an alliance involving such assets a moral hazard is created. The party contributing the specific assets to the alliance runs the risk of expropriation of those rents if the other party behaves opportunistically in the Williamsonian sense of “self interest seeking”. Although the contribution of specific assets may result in greater operational efficiency, incentives for undertaking such investment are tempered by risks of expropriation. Assets specificity is the core determinant in the transaction cost logic. When two parties sign a contract that requires investments specific to the contract, they enter a relationship of mutual dependence and market forces will no longer be able to discipline the partners for their opportunism.

In the earlier literature such “market failure” left the firm with no choice but to put for the hierarchical, full-ownership mode: the transaction cost literature was gloomy about the prospects of contractual relationships being able to effectively substitutes for a company’s own control and operation through ownership (called “internalization” by Dunning, 1980). Today, however, the abundance in the use of cooperative modes, especially in the hotel business, suggests that such market failure is not common. Contractual relationship, and especially the “hybrid” organizational forms – such as franchising, which are not mere arms length contracts but long term strategic relationship – may actually sometimes be a superior alternative to equity ownership (Shane, 1996). After all, franchising has proliferated at the expense of company run operations in some sectors. The fact that the chain retains legal or de facto control over strategic assets, such as brands or global reservation systems, can moderate such opportunism on the part of the partners.
The brand and the global reservation system are the two principal codified strategic assets, over which proprietary control is usually maintained by the hotel firm, regardless of the organizational mode (Viceriat, 1993; Dunning and McQueen, 1981). In particular, codified assets increase the ability of the firms to have alliances for three reasons (Contractor and Kundu, 1999b). First, codification reduces the “bounded-rationality” problem of partners, who seek to assess the value they will receive from a partnership with the hotel firm. Second, by maintaining a de jure and de facto control over these resources the firm greatly reduces the opportunism of franchisees or partners in a management contract, who may be tempted to strike out on their own, on expiry of the agreement. Moreover, many contracts take great care in specifying the standard of quality that partner must meet, including detailed remedies for default on these quality provisions (contract termination and fines). Third, while creation of brand equity and a global reservation system involves large sunk costs, the incremental cost of adding another franchisee or partner is low. Thus, such strategic specific assets enhance the hotel firm control. As we will see later on, control over codified strategic assets occurs typically in all governance mode analyzed in this paper. The potential threat of withdrawing permission to use the global company’s brand, reservation and support systems, moderates the opportunistic behaviour of the partners. In fact, this is definitely one factor which explains the high use of non equity forms in the hotel business.

Therefore, transaction cost economics is concerned not only with the emergence of particular organizations to manage transaction costs such as strategic alliances, but also with the way in which transaction costs depend on the types of exchange activities. Strategic alliances will be closer to the market (franchising) or hierarchy (management contract) depending on the magnitude of the transaction costs. (Pisano, 1989).

Transaction cost theory will comprise a significant input in the development of this paper hypothesis.

In fact, Hypothesis 1 states: if control over the brand is low, that is to say if the brand reputation and recognition is weak, ownership or management contract will be preferred to franchising.

2.2 Resource-based Theory

This paper proposes that the choice of the organizational mode is not determined by transaction cost considerations alone. The characteristics of the firm and its strategy comprise the other part of our examination. We believe that control in the hotel industry is only loosely correlated with ownership: in the hotel sector control has been de-linked from equity ownership, even though control and an overall strategy still exist.

The choice of using non equity forms of governance in this industry is difficult to explain using only traditional economics theories because the hotel firms’ concern, during its expansion, is not on the risk connected to the dissipation of transaction-specific assets, such as brand and global reservation system, but on the possibility to transfer or replicate valuable, rare, and costly to imitate resources and capabilities which constitute the source of sustained competitive advantage (Barney, 1991). The transfer is essential to maintaining consistency of brand image, quality and service. Therefore, hotel firms are less concerned about control and more concerned about the effectiveness or their transfer of assets and knowledge. To address this issue, we adopt resource based theory, an approach that focuses on the transfer of one firm’s competencies to another.

A useful perspective is to consider the hotel firm as a knowledge-based service company, related to the transfer of knowledge between partners over some duration of time, rather than as a transaction. Winter (1987) focuses on the creation of knowledge and competencies within the enterprise, and on how expertise is embedded in tacit organizational “routines”. Teece (1987) distinguishes between tacit, unwritten or informal knowledge and formally registered intellectual property which is far more transferable and shared with other firms. Contractor (1985) points out that intellectual property, such as patents, trademarks or copyrights are only of minor strategic importance, as an all-industry generalization. However, as we stated previously, in the hotel business registered brand names, as well as unregistered, but proprietary reservations and logistic systems, are a powerful source of control. It is
nevertheless true that codified strategic assets are only the visible, formalized tip of a vast iceberg of tacit information embedded in trained personnel and technicians, and in implicit routines. Hence, the transferring of such knowledge to another partner firm can be protracted, difficult, costly and incomplete. This also partially depends on the “absorptive capacity” (Contractor, 1980; Cohen and Levinthal, 1999) of the partner firm. Management of knowledge flows within and across organizational boundaries is therefore key to strategic success.

