Expansion Strategies of International Hotel Firms: A Transaction Cost Economics and Agency Theory Approach

by

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ABSTRACT

The present study examines the decision of international hotel companies to expand using market versus hierarchical modes. So far, there are only a few studies that examine the entry mode or corporate development decision of service firms and even fewer that are focused specifically on the hotel industry. This study provides a robust theoretical discussion on the decision for corporate development in the hotel industry, combining both Transaction Cost Economics and Agency Theory. Moreover, it is the first to argue that management contracts, although a non-equity mode of organisation, should be viewed as a more hierarchical form of organization, and to provide empirical support for that statement.

The primary objective of this study is to develop a comprehensive framework to determine the variables that influence the expansion strategy of international hotel firms and to test the respective hypotheses. Three of these hypotheses, the ones that refer to the influence of brand growth, proprietary knowledge (market segment) and country of origin of the brand, have not been examined by previous studies in the hotel industry.

The power of Transaction Cost Economics and Agency Theory to predict the expansion strategy of international hotel firms is supported by the empirical results of this study. There is clear empirical evidence that the degree of proprietary content and idiosyncratic knowledge embedded in the service provided by the hotel company is one of the most important factors to define international hotel expansion strategy. The results of the data analysis also provide support for the importance of country of origin of the brand in the corporate development decision.

Besides the limitations, which refer mainly to data collection and measurement issues, this study makes an important conceptual and methodological contribution in the existing literature and identifies several areas that need to be explored by future studies in order for our understanding regarding the strategic behaviour of international hotel firms to be enhanced.
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CHAPTER 1: INTRODUCTION

The service sector has grown rapidly in importance in both developed and developing countries. In the past three decades the share of services in the gross domestic product of 55 out of 78 countries has increased (World Development Indicators, 2000). Accordingly, a great amount of research has been done within the last twenty years regarding the international service sector. More specifically, a significant part of that research has focused on the reasons for globalisation of service firms. Industries that have attracted the interest of researchers include advertising (Terpstra and Yu, 1988), banking (Goldberg and Johnson, 1990; Sabi, 1988 and Yannopoulos, 1983) and the hotel industry (Dunning and McQueen, 1981; 1982). Other scholars have attempted to explain the interaction between international growth of services and multinational service enterprises (Boddewyn, Halbrich and Perry, 1986; Li and Guisinger, 1992).

More recently, however, the interest of the researchers has shifted to the reasons for the increase in the multinational activity of service sector firms (Dunning and Kundu, 1995), the reasons for variation in the degree of internalisation (Contractor and Kundu, 1995) and even more intensively on the modes of entry into foreign markets (Contractor and Kundu, 1998a; Erramilli, 1990; 1991; Erramilli and Rao, 1990; 1993).

Although the market entry mode is usually chosen from several alternatives, such as company ownership, joint ventures and licensing, scholars have lately directed their conceptual and empirical work to the study of non-equity (contractual) modes of entry, such as licensing and franchising. More specifically, there has been a great amount of work that focuses on explaining franchising arrangements (Brown, 1998; Dnes, 1996; Klein, 1995; Michael, 1996; Minkler, 1992; Norton, 1988a), as well as on the choice between franchising and company ownership (Brickley and Dark 1987; Combs and Castrogiovanni 1994; Lafontaine, 1992; Maness, 1996; Martin, 1988; Scott, 1995; Shane, 1996 and Thomson, 1992).

However, despite the fact that there is sufficient research available regarding the determinant factors of franchising, most of this research does not make any distinctions between industries, even though it is widely accepted that different features would
influence the franchising decision in the manufacturing sector as opposed to the service sector. As a result, there are only few studies so far, that attempt to explain the choice between franchising and company ownership in the service sector (Fladmoe-Lindquist and Jacque 1995, Contractor and Kundu 1998b). Moreover, in the hotel industry another alternative to franchising exists, namely the use of management contracts (Contractor and Kundu 1998a, Eyster 1993, 1997). Thus, when the modes of development in the international hotel industry are the focus of a particular research, management contracts should also be included in the analysis, since they present one of the most commonly used modes of expansion.

Franchising is a contractual arrangement whereby one firm, the franchisor, sells the right to another firm, the franchisee, to operate under a particular trademark following a set of guidelines (Lafontaine and Masten, 1995). Additionally, when it comes to business format franchising, the franchisor agrees to provide managerial assistance regarding issues such as advertising and promotion, personnel development, operating procedures, whereas the franchisee runs the business in a way that has already been agreed, pays royalties, usually a percentage of sales, and sometimes is obliged to buy supplies from the franchisor or from approved suppliers (Rubin, 1978).

A management service contract is a long-term agreement, of up to ten years or even longer, whereby the legal owner of the property enters into a contract with another firm, in this case an international hotel company that agrees to run the hotel’s daily operations. Usually the property carries the name of the international hotel company and moreover, quality control, daily management, and senior staffing rest with the hotel company, not with the owners. This arrangement is favoured in many international settings as it allows the international hotel firm to establish a presence without investment in property ownership.
1.1 Problem Formulation

The purpose of this study is to provide a robust theoretical framework in order to identify the factors that influence the expansion strategy of international hotel companies. Hotels, although classified in the service sector, are characterised by certain distinctive features, that differentiate them from other service industries. More specifically, the hotel industry has very high capital intensity, contrary to other parts of the service sector, such as advertising and consulting (Contractor and Kundu, 1998a). Moreover the logistics and supply chain can be as complex as in manufacturing operations. Therefore, it can be argued that the hotel industry presents a challenge and deserves separate research, regarding the decision on the mode of corporate development.