A resource based theory (Barney, 1991; Grant, 1991; Wernerfelt, 1984) seems particularly appropriate for examining governance form, and in particular the non equity modes, because firms essentially use them to access valuable resources that they do not own. Van de Ven (1976) noted that process of building inter-organizational relationship could be regarded as a flow of resources between organizations. The resource-based theory suggests that the rationale for alliances is the value creation potential of resources that are to be pooled together. It’s argued that certain characteristics of resources, such as imperfect mobility, inimitability and substitutability, promise accentuate value creation and thus facilitate the formation of alliance. In terms of alliance structures, the resource based theory suggests that the resource profiles of partner firms determine their structural preferences. Resource profiles determine the structure of alliances because firms are interested not only in accessing or acquiring valuable resources that they do not own, but also in protecting their own valuable resources in the alliance formation process.

Firm resources can be generally classified into three categories (Barney, 1991): physical capital resources (e.g., plant, equipment, location, brands, patents and trademarks), human capital resources (e.g., the skills and knowledge of individual employees), and organizational capital resources (e.g., culture, routines and rituals). Note that capabilities develop as firm combine resources to create what are known as higher – order competencies (Madhok, 1997).

For the purpose of this paper we identified the main strategic resources, source of competitive advantage for the hotel firm in the following:

- Brand image and reputation, that enable the firm to assert its quality standard and its positioning in the mind of the customers;
- Organizational competence, that captures skills and capabilities that enable the hotel to compete effectively, such as corporate culture, empowerment, operating policies and procedures, and in particular, the global reservation systems;
- Quality competence, that includes skills and capabilities needed to build high-quality service and to ensure customer satisfaction, to help the hotel create its brand reputation, and build customer loyalty, based on managerial and employees’ skills and capabilities;
- Physical competence, that captures the hotel’s capabilities to design and build physical facilities that are of desirable quality, comfort, and ambience.

A firm typically possesses a mix of reproducible competencies, as physical competences, and irreproducible competencies, above all its organizational and quality competences. The firms are driven primarily by transferability of their advantageous capabilities when choosing between the organizational forms. If we can understand the factors that influence the effective transfer of a firm’s resources, we can understand better how firms might choose between full ownership, franchising and management contract.

As we said before, the resource-based view identifies resources and capabilities in terms of their contribution to a firm’s competitive advantage (Collis and Montgomery, 1995). When a firm has to operate another unit it must transfer its resources and capabilities ensuring, at the same time, that the transfer of such assets does not diminish its ability to generate the desired competitive advantage. Resources and capabilities that need to be transferred are those that are source of the firm’s competitive advantage and, therefore, that are in some ways unique, difficult to imitate and to reproduce. The main factors that prevent one firm from replicating another firm’s resources and
capabilities are specific historic conditions, complex social interactions, and tacit (intangible) nature of know how involved (Barney, 1991). Transferring tacit knowledge is difficult because it is complex and casual ambiguous, it is acquired through trial and error, it’s taught and learned by observation, it’s continuously evolving. Resources and capabilities may be embedded in the firm, deeply entrenched in company-specific routines and practices, characterizing complex social interactions and team relationships within an organization. When such capabilities do not generate value for the firm and are difficult to transfer they are not likely to influence the firm’s choice. On the other hand, when such capabilities are critical to the firm’s success, they dominate the decision-making process. Therefore, the more important irreproducible resources and capabilities are to the hotel firm’s competitive advantage, the greater will be its preference to own or employ management contracts. As a result, a franchise arrangement means that the chain relies heavily on the franchisee’s capabilities, while under ownership or management contract the firm provides most of the day to day managerial and technical support from within its own ranks and resources. This means that franchising requires a firm to transfer resources and expertise across boundaries (i.e. form the firm to franchisee), whereas ownership and management contracts involve the transfer of such assets within the firm (Dev et al., 2002). From this we can define our second hypothesis:

Hypothesis 2 – *If strategic resources and capabilities are transferable, franchising will be preferred to ownership or management contract.*

Figure 1 shows how, from our point of view, the answer to the modal question derives from combining the two hypothesis, and, therefore, integrating transaction cost and resource-based argument.