Furthermore, as documented in the most recent study of Contractor and Kundu (1998a) regarding the choice of entry mode in the hospitality industry, non-equity arrangements (i.e. franchising and management service contracts) account for 65.5% of foreign operation properties in the world as a whole. The prevalence of management contracts and franchising is even higher in North America, where they account together for 79% of the organisational forms in “foreign operations”. A very important element arising from the data they gathered is that management contracts, a neglected mode in the research so far, are quite popular not only in the world as a whole, but also in each region separately (in North America 41%, in Europe 37% and in Asia 42%). The fact that contractual modes of corporate development are quite prevalent in the hotel sector worldwide, in combination with the lack of research that includes management contracts in the analysis, suggests that this study could reveal important findings regarding the factors that influence the expansion strategy of international hotel corporations.

Although strategic alliances are also a non-equity form, it has been decided not to be examined in this study. The reason is that they are not a common mode in the hotel sector. Whereas in the other service industries, like the airline industry, strategic alliances constitute a common mode of co-operation and expansion, this is not the case

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1 Contractor and Kundu (1998b) define as foreign property one that is located outside the home nation. However, in the present study this definition will be treated with caution, since a multinational company does not really have home-base, especially when it comes to hotel operations. Therefore in this study the term international company will be used but no distinction will be made between domestic and foreign operations.
for the hotel industry. So far, the author is aware of only two strategic alliances in the industry, both involving Radisson Hotels (a division of Carlson Hotels), namely the one between Radisson Hotels and SAS (the Scandinavian Airline company) and between Radisson Hotels and Edwardian Hotels. Thus, it is suggested that the two contractual modes of expansion that need to be studied in the context of the hotel industry, along with the company ownership mode, are management contracts and franchising.

Additionally, since the theoretical background of the study derives from transaction cost economics and agency theory, this study will also assess whether these theories can predict the strategic behaviour of international hotel firms. What makes this study more interesting and challenging is the suggestion that management contracts should be viewed as a more hierarchical form of organisation. Previous research considered franchising and management contracts as two alternative forms of contractual agreements that both lie towards the so-called “market” mode of organisation, whereas an application of transaction cost theory supports the view that management contracts should be placed further towards the “hierarchy” end (Dimou et. al, 2003; Williamson, 1975).

1.2 The main objectives of the study

Subsequent of the analysis in the previous section, one could formulate the main research question of this study as follows:

Using Transaction Cost Economics and Agency Theory, what are the main (country-) location-specific and firm-specific factors that influence the corporate development decision of international hotel firms?

The above mentioned research question could be further decomposed into the following research objectives:

- Examine whether Transaction Cost Economics (TCE) and Agency Theory (AT) can provide an explanation for the expansion strategy of international hotel firms, i.e. for their choice among the three most common development modes, company ownership, franchising and management contracts.
• Identify the firm- and (country-) location- specific factors that influence the expansion decision, namely the factors that would favour the use of a hierarchical, market or hybrid mode in the hotel industry. Firm-specific factors refer to variables related to the structure of the firm and its competitive advantages (e.g. firm size and scale, experience, investment in research and development, global reservation systems). The location-specific factors on the other hand refer to the specific characteristics and conditions of the country where the company wants to expand, such as political and economic risk, market size and growth, level of economic development and degree of foreign direct investment in the country (Dunning and McQueen, 1982).

• Find out whether there are interactions between any of those factors and how these interactions affect the initial expansion decision.

• Identify whether hotel companies that operate in different market segments (i.e. upscale vs. mid-market vs. budget segment) use these modes for expansion in a different degree and why.

• Examine the similarities and differences between the results of this study and the results of previous studies in different sectors, in order to conclude whether the expansion decision of international firms varies according to the sector where the firm operates.

1.3 Structure of the study:

Chapter Two will provide an overview of the international hotel industry including a presentation of the historical and geographical development of the industry, as well as an analysis of the current situation. Furthermore, the various growth strategies will be presented and the most common strategies will be further analysed. Finally, a short overview of the largest international hotel companies will be provided.

In Chapter Three the relevant theories of corporate development that are currently most prevalent in the literature will be presented. The usefulness of Transaction Cost Economics (TCE), as developed by Williamson (1975, 1985, 1996a), has been extensively discussed in the literature (Anderson and Gatignon 1986, Gatignon and
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Anderson 1988, Hennart 1988, 1989; Klein, 1980; Shelanski and Klein, 1995; Teece, 1981, 1986) and several scholars have used transaction cost theory as a basis for their theoretical framework, to examine the entry mode decision of multinational corporations (Anderson and Gatignon 1986; Gatignon and Anderson 1988; Erramilli, 1991; Erramilli and Rao 1993; Hennart, 1991).

Additionally, as far as the research on franchising is concerned, there has been a widespread use of Agency Theory (Rubin, 1978; Mathewson and Winter 1985), along with TCE (Caves and Murphy, 1976; Klein, 1995; Klein and Saft 1985), which attempt to explain various aspects of the franchise contract, including the decision to franchise or to own outlets (Brickley and Dark, 1987; Brickley, Dark and Weisbach, 1991; Brown, 1998; Gallini and Lutz, 1992; Lafontaine, 1992; Norton, 1988a; Scott, 1995; and Shane, 1996, 1998), as well as the specification of the optimum use of franchise fees and royalty rates (Blair and Kaserman, 1983; Wimmer and Garen, 1997).

In the same chapter, a brief presentation of alternative theories that have been applied recently in the research regarding especially the entry mode decision will be given: Internalisation Theory (Buckley and Casson, 1976, Rugman, 1986), Dunning’s Eclectic Paradigm (Dunning 1980, 1988; Dunning and McQueen, 1981) and Resource-Based Theory or Organisational Capabilities theory (Conner 1991, Madhok 1996, 1997). Along with a short presentation of the above mentioned theories, an explanation for their exclusion from the theoretical framework of this study will be provided. As will be presented in the next chapter, the basic arguments presented by Internalisation Theory and Dunning’s Paradigm can be found in the main assumptions and arguments of Transaction Cost Economics, therefore it is suggested that neither of these theories provides vital arguments that justify their inclusion in the theoretical framework. Furthermore, Organisational Capabilities theory (OC) will not be considered either, since some of its arguments are contradictory to what Transaction Cost Economics assert. A justification will be provided with respect to the preference for TCE arguments over OC theory.

Chapter Four will present a theoretical framework that will be used for analysing the choice among the most commonly used modes of expansion in the international hotel industry, namely franchising, management contracts and company ownership. Firstly, a short presentation of franchising and management contracts will be given, along with an
analysis of the importance of control over the hotel operations. The subsequent sections will provide an explanation of the influence of Transaction Cost Economics and Agency Theory on the expansion strategy of international hotel companies. Finally, a review of previous studies on the choice of market entry in the hotel industry will be provided, in order to identify the gap in the literature and the opportunity for this research to reach some interesting conclusions with respect to the corporate development of international hotel firms.

In Chapter Five various factors that influence the choice of the organisational mode of a new hotel operation will be identified. Location- as well as firm-specific variables that have been examined by previous researchers will be pinpointed and those that are relevant for this study will be included in the theoretical framework. Subsequently, the respective hypotheses will be formulated, using both TCE and AT arguments.

The first sections of Chapter Six will present the population, sampling strategy and data collection method that will be followed in this research. Afterwards, the definitions and measures of the variables will be introduced and data analysis considerations will be discussed. Finally, the corporate development decision will be modelled and the appropriate software package for the analysis will be chosen.

Chapters Seven and Eight will present the findings of this study. As will be explained in the research design chapter, two different models will be tested. The first model will treat the expansion as a one-stage process, where the hotel company chooses among the three alternative development modes. The second model on the other hand, will examine the expansion decision in two stages: in stage one the decision will be whether to franchise or to integrate (i.e. use a management agreement or company ownership) and in the second stage the decision will be between these two hierarchical modes. The last section of the chapter will present a comparison of the findings of the two models, in order to identify whether the data suggests that the expansion strategy of international hotel companies is a one- or a two-stage process.

The last chapter of the thesis will provide a summary of the study, along with a discussion of the contribution of this research to the existing literature with respect to the expansion strategy of international hotel firms. Moreover, the limitations of the study will be analysed and directions for future research will be pinpointed.
1.4 Conclusions

This study will examine the expansion decision of international hotel companies and more specifically, the choice between “hierarchical” and “market” modes of development. A robust theoretical discussion on the decision for corporate development in the hotel industry will be provided, combining both transaction cost economics and agency theory. A theoretical framework will be developed, identifying the location- and firm-specific factors that influence the choice among the three most common modes of development available in the hotel industry, i.e. company ownership, management contracts and franchise agreements. The results of the study will be presented in detail, in order for the contribution of this study in the existing literature to be revealed.
CHAPTER 2: GLOBALISATION OF THE HOTEL INDUSTRY: PAST, PRESENT AND FUTURE TRENDS

2.1 Introduction

The international hotel industry has undergone a tremendous development, from the small, privately owned, independent enterprises of the 1900s to the large, multinational organisations of the 21st century. The second half of the last century marked the beginning of the internationalisation of the lodging industry, starting with the expansion of U.S. companies in the American region and later in the rest of the world. As the world gradually converged toward a global marketplace, lodging firms began to look for opportunities to serve an increasing international customer base (Gee, 2000).

Until the 1960s, the development areas of the world attracted most of the attention of the international hotel companies. By the end of 1970s, though, the situation started to change and large multinational hotel companies started to expand in developing countries, as well. According to Dunning and McQueen (1982), almost half of the hotels owned and operated by multinational hotel chains outside their home countries were located in developing countries. The increased presence of large corporations in the developing regions was the result of the saturation in developed markets, the rapid development of transportation and the developing countries' desire to bring in foreign capital.

The 1980s were a period of intense turbulence in the hotel industry, and in the world economy in general. Inflation, recession, a volatile global economy, and the worldwide airline restructuring were some of the events that influenced the hospitality industry and resulted in numerous mergers and acquisitions in late 1980s (Rushmore, 2001). Consolidation of hotels into mega-chains became more prominent, while smaller chains joined marketing consortiums or partnerships in order to survive.

The oversupply of hotel rooms, along with the saturation of the U.S. market, forced American hotel chains to expand in order to grow and retain their market share.
Franchising, which was the first growth strategy applied by hotel chains like Holiday Inn and Ramada Inn, as early as the 1950s, is among the most popular strategies, along with management contracts, since both are means of inexpensive, rapid growth. By the turn of the 21st century, most of the well-established hotel companies used more than one expansion strategy simultaneously. In addition, there are “pure” franchise chains, like Cendant Corp. and companies that operate solely as hotel operators, like Hyatt and Four Seasons Hotels.