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**Figure 1 - Determinants of Modal Choice**

3. ORGANIZATIONAL FORMS IN THE HOTEL BUSINESS

There are essentially three forms of governance in the hotel industry: straight ownership of properties, management agreements, and franchising. Most large hotel companies are active in all three categories, keeping themselves flexible to utilize varied strategies as the market dictates. Delineating the value-maximization organizational form for a given company is a difficult theoretical question and one we don’t address here. An analysis of the main forms of governance in the hotel industry can, however, allow us to specify factors that favor each one of them.

3.1 Defining Ownership

An equity investment means that the hotel owns the physical facilities and operates them by hiring employees who are then managed through a traditional hierarchical structure. Owning a hotel is a capital-intensive endeavour, it’s risky and it implies high level of resource commitment, yet it imparts control and can be very lucrative in an expanding market, when asset values show sizable appreciation.

In fully owned operations, the hotel chain has control on daily operations and quality, over the physical assets, over the tacit expertise embedded in the routines of the firm, and over the codified assets. Equity investment provides stronger long-term strategic control compared with non equity alliances for the simple reason that the latter are time-bound and, on expiry of the agreement, subject to cancellation. Vice versa, an equity stake is not so easily dissolvable. Moreover, the majority of studies indicate that usually firms consider ownership as crucial for achieving large global operations (Gomes-Casseres, 1989). Nevertheless, it has to be pointed out that in the hotel business many firms have concluded that they can be “big” enough not necessarily via controlled, equity investments, but by building a network of alliances. A network of franchisees and hotels under management contract enable them to capture some of the economies of global logistics, supplies, architectural design, training, reservations and brand recognition.

Nevertheless, if a firm possesses irreproducible resources and capabilities that are keys to achieving a competitive edge in the marketplace, maintaining irreproducible capabilities is the only one approach to sustaining a firm’s competitive advantage. In this case, ownership is necessary to preserve management practices and corporate culture.

3.2 Defining Management Contract

A management service contract is a long term agreement, of up to ten years or even longer, whereby the legal owners of the property and real estate enter into a contract with the hotel firm to run and operate the hotel on a day to day basis, usually under the hotel recognized brand. Therefore, in the hospitality management contracts, the property owner provides the infrastructure requirements, while the operator provides management expertise. The contractual relationship between the owner and the operator is such that the operator is given exclusive rights to manage the property, while the owner assumes the venture’s financial risks (Eyster, 1997). The operator’s main objective is earning management fees that are a percentage of revenues (Alexander and Lockwood, 1996; Eyster, 1997), whereas the property owners are concerned with net operating cash flows (Eyster, 1997). Although both firms combine specialized assets, the value of the operating company’s expertise is more perceived. In addition, the operator may earn extra profit margins on any supplies and materials it sells to the property. Finally, in several cases, the property is charged a small fee for every reservation booked through the global reservation system of the hotel firm. Therefore, such codified strategic asset remains in the control of the hotel firm.
Quality control, daily management and senior staffing principally rest with the hotel firm and not with the property owners: the operations are run as if the property were part of the hotel chain. In this sense, management contract can be seen as a less constrained substitute for ownership, since it requires less investment costs, still providing the chain with strong control over daily operations and quality standards. In fact, according to Reynolds (1994) customers cannot tell the difference.

In the effects, for the hotel firm management service contracts provide strong day-to-day control without ownership. Moreover, such contracts can amount to surer returns without real estate investment risk. Even ordinary commercial or economic risk is greatly reduced since the hotel operator’s take is often a percentage of revenues and not expressed as a percentage of profits (as it would be the case in an equity joint venture), which are far less volatile than the latter. A perfect example of this trend of preferring management contract to ownership is Marriott Corp., which in 1993 split itself into two firms: one a profitable hotel management firm, and the other a debt-laden real estate owning company (Doyle, 1993).

Nevertheless, this governance form has some potential for risk: local partners, which usually make up much of the middle management, can acquire tacit expertise on the job and learn the business well enough to lunch their own hotel chain, as is the case of Oberoi Hotel Group after terminating its partnership with Intercotinental Hotels (Contractor and Kundu, 1998b).

3.3 Defining Franchising

Not all individuals within the firm can be expected to have a strong interest in expending the effort to maintain the quality and reputation of the product. Fama and Jensen (1983) suggest that there are two general and substitutable methods for controlling behaviour of agents in the firm. First, there are control devices, such as boards of directors and monitoring systems that limit the discretion of decision agents. Second, ownership of residual claims can be restricted to the decision agents. Companies with valuable brand names are not likely to adopt an extreme form of the second alternative, in which each unit manager purchases all the residual claims and decision rights for his unit. An externality problem among units within the organization implies that some central control is likely to be beneficial in maintaining the trademark value. Alternatively, operation of all units by the central company can be very costly because it is expensive to develop systems for controlling employees behaviour, especially when units are disperse over a wide geographic area (Brickley and Dark, 1987). Franchising is a hybrid between the two methods of control (i.e., control devices and residual ownership). In franchise agreements, the franchisee purchases a residual claim for his unit but does not have full decision rights. Some are maintained by the central company that has the authority to monitor the franchisee for quality and to terminate the contract if the quality is not maintained.