In the first section of the chapter, the historical, as well as the developmental, context of the international hotel industry will be examined. In the second part, the various growth strategies available to international hotel chains will be presented. Currently, the most common among them are full ownership, joint ventures, franchise agreements and management contracts.
2.2 Historical and Geographical Development of the Hotel Industry

For centuries, the hotel business has been characterised by the existence of independent, privately owned hotel properties. Occasionally, a well-known hotel would successfully develop a few properties under the same management but such examples were rare. The Ritz Group was the first to appoint and oversee the managers of separately owned luxury hotels in major American, European and African cities (a predecessor of the hotel management contracts), in the late 19th century. Then, at the beginning of the 20th century, it was the founder of Statler hotels who realised that operating several hotels under a single management provided several economic and financial advantages, due to centralized purchasing, cost control and marketing.

Later, in the years following the Second World War, construction levels did not meet the expectations, and thus hotel investors provided capital only to the already established brands, like Hilton and Sheraton, which expanded their chains both by acquiring existing properties and by developing new hotels. At the same time, the continuing growth of high-end chains was matched by expansion of low-end, family-owned hotels due to the increase in travel in the United States, after the war. Several new lodging firms had their beginnings during that period: Holiday Inns, Ramada Inns, Marriott, Hyatt and Radisson, all successfully gained market share in their market segments (Rushmore, 2001).

Whilst Hilton developed the chain concept, which facilitated the growth of the management company, the initiators of Holiday Inn established their brand by franchising the Holiday Inn name and setting up a national reservations network. Rather than developing motel properties with their own funds, the lodging firms that adopted franchising sold a standardized product and package to investors who then developed and operated the properties as their own business.

As the world progressively created a global marketplace, hotel and management companies began to look for opportunities to serve an increasing international market. Large lodging firms also realised that a strong presence abroad would increase brand awareness worldwide and help their domestic operations gain a larger share of foreign travel. At the same time, American corporations were encouraged by the U.S foreign
policy for economic development of lesser-developed countries to build hotels in regions such as Latin America, Caribbean and Europe (Gee, 2000).

During the 1950s and 1960s, Pan American Airways – with its subsidiary Inter-Continental Hotels Corp. – as well as Hilton Hotels, were among the first to operate internationally by developing the chain concept. Inter-Continental Hotels, which had already developed its first hotel in Brazil, continued to expand in Latin America, while Hilton Hotels established its international division and began expanding operations in Europe and South America. The first efforts focused on developments in large gateway cities and world capitals, since these properties would incur the lowest financial risks and attracted the most investors. The general strategy was to establish the brand name in large cities, and then expand to secondary locations and resort areas. London, Paris and Rome were the primary targets, whereas cities in Ireland, Spain and Scandinavia did not attract much attention, mainly because domestic chains had already been established in those countries.

In the early 1970s, as a result of a healthy global economy, travel in the United States was experiencing high growth rates, which consequently gave a boost to hotel occupancies and profits. High occupancy, combined with easily accessible financing, accelerated hotel development. At the same time many franchise companies were aggressively expanding to increase their national exposure. The favourable conditions and the confident atmosphere encouraged the development of more hotel companies.

However, by the time these hotels entered the market, the U.S., and consequently the world economy, had already entered a recession phase due to the oil crisis, and the hotel industry did not remain unaffected. Leisure and business travel declined, construction costs and interest rates increased and as a result, both European as well as U.S. hotel chains diverted their attention to the Middle East and, gradually, to the Pacific Rim. The enormous increase in the wealth of Middle East oil-producing countries and the prosperity created by the increase in the oil prices triggered hotel construction in the region which continued until the late 1970s.

As the price of oil slumped, though, at the beginning of the 1980s, so did room occupancy and hotel profits. The Middle East region’s failure to expand its economic base sufficiently, along with the continuing political difficulties in certain Middle East...
countries, turned most of the hotel development interest towards the Asia-Pacific region. Mass travel came late to that region and demand for accommodation has been supported by the highest growth rate of tourism in the world. Therefore, the international hotel companies that developed properties in that region focused on the upper market segment, that is, the properties were typically large, luxury hotels, affiliated with major, well-established brands.

Initially, international hotels were developed and operated by U.S. hotel companies, like Hilton International, Sheraton, Hyatt International, Holiday Inn, and Inter-Continental. By the end of 1980s, European, Japanese and Asian brands also began hotel operations not only in gateway cities, but in secondary and resort locations, as well. The higher than average gross operating margins, made the operation of four- and five-star hotels much more feasible in the Asian-Pacific region than in Europe or the United States.

In the middle of the 1980s, the stabilization of the American economy and the European Economic Commission’s decision to move towards a single European market by removing trade barriers among its members caused a second wave of construction activity in both regions. Until then, the American hotel industry was mostly dominated by U.S. companies, with the exception of a few Canadian-based chains. However, the situation started to change with the acquisition and merging of American chains with European. The most important developments were the acquisition of Hilton International by the British Ladbroke PLC and the merger of Holiday Corporation with the hotel division of Bass PLC.

At the same time, international hotel companies expanded their activities in areas that had received little attention during the first construction wave in the region. Since the prime locations were already taken in the 1960s, it became more difficult to secure suitable sites in well-established cities. Thus, the international hotel operators had to purchase existing properties in those locations or to consider developing properties in cities with growing financial importance, like Vienna and Brussels or the resort areas of the Mediterranean.

The decade of the 1990s’ started with a severe recession of the American economy which, along with overbuilding and the negative effects of the Gulf war caused hotel occupancy to drop mainly in the US, but in other regions as well. Management
companies faced severe competition as both investors and lenders were looking for well-established brands to operate their properties and capital sources were scarce. The economy started to recover by the middle of the same decade and hotel owners were able to raise their room rates again. The rest of the 1990s was marked by a series of massive takeovers, driven by US-based operators. The companies engaged in the takeovers were Real Estate Investment Trusts, a vehicle created by the U.S. law to give tax breaks to property investors. They were governed by strict rules in order to enjoy exemptions from corporate tax, one of which was to use a management company that paid corporation tax to operate their property assets.

2.3 International Corporate Development: Advantages and Disadvantages

When a hotel company decides to expand its operations, there are three different ways to pursue this goal: (a) to expand existing markets at home, (b) to create new products that target particular market niches or to (c) develop new markets in foreign countries. Most of the established hotel chains have applied all three strategies at some point, alternatively or simultaneously. Well-known hotel companies like Hilton Corp. started with expansion in their neighbour countries (Canada and Mexico), continued with developments in Latin America and Europe and at the same time created new brands to suite budget-conscious customers.

One major force that has encouraged the hotel companies to aim at new markets abroad is the need to increase levels of profits and growth (Tse and West, 1992). When most of the primary locations in a particular country are taken, the key practice for a hotel company to enhance its growth is to expand its business in countries with a less developed hotel industry. This strategy has been pursued by European hotel chains that expanded in North Africa and the Middle East, as well as by U.S companies that developed operations throughout the Middle East region.

Another reason for international expansion is brand recognition. The more locations a hotel company has, the more loyalty and familiarity it can build among its existing and potential markets (Bell, 1993). When people travel to foreign countries, usually they choose familiar hotel brands, because they know the quality of the products and the
Expansion Strategies of International Hotel Firms

standards of the service. A well-established brand offers some kind of reassurance, especially to first-time customers who are concerned about safety and comfort in a foreign environment.

Finally, international corporate development creates geographic diversification of operations, which enhances business in prosperous countries and hedges against economic downturn in other countries. The more global the company, the less dependent it will be upon the changing circumstances of any one country or group of countries (Gee, 2000).

Although global expansion offers wide opportunities for growth and increased market share, it is not without its drawbacks. Only in few cases has expansion in foreign markets been marked by immediate success and profitability, especially when success is measured against domestic standards. One important reason that renders success in a foreign environment a challenge is that the hotel company has to deal with multiple political, economic and legal issues, as well as to overcome the communication and co-ordination difficulties that accrue from geographically dispersed operations (Gee, 2000).

Furthermore, there may be problems related to financial accounting and control, quality control, providing support and securing adequate resources, dealing with conflicting or adverse regulations regarding repatriation of royalties and profits. Also, differences in industrial structure and business practices render analysis of present and future competition in a number of countries more difficult. Finally, the degree of significant economic, marketing and other information required for planning varies considerably among countries in availability, depth and reliability.

Overall, successful international corporate development is the outcome of various factors related both to the particularities of the new markets under consideration, as well as to the characteristics of the hotel chain and its competitive advantages. The existence of adequate managerial resources at headquarters to commit to the expansion, as well as the ability to control and co-ordinate all different locations, are among the factors that need to be considered.
2.4 Current Situation

2.4.1 Geographical Distribution of Hotel Chains

Until the 1980s, the United States was the most important player in the hotel industry and American hotels chains used to dominate not only the American, but the world hotel industry, as well. However, during the last two decades the extensive merger and acquisition activities have created significant new players that have entered the lodging market. European hotel operators, especially British and French, now control some of the well-established brands in the world: Hilton International, Inter-Continental and Holiday Inns, in the United Kingdom and Accor (which controls among others Sofitel, Novotel and Ibis hotels), Société du Louvre and Club Méditerranée, in France.

Additionally, the international hotel industry has been influenced by the emergent economic power of the Asian-Pacific region. Some of Asia’s brand names, such as Shangri-La, Pan Pacific Hotels, Nikko Hotels, Peninsula, Mandarin Oriental and Regent International\(^2\), have started to gain brand awareness beyond Asia and the Pacific. There are also some of Asia’s emerging conglomerates, like Aoki Corporation (the previous owners of Westin Hotels) that are investing in the international hotel sector.

Still, the geographic distribution of the ownership of the major hotel companies is concentrated. As can be observed from the following chart, companies based in the United States, United Kingdom and France together account for the 87 percent of the total number of rooms worldwide, although the increasing activity from the Spanish and Asian-Pacific chains can be expected to raise their share in the future (Hotels, July 2002).

\(^2\) Regent International Hotels, the luxury chain that was until recently based in Hong Kong, is now part of Carlson Hospitality, a U.S. based lodging company, and accounts for 11 luxury hotels in 9 different countries.
Just as U.S. hotel chains are expanding in the international market, in the same way European and Asian companies have developed a strong presence in North America. International investments in U.S. hotels have increased extensively during the last decade and negotiating with international business partners has become common practice in many areas of the United States. Besides the fact that, like every U.S. company, these hotel chains want to gain international presence, another important reason for entering the U.S. market is, or used to be, the political and economic stability of the country, as well as the fact that some of the most important gateway cities in the world are in the United States. In order to gain market share, “foreign” hotel chains are willing to provide equity to negotiate joint ventures or to get a management contract, while others attempt to offer a distinct hotel product.