The hospitality industry has witnessed the use of alliance strategy in the past that has been centred predominantly on franchise agreements. The strategic popularity of franchising is due largely to the proficient manner by which geographical coverage can be achieved.

Franchising has been defined as an organizational form “in which the owner of a protected trademark grants to another person, for some consideration, the right to operate under his trademark for the purpose of producing or distributing a product or service” (Caves and William, 1976) and in return receives a payment or royalty and conformance to quality standards. Large franchise chains are first and foremost based on the benefits of brand name recognition, for which an operator either pays a straight fee or gives up a percentage of revenue. The name represents a specific concept and standard, consistent at every location. This familiarity appeals to many consumers. It also provides the company a greater efficiency in the use of resources, especially as the chain grows. Through franchise agreements, hotel companies can generate revenues from limited capital investments and can market their product more pointedly. In an attempt to segment the market, some companies have successfully developed a variety of chains that are advertised aggressively and provide varying levels of service (Hoover et al., 2003).
It’s clear that much of franchising involves competition based not just on brand but on differences in the business methods, procedures, and services offered to customers. Hotel chains try to distinguish themselves from others by their brand names, architectural designs, and levels of logistics delivery. The hotel business involves as much “technology” or proprietary competitive expertise, as manufacturing systems. In the hotel business, therefore, a franchise is not merely a matter of signing an arms-length contract and then passively raking in the royalties; it involves intense transfers of knowledge or organizational, technical, and marketing expertise. The legal form may be a contract, but the de facto organizational behaviour is an evolving strategic partnership between the franchisor and its franchisees.

In franchising, daily management and quality control and control over physical assets reside with the franchisee, and not with the hotel chain. In this case, the hotel firm does not run the hotel’s management, but trains and guides it under a contractual relationship, sharing only some tacit expertise. But it would be a mistake to assume that franchisor exercises no control. Typically, hotel standards are sought to be zealously enforced. Codified assets such as brands and reservation systems reside with the hotel chain. The franchisor earns fees linked to revenues and profits, additional margins on the material supplied, booking fees for clients booked via the global reservations network, and training fees for personnel trained. Moreover, if the hotel chain has a network of franchisees enables it can capture at least some economies of global scale in logistics, supplies, architectural design, reservation, training and brand recognition. Of course, not all firms will replicate the hotel architectural design or purchase from the hotel central procurement channel, but at least some economies of scale can be hypothesized. Furthermore, franchising earnings, being a percentage royalty claim on gross revenues, may be preferred to ownership claims on residual profits in competitive conditions.

A major problem related to franchising is the possibility to encounter free riding by the franchisee. This problem arises especially where franchised units have a low proportion of repeat purchases such as tourist areas. Customers, perceiving brand name capital as developed by franchisor, will patronize those units. A franchisee in one of these locations may have an incentive to shrink on input quality and consequently pass the costs associated with lost customers’ confidence along to other units in the chain (Alchian and Demsetz, 1972; Caves and Murphy, 1976). In addition, there can be the potential for post-contractual opportunistic behaviour. Depending on the nature of the contract, either the franchisee or franchisor may have to invest in specific assets which, by definition, create appropriable quasi-rents, i.e. rents that can be appropriated via post contractual opportunistic actions. The quasi-rent exists if the value of an asset is higher in a given use than its value in its next best usage (Brickley and Dark, 1987). Providing contractual mechanism to protect either party from quasi-rent appropriation raises the costs of franchising (Klein et al., 1978). In a hospitality franchise agreement, although the two firms involved typically share assets, the risk exposure is not equally shared. The franchisor is exposed to lower risks than the franchisee, who meets the infrastructural requirements of the agreement, as the construction of a distinctively designed building that is the symbol of the franchise. It’s interesting that although firm specific assets increase contracting problems, they are observed frequently in franchise companies. One explanation is that investments in these types of assets serve as a quality bond to customers and to partners. These investments are regarded as a commitment that the franchisee is making to the hotel firm. If franchisees do not maintain specified quality standards, the franchisor may attempt to terminate the contract. Should that occur, the franchisee would be saddled with assets that are difficult to use for another purpose. Therefore, once the investment is made it provides an indirect substitute for monitoring since the owner has an increased incentive to uphold the value of the trademark because the salvage value of the asset, should the franchise fail, is low.