Regarding the distribution of international hotel chains outside the country where they operate most of their hotels (what is call by other researchers home country), it varies according to the characteristics of each home country. Besides North America, chains that originated in the U.S. have also a strong representation in the Caribbean, in Latin America, as well as in Asia. Regarding the European chains, they are much more concentrated. French chains are well represented throughout Europe and in French-speaking African counties, whereas British brands are highly concentrated in Europe and less in African countries and the Caribbean. Finally, Japanese hotel chains have comparative strength in North America (mainly in the West Coast), Southeast Asia and more recently in Australia.
The diverse geographic distribution patterns of hotel chains can be explained by a number of political and economic factors. For example, France’s presence in French speaking countries of Africa can be simply justified by the existence of colonial relationships in the past. Moreover, geographic proximity plays a significant role in the travellers’ decisions, since holiday tourists usually choose destinations as near to their home country as possible, in order to economize on time and travel costs. This pattern can be easily observed in practice: European hotel chains have a strong presence in other parts of the continent, U.S. chains have expanded their operations throughout North and Latin America, while Australian lodging companies are concentrated in the South Pacific.

2.4.2 Industry Structure

A hotel company that operates within the international hotel industry could fall in one of the following three categories (Gee, 2000):

(a) voluntary associations, organisations that consist of independently owned and operated hotels which join together mainly for marketing purposes,

(b) corporate hotel chains, namely hotel companies that have their one brand(s), which can be managed by the corporate chain or by a conglomerate and

(c) conglomerates, companies that manage corporate brands or independent unbranded hotels.

Voluntary associations - which, as will be explained further on, will not be examined in this study - are usually recognized as representative companies or consortia. Currently, the most well-known among those organisations is Best Western in the U.S., an association that consists mainly of small family-owned hotels.

International hotel corporate chains and conglomerates are changing the international hotel industry rapidly through mergers and takeovers. By the end of 2001, the 20 largest corporate hotel chains controlled almost four million hotel rooms in over 30,000 properties (Hotels, July 2002), almost double what it used to be ten years ago (Hotels, July 1993). The first five corporate chains controlled 63 percent of those rooms, as

3 Nowadays, though, this pattern is not as strong as it used to be in the previous decades.
opposed to 53 percent in 1992 (Hotels, July 1993), a fact that suggests a strong trend towards concentration in the industry.

Concentration is the result of mergers and acquisitions and has become a significant phenomenon in the hospitality industry, mainly due to the companies’ need to have representation in key markets and access to new markets, but also as a result of saturation in their home market. Major chains from all areas have looked increasingly to Europe, North America and the Asian-Pacific region to expand their chains.

Created through a combination of mergers, takeovers and joint ventures, these large corporations are likely to have several different brands, differentiated by price and product. Many analysts predict that the multinational “mega-chains” will grow to the detriment of the smaller and newer chains, as the costs of maintaining a small or start-up hotel company becomes prohibitive. In the end, the predominance of few large national and international corporations is likely to prevail, the only exception being a few small hotel companies that operate in the upper market segment, like the Canadian Four Seasons and the Asian Peninsula Hotels, which are proving they can survive with careful niche marketing and strong product quality control.

2.4.3 Separation of Ownership from Management

A characteristic of the early hotel pioneers was that they were real estate oriented, and thus they owned the properties and buildings they operated. The management of those properties was only a means to increasing their market value. Hyatt was among the first hotel companies to realise the benefits from separating the ownership from the management aspect, by setting up one company to manage the properties and another one to own the real estate. Many of the U.S. companies followed that practice by selling off much of their capital-intensive real estate, while keeping the management rights. Through the redeployment of assets, that process allowed hotel chains to grow more rapidly, with emphasis on acquisition of superior properties (Gee, 2000).

During the 1970s and 1980s, as the role of independent hotels started to decline, chains worked with owners and developers to open new, large, upscale hotels. The combined effect of the significant size of the major chains with economies of scale has tended to put the independent operator at an increasing disadvantage. The crucial boost to chains
was given by lenders who were generally more willing to invest funds for new properties, if these properties were operated by a well-established hotel chain.

**Table 2.1: The top 15 Corporate Hotel Chains in 2001**

<table>
<thead>
<tr>
<th>Rank</th>
<th>Corporate Chains</th>
<th>Rooms</th>
<th>Hotels</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Cendant Corp (U.S.A.)</td>
<td>553,771</td>
<td>6,624</td>
</tr>
<tr>
<td>2</td>
<td>Six Continents (U.K.)</td>
<td>511,072</td>
<td>3,274</td>
</tr>
<tr>
<td>3</td>
<td>Marriott International (U.S.A.)</td>
<td>435,983</td>
<td>2,398</td>
</tr>
<tr>
<td>4</td>
<td>Accor</td>
<td>415,774</td>
<td>3,654</td>
</tr>
<tr>
<td>5</td>
<td>Choice International Hotels (U.S.A)</td>
<td>362,549</td>
<td>4,545</td>
</tr>
<tr>
<td>6</td>
<td>Hilton Hotels Corp. (U.S.A.)</td>
<td>327,487</td>
<td>1,986</td>
</tr>
<tr>
<td>7</td>
<td>Best Western International (U.S.A.)</td>
<td>306,851</td>
<td>4,052</td>
</tr>
<tr>
<td>8</td>
<td>Starwood Hotels &amp; Resorts (U.S.A.)</td>
<td>224,467</td>
<td>743</td>
</tr>
<tr>
<td>9</td>
<td>Carlson Hospitality Worldwide (U.S.A.)</td>
<td>135,066</td>
<td>788</td>
</tr>
<tr>
<td>10</td>
<td>Hilton Group PLC (U.K.)</td>
<td>92,778</td>
<td>384</td>
</tr>
<tr>
<td>11</td>
<td>Hyatt Hotels Corp / Hyatt International (U.S.A.)</td>
<td>88,442</td>
<td>204</td>
</tr>
<tr>
<td>12</td>
<td>Sol Meliá S.A. (Spain)</td>
<td>85,987</td>
<td>350</td>
</tr>
<tr>
<td>13</td>
<td>TUI Group (Germany)</td>
<td>70,293</td>
<td>278</td>
</tr>
<tr>
<td>14</td>
<td>Société du Louvre (France)</td>
<td>69,049</td>
<td>933</td>
</tr>
<tr>
<td>15</td>
<td>Wyndham International (U.S.A.)</td>
<td>57,211</td>
<td>224</td>
</tr>
</tbody>
</table>

*Source: Hotels Special Report: Corporate 300, Hotels, July 2002, p.52*

### 2.4.4 Major International Hotel Chains

As already explained above, the international hotel industry went through a significant restructuring during the last decade, which was marked by numerous mergers and takeovers. As a result, some of the well-known hotel brands were acquired by competitors and large conglomerates started to evolve (see Table 2.1 above). For that reason many of
the hotel brands that will be presented in this section will be classified under a different country ownership than they would have, had this thesis been written a few years ago.

**(a) American Companies**

Although the early traditions of hostelry were established in Europe, it is the American hotel chains that are held responsible for the globalization of the hotel industry. The U.S hotel chains first applied the concept of standardization of products and services, the segmentation of operations and the separation of properties ownership from hotel operation. The most well-known American hotel chains are presented below.

(i) **Cendant Corp. and Choice Hotels:**

Among the largest hotel companies worldwide are Cendant and Choice Hotels, which are pure franchise companies, that is, both of them “rent out” their brand names to hotel owners in return for a fee. Choice Hotels is significantly smaller than Cendant in the U.S., but has made more rapid progress overseas, with more than 1,000 hotels in the rest of the world (TTI, 2001). Like Cendant, it focuses more on the economy market segment, although it also has a more developed mid-market and upscale offering.

(ii) **Hilton Hotels Corporation**

It owns the Hilton brand in North America and, through acquisitions of small hotel chains, it also has a range of mostly franchised mid-market brands. It has an alliance with the U.K. based Hilton Group, in order to facilitate marketing activities and system reservations and to develop the brand worldwide. By the end of the year 2000, the Hilton brand, which operates in the upscale segment, enjoyed the highest brand awareness and accounted for 500 hotels in more than 50 countries (TTI, 2001)\(^4\).

(iii) **Marriott International**

Most of the hotel brands of Marriott operate in the upper market segment. Although the Marriott brand has been long established outside the U.S., the true internationalisation of the company was marked by the acquisition of the Renaissance group in 1996. One of the most significant strategic moves of Marriott International, which was then followed

\(^4\) Although Hilton International is a UK-based company, it is presented together with Hilton Hotels Corporation.
by many rivals, was the separation of real estate from hotel management, with the creation of two companies, Host Marriott - the real estate company - and Marriott Hotels and Resorts, the management company.

(iv) **Hyatt Hotels Corp. and Hyatt Int’l**

Hyatt is a privately-owned hotel management company, which, as mentioned before, was among the first to realise the advantages of separation of property ownership from operating functions. It is split between Hyatt Hotels Corp. in North America and Hyatt International in the rest of the world. Hyatt is mostly an upscale hotel management company, although it also has some ownership interest in its properties. By the end of 2000, its portfolio included more than 200 hotels in 43 countries.

(v) **Starwood**

Starwood is an owner, operator and franchisor which owns a number of well-established brands, including Sheraton and Westin Hotels. Both hotel brands were bought in 1998, in series of aggressive takeover moves. Although Starwood is a relatively new company, the Sheraton brand has been operating for more than 60 years (with over 50 years of international experience) and currently operates or franchises hotels in more than 70 countries.

(2) **European Companies**

The European hotel chains, as opposed to the American ones, began their aggressive internationalisation strategy in the late 1980s, when home markets stagnated. European chains adopted many U.S. management techniques and made extensive use of the management contracts. However, they were more willing than their U.S. competitors to participate in equity to gain presence in major markets. Currently, the largest European hotel companies are based in the U.K., France and Spain.

(i) **Six Continents Hotels**

The U.K. based Six Continents Hotels (formerly Bass Hotels and Resorts) is one of the leaders in the international lodging industry. The most famous brand names owned by Six Continents are Inter-Continental and Holiday Inn Hotels. Both brands originated from the U.S. and were bought by Bass in 1998. Inter-Continental, the upscale brand,
was created by Pan American Airlines in order to accommodate its passengers in Latin America and the Caribbean and later in Europe, Middle East and Asia. Holiday Inn, on the other hand, first operated in the U.S. and was one of the first chains that applied franchising extensively for its expansion both in North America and abroad. By the end of 2000, Six Continents Hotels owned, operated and franchised almost 3,000 hotels in over 100 countries.

(ii) Accor Hotels

Accor is the dominant hotel company in France and was among the first to realise the value of product segmentation. It operates numerous brands, ranging from the four-star Sofitel, three-star Novotel and Mercure and two-star Ibis to the one-star Formule 1 and Motel 6. Expanding largely through acquisitions, by the mid-2000 Accor was the second largest hotel company in Europe (in terms of rooms) and the fourth worldwide, after Cendant Corp., Six Continents Hotels and Marriott International. By September 2002 it owned, managed or franchised over 3,700 hotels in 90 countries (www.accor.com, 2002).