Regarding transferability of resources, knowledge flows across organizational boundaries in partnerships can lack reciprocity. Unequal cross-flows of knowledge can lead to perceptions of “free riding”, and unintended leakage of knowledge can lead to opportunism in the form of partners terminating the relationship and becoming competitors.
4. GOVERNANCE STRUCTURE/STRATEGY FIT

The second part of the paper will cover the issue of aligning strategy and governance structure. Interest in determining the fit between an organization’s strategy and structure finds its roots in Contingency Theory (Chandler, 1962; Donaldson, 2001). In order to enquire empirically into the dynamics of change in organizational structure, attention will be directed towards one branch of contingency research – the relationship between strategy and structure (Drazin and Van de Ven, 1985). There are several dimensions to each of corporate strategy and structure. We will focus on the ability of the units of the global hotel chains to create alliances with the other players of the tourism industry (tour operators, airline companies, travel agencies, PCO, local authorities), according to the different governance structure chosen (Chathoth and Olsen, 2003).

The importance of matching an organization’s strategy and structure is one of the fundamental insight in the strategic management literature (Chandler, 1962; Rumelt, 1974). This stream of research has shown that while strategy or structure alone may have some influence on organizational performance, differences across firms are better predicted by considering the nature of the strategy/structure fit. If strategy is about realizing a plan, then in implementing it, a suitable means of structuring resources and activities must be found and maintained. Olsen (1993) uses the terms “co-alignment” to describe the “best fit” relationship between strategy and organizational structure. He observes that without co-alignment between strategy, strategy and environment, organizations may experience difficulty in achieving long term success (see Figure 2).

**- Figure 2 – Aligning Organizational Strategy and Structure**

This study seeks to contribute to the strategy of hotel chain by developing and testing a contingency perspective regarding the fit between strategy and governance structure and the implications of this relationship on strategic alliances. In particular, we believe that the different governance structures dealt in the first part of the paper have fundamental differences that go beyond the usual discussion of incentive issues and control mechanism to include differences in flexibility, local adaptation and decision rights. Our aim is not to conclude that one form of governance is superior to the others, quite the contrary. Our main argument is that each structural arrangement has particular advantages, and that the relative superiority of one versus the others may be attributable more to the matching of one
structure with a correspondingly appropriate strategy. Specifically, we posit that hotel firms will act in fit-enhancing ways by pursuing strategies that are more congruent with their governance structure. So, we develop the argument that ownership, contract management and franchise agreement differ along important dimension of decision rights, operating flexibility, and incentive structure, and that these differences are well matched with the pursuit of alternative strategic alliances.

An important dimension upon which strategic alliances can be characterized is whether they are more centralized by the hotel chain versus more focused on the local environment. Franchised hotels tend to have a wider range of decision rights, a higher levels of autonomy and of operational flexibility to achieve system-wide adaptation as compared to company owned hotels, which have to maintain uniformity across units. As franchised hotels tend to develop local management skills we expect them to be more prone to choose a strategy that requires more local coordination. Viceversa, the operational conformity, more centralized decision right, and weaker financial incentives of company owned hotel/management contract units are better aligned with strategic choice that value routinization, efficiency and control. The fact that hotels managers have to comply and follow routines can make them quite effective in strategies that emphasize predictability and standardization. Tightly controlled companies in ownership and management contract fit better with and, therefore, will be more likely combined with strategies that have more unitary demands. In particular, we expect that franchised units will be closer to the local environment by creating tourism local system with the other actors of the tourism industry, whereas owned and managed units to reflect the more centralized alliances of the chain (probably just with airline company and car rentals).

Hypothesis 3 – Franchised units will tend to have more local alliances with other firms of tourism industry, than owned or managed units.

5. METHOD

To test our expectations, we gathered qualitative information and attended international industry trade shows during which we interviewed managers and staff members to develop a more fine-grained understanding of governance structures and strategies in the industry, focusing our analysis on the main global hotel chains. Table 1 lists the well-known brands of the chains represented in the study.

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<td>Confort Suites</td>
<td>Hilton Hotel</td>
<td>Motel6</td>
<td>Sina Hotel</td>
</tr>
<tr>
<td>Coralia Hotels</td>
<td>Holiday Inn</td>
<td>Novotel</td>
<td>Sleep Inn</td>
</tr>
<tr>
<td>Courtyard Hotels</td>
<td>Holiday Inn Express</td>
<td>Quality</td>
<td>Sofitel</td>
</tr>
<tr>
<td>Crowne Plaza</td>
<td>Ibis</td>
<td>Ramada International</td>
<td>SpringHill Suites</td>
</tr>
</tbody>
</table>

Our final sample is made up of 54 European and American hotel chains, which accounts for a total of 19.646 hotels and approximately 2.488.996 rooms. The organizational modes of our sample are as follows and as detailed in Table 2:

- 45% have a mix of owned, managed and franchised units;
30% are either owned, managed or franchised chains;
25% have two out of the three forms of governance studied: owned and franchised, or owned and managed, or managed and franchised.

- Table 2 –

**Salient Characteristic of Sample Hotels**

| All Three Forms of Governance | 45% |
| One Form of Governance | |
| Ownership | 7% |
| Management Contract | 6% |
| Franchising | 17% |
| Two Governance Forms | 25% |
| Ownership and Franchising | 4% |
| Ownership and Management Contract | 15% |
| Management Contract and Franchising | 6% |
| Average Number of Rooms per Unit | 127 |

The questions raised during the interviews covered the following topics:

1. Rationale for the chain governance structure. In particular, we identified the critical variables that have emerged from the above – mentioned theoretical approaches used in the analysis: history as the main determinant of the organizational mode; ability to exercise control over the brand and quality, considering if the brand could be at risk; perceived ease/difficulty of transferability of strategic resources and capabilities; importance of flexibility; level of tourism attractiveness of the destination;
2. Risk associated with the chosen structure;
3. Forms of alliances with other tourism firms. Our interest is mainly on whether the alliances are centralized or local according to the different forms of governance.

Given this information, the data enabled us to examine the extent to which TCE variable and RBT variables affect the choice of the organizational mode.

**5.1 Discussion**

Although our analysis does not necessarily qualify as identifying “best practices”, looking at what the firms in our sample did may provide a framework with which to analyze the modal question.

- Table 3 –

**Main Reasons for Governance Structure**

<table>
<thead>
<tr>
<th>Reason</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>History</td>
<td>84%</td>
</tr>
<tr>
<td>Control over the Brand</td>
<td>79%</td>
</tr>
<tr>
<td>Flexibility</td>
<td>62%</td>
</tr>
<tr>
<td>Transferability of Resources and Capabilities</td>
<td>53%</td>
</tr>
<tr>
<td>Tourism Attractiveness</td>
<td>29%</td>
</tr>
</tbody>
</table>
The first question was about the main determinants of the governance structure and the interviewed could express more than one choice. From the analysis of the gathered data (Table 3), the majority of managers interviewed consider history (84%) as the main determinant for the actual governance structure of the chain. The main TCE variable, control over the brand, appears the second main determinant with almost 80% of the responses. Flexibility accounts for 62% of total responses and the main RBT variable, transferability of resources and capabilities, for 53%. The last variable, tourism attractiveness, was chosen by only 29% of the sample. Recall that executive responses indicate the firms’ general preferences, but in the “portfolio” of each firm in the sample we have a mix of organizational modes. Therefore, since the aim of this paper is to determine the conditions under which one form of governance is chosen over another, the analysis will proceed underlining the impact of the TCE and RBT variables on each organizational mode.

- **TABLE 4 -**

**MAIN VARIABLES FOR GOVERNANCE STRUCTURE**

<table>
<thead>
<tr>
<th>Control over the Brand</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Ownership</td>
<td>9%</td>
</tr>
<tr>
<td>Management Contract</td>
<td>72%</td>
</tr>
<tr>
<td>Franchising</td>
<td>19%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Transferability of Resources and Capabilities</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Ownership</td>
<td>6%</td>
</tr>
<tr>
<td>Management Contract</td>
<td>13%</td>
</tr>
<tr>
<td>Franchising</td>
<td>81%</td>
</tr>
</tbody>
</table>

Table 4 shows that TCE control over the brand is the main determinant for ownership for 9% of the sample, management contract for 72% of the cases and franchising for 19%.

It has to be said that those chains that have considered control over the brand as the main determinant for franchising are pure franchising chains. Their growth strategy is based on a strong and recognizable brand name, distinctive physical assets - transaction specific investments made by the franchisees - and strict quality standards, which serve as quality bond for partners and can be considered by the hotel chain an indirect substitute for monitoring.

Hypothesis 1 – *If control over brand is low, ownership or management contract will be preferred to franchising* – is therefore significant since it explains 81% of the sample. Nonetheless the high percentage of management contract compared to ownership demonstrates the importance of combining TCE and RBT, since control can equally be achieved by full ownership forms and contractual forms. Contractual relationships can effectively substitute for equity ownership when the fear of partner opportunism is reduced by the company’s ongoing control over key strategic assets. The threat of withdrawal of a global reservations system or brand name moderates the behaviour of partners. Moreover, these same strategic assets enable the firm to earn additional royalties in management contract and franchising.

Note that the relative small incidence of ownership is consistent with the findings that history is considered the main determinant of the governance structure. Nowadays, hotel chains can maintain equal control over quality and standards exploiting more flexible contractual arrangements such as management contract.

Hypothesis 2 – *If strategic resources and capabilities are transferable, franchising will be preferred to ownership or management contract* – is fully demonstrate since over 80% of our sample has identified as the main reason to choose franchising the possibility to replicate resources and capabilities that constitute the source of sustained competitive advantage.
According to the Resource-based Theory, firms are driven primarily by transferability of their advantageous capabilities when choosing their governance structure. When these capabilities are irreproducible (as for organizational competence and quality competence), firms advocate more controlled modes, such as ownership and management contracts. If a firm possesses irreproducible resources and capabilities that are keys for brand’s establishment and survival and for achieving a competitive edge in the marketplace, it is imperative for it to choose ownership/management contracts over franchising to reduce technology transfer. Management contract are also favoured when the firm has high quality competence and the market that it caters to is service sensitive. The interaction between quality competence and service sensitivity highlights the interplay between internal capabilities and external market requirements, a noted strength of resource-based approach (Collis and Montgomery, 1995). It should be considered that the main condition for the use of management contracts depends on the availability of reliable investment partners. This form of governance is also more attractive for large firms and for those that construct large hotel properties.

On the other hand, franchising can be suitable used as long as key aspects of hotel operation can be codified and transferred. The size, layout, and decoration of the building can be standardized and replicated with little difficulty. Thus as long as there is no specific knowledge or skill that comes in the form of expert managers, requisite knowledge can be transferred in form of franchise arrangement. Nevertheless, reproducible competencies are not expected to influence alone the choice between franchising and ownership/management contract. Franchising is favoured when the firm has both a high physical competency and a strong brand reputation. The effect of interaction between physical competence and a strong brand reputation sheds some light on the conditions under which clear choices could be made when transferring reproducible capabilities.

The objective of this paper is to provide a unified framework of analysis of the modal choice question, combining variables from transaction cost economics and resource-based theory. Figure 3 is the result of this effort.

-FIGURE 3—

CONTROL OVER THE BRAND AND TRANSFERABILITY OF RESOURCES AND CAPABILITIES

<table>
<thead>
<tr>
<th>Control over the Brand (TCE)</th>
<th>Management Contract</th>
<th>Franchising</th>
</tr>
</thead>
<tbody>
<tr>
<td>HIGH</td>
<td></td>
<td></td>
</tr>
<tr>
<td>LOW</td>
<td>Ownership</td>
<td>Management Contract</td>
</tr>
<tr>
<td>LOW</td>
<td></td>
<td>HIGH</td>
</tr>
</tbody>
</table>

Transferability of Resources and Capabilities (RBT)
The model examines the impact of control over the brand and transferability of resources on the hotel firms’ propensity to establish contractual modes or go for equity investments. What we proved are the two main determinants of the governance structure constitute the dimensions of the matrix.

As we stated earlier on, regarding the decision of the modal choice TCE is well equipped to explain why firms prefer full ownership to partnership, while it does not distinguish well between the different degrees of partnership (Gatignon and Anderson, 1988). The choice of integrating TCE with RBT responds to this problem. Therefore, we can see that if control over the brand and transferability of resources and capabilities are low, both theories will suggest ownership as the best governance form. On the opposite side, franchising will be considered the best choice when control over the brand is high (because of a strong brand reputation and high transaction specific investments for the franchisee) and there are reproducible resources and competencies which are an important source of competitive advantage (such as distinctive physical assets). The highly standardized business format and investments in infrastructural requirements, as expressive architectural design symbol of the chain will provide a relatively high degree of control because of in-built explicit corporate standards which will guarantee conformance and bind the franchisee to the chain.

With the above consideration in mind, we can see that in most cases a hotel firm that expands by transferring irreproducible competence (low transferability) will clearly favour ownership/management contracts for that expansion; as we stated earlier, any attempt to transfer such resources and capabilities within the context of a franchising may lead to a serious loss of competitive advantage for the hotel chain. Moreover, the influence of these irreproducible capabilities on the choice between more or less control depends on the strength of the competitive advantage generated by those capabilities. Therefore, the greater the competitive advantage generated by a firm’s irreproducible capabilities, the higher is the firm’s probability of choosing ownership or management contract according to the level of control over the specific assets. Therefore, management contract seems the choice in the middle: it substitutes ownership when transferability of resource and capabilities is low, but control (brand reputation) is high and vice versa when the brand is weak, therefore at risk, but the competitive advantage is transferable. Moreover, we have noted that a firm’s preference for using more controlled governance structures becomes stronger with the rising importance of quality competence (irreproducible) mainly in large hotels. As quality competence becomes more important as a source of competitive advantage, the firm’s desire for an internal arrangement such as a management contract varies with the size of the hotel property. Executives have responded to this by pointing out that the know how needed to offer quality service becomes increasingly complex as the hotel property expands in size, thus making a higher level of control more necessary (Gatignon and Anderson, 1988).

With respect to the governance structure/strategy fit, it has to be underlined that as the travel industry has become increasingly sophisticated and global in nature, hotel operators have developed competitive advantages through agreements of various kinds with other industries that serve travellers. Frequent-flyer/guest/renter programs have been developed in cooperation with airline and car rental companies. These programs offer "points" for air travel, hotel visits, and car rentals that can be redeemed for upgrades and awards through any of the three partners. These programs are geared towards fostering brand loyalty, both in the individual leisure traveller, who receives regular statements, and in the corporate traveller who, through side agreements with certain companies, is often given corporate rates or some other preferred-customer benefits. Relationships with travel agencies and tour operators are also an integral element in the success of many hotels. Agencies, which book approximately 40 percent of the hotel rooms in the United States, are a crucial sales mechanism for the industry. Agreements with tour operators to offer substantial room discounts on bulk bookings are ubiquitous in the hotel industry, as properties benefit not only from the added business but also by the free publicity from appearances in tour operator brochures.
- Table 5 -

ALLIANCES AND GOVERNANCE STRUCTURE

<table>
<thead>
<tr>
<th>ALLIANCES</th>
<th>OWNERSHIP</th>
<th>MANAGEMENT CONTRACT</th>
<th>FRANCHISING</th>
</tr>
</thead>
<tbody>
<tr>
<td>Central</td>
<td>95%</td>
<td>83%</td>
<td>51%</td>
</tr>
<tr>
<td>Local</td>
<td>5%</td>
<td>17%</td>
<td>49%</td>
</tr>
</tbody>
</table>

By looking at Table 5, we can affirm that also hypothesis 3 – franchised units will tend to have more local alliances with other firms of tourism industry, than owned or managed units- is supported. Centralized alliances make up 95% of the total alliances of owned hotels, whereas in franchised units 50% of total alliances come from local tourism firms. Consider that 45% of our sample is made up of hotel chains that have a mix of owned, managed and franchised units. Therefore, franchised units will inherit centralized alliances of the chain plus activate local ones. Moreover, regarding the partners in the alliances, centralized alliances usually are with international tour operators, airlines companies and car rentals, whereas local alliances include destination firms like incoming agencies, tourism local authorities and event organizers. Many franchised units have also signalled alliances with local tour operator. Therefore, the results show that the governance structure has an effect on the choice of the scope of the alliances that is theoretically predictable from the strategy/governance structure fit framework that we proposed in the study.

6. CONCLUSIONS

When deciding on the governance structure hotel firms must choose from a large set of options. Today the modal choice discussion has gone beyond the Transaction Cost question “internalize or not”, to include different types of alliances. With regard to this aspect, Resource-based Theory can help to better define the various types of partnerships. This study seeks to contribute to the strategy literature by providing a unified framework of analysis, combining both TCE and RBT argument, for the three main forms of governance in the global hotel industry: ownership, franchising and management service contracts.

The results show that both the TCE and RBT variables influence the selection of organizational mode. The TCE variable, control over the brand, continues to be the main determinant of the organizational structure, since the brand is considered the first transaction specific investment in the hotel chain business. The results also provide a strong support for the Resource-based view that when competitive advantage is based on irreproducible resources and capabilities, such as organizational competences and quality competencies that cannot be transferred effectively between firm boundaries, more “controlled” governance structures such as ownership or management contract need to be employ. Therefore, the difficulty in reproducing competencies not only protects a firm from its competitors, but constitutes a limit to its ability to transfer the needed capabilities to partners. Management contract, in the past literature a relatively neglected mode, has been showed to be an effective substitute for equity ownership in several circumstances, in particular when brand recognition and reputation is high, while key resources and capabilities are irreproducible. Further research could examine if the variables considered in this paper and the model developed could be equally applied to organizational mode decisions in a national or international context.

Moreover, we have sought with this paper to contribute to the literature on strategy-structure fit by addressing why some strategies may be better suited to certain governance structures. We have found support for our notion that certain governance structures are better matched with particular strategies than with others, focusing our attention on the strategic alliances with the other players of the tourism industry. Ideally, firms could begin to consider governance structure alongside with the usual considerations when selecting a strategy. This aspect should be further investigated, considering for
example, the conditions which facilitate the emergence of strategic alliances, their governance structure, and the likelihood of the development of a network of tourism firms or, even, the creation of tourism local systems. Other dimension of a firm strategy may as well be developed.

Although our findings are by no means comprehensive, they can offer manager a support when deciding on the organizational mode and on the best strategy they can pursue, based on the chosen governance form. With regard to this aspect, the global hotel business may be a precursor for other service sectors in terms of prevalence of non equity modes of doing business, compared to equity ownership. We hope that our study can stimulate further research to consider theoretically and empirically the determinants of the modal choice and how different structures can affect the choice of strategy.
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Olsen M.D., (1993), Accommodation: international growth strategies of major US hotel companies, Travel & Tourism Analyst, Economic Intelligence Unit, 3, 51-64.