(iii) Sol Meliá S.A.

Although Sol Meliá is a hotel company with less than 20 years of international experience, by the middle of 2002 it was the third largest hotel company in Europe and twelfth worldwide, with more than 85,000 rooms (Hotels, July 2002). It is strong in city and resort properties and is taking the acquisition route to expansion both domestically and internationally.

(c) Asian-Pacific Companies

Asia's three major Hong Kong-based hotel brands, namely Mandarin Oriental, Shangri-La, and Peninsula Hotels, which consistently appear on the list of the world's best hotels, continue to expand within Asia and Pacific, but also venture outside the region. Additionally, the pioneering Tokyu Group in Japan continues to develop its upscale Pan Pacific brand and Japan's two airline-backed hotel chains, Nikko and ANA Hotels are also expanding aggressively. Shangri-La and Pan Pacific Hotels are the most geographically diversified among the Asian companies, with hotels in 10 and 12
countries respectively (TTI, 2001). Both are mainly hotel operators although in some cases they do participate in the equity of the property.

### 2.5 Modes of development of International Hotel Firms

A firm seeking to expand into a new market needs to make an important strategic decision about which mode of development to use for that market. Development strategies can be classified into two main categories, according to whether there is equity participation in the new operation or not. Equity modes usually include full ownership, where the hotel company develops a new property from scratch or acquires an existing property, and joint ventures, which can be either majority or minority ventures.

Contractual modes, which are the least examined so far in the hotel industry, can take the form of (a) franchise agreements, which leave the hotel company with the least control over the property and the operations, (b) management contracts, where the hotel company has full control over the daily operations and the quality of the service provided, (c) leasing, which, as will be explained later on, is quite similar to the equity ownership mode, and (d) strategic alliances, which usually take the form of a marketing agreement between a large well-established and a smaller company that wishes to enter a global reservation system.

#### 2.5.1 Equity Modes of Development

(a) **Full Ownership**

One of the ways for a hotel company to expand in new markets is sole ownership, either by acquiring an existing property or by developing a new building. In fully-owned operations, a hotel company exercises a strong amount of control both over the tangible and the intangible assets, namely the company has full control over the property, as well as the codified assets and the daily operations. However, while the hotel company enjoys full control, along with all the profits from the hotel operations, it also bears all the risks

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5 Ibid 2.
and moreover needs to secure the required financial resources for the development of the property (Contractor and Kundu, 1998a).

In addition, a hotel company that plans to expand into a new market needs to take into consideration the fact that some developing countries' governments oppose equity investment by foreigners. Government policy makers in many countries find it difficult to accept the idea of foreign ownership of businesses, even when such investments may serve the country's national goals and priorities (Gee, 2000). Overall, full ownership allows the hotel company to gain greater economic reward, but also presents greater investment risk when crisis develops in a host country.

(b) Joint Ventures

A joint venture could be defined as a separate legal organisational entry representing part of the holdings of two or more parent companies (Zahra and Elhagrasey, 1994). Each party of a joint venture contributes assets, owns the entity to some degree and shares risk (Harrigan, 1984). It is important to note that there is a wide range of definitions for joint venture and numerous ways in which to analyse their variety. Although some researchers and industry practitioners usually include strategic alliances and technology agreements in the spectrum of joint ventures, in the context of this study those agreements will be treated separately, since a condition for joint ventures is equity participation of all the partners in the new business.

Foreign and local hotel companies often find that one way to compete more successfully in the market place is to combine their different strengths in a joint venture. Among the most important advantages of an international joint venture is that it facilitates the relationship with local authorities, especially when the local government is one of the partners. For example, in China, several of the hotels that were developed over the past two decades have been joint venture initiatives between foreign hotel companies and China Travel Service (Gee, 2000). The joint venture used to take the form of a multilateral agreement, whereby the Chinese government provided the land and the labour, a Chinese investor secured the required capital and a hotel company provided some operating funds and received the management contract.
Moreover, even if there are no governmental restrictions, there are some important economic benefits that accrue from a joint venture, compared to full ownership or non-equity agreements. The primary benefits are added efficiency (i.e. cost reductions) and market-power enhancement (Hennart, 1988). Because of complementary skills, economies of scale and scope and the local partner's knowledge of the local environment, a joint venture may incur lower operating costs and become more efficient than a wholly-owned subsidiary (Yu and Tang, 1992). Compared to licensing, on the other hand, joint ventures are more efficient mechanisms for transferring know-how and for minimizing transaction costs (Hennart, 1988). Finally, since less investment is needed, joint ventures are less risky than wholly-owned subsidiaries in new markets.

However, joint ventures, especially with governmental agencies, do not come without drawbacks. The most important among them are the loss of flexibility to respond quickly to market demands and labour needs, and the loss of control in hiring and firing staff, determining compensation packages and exercising discretion over the aspects of the hotel management (Gee, 2000). Furthermore, empirical evidence has suggested that joint ventures may cause conflict between the two (or more) parties, due to changes of the partners' objectives, lack of trust, different management styles, lack of co-operative behaviour or limited interest from either partner (Zahra and Elhagrasy, 1994; Shaughnessy, 1995).

In addition, joint ventures usually involve complex structuring arrangements and difficult negotiations. The basic issues involved are (a) the determination of the value of what each party contributes to the joint venture, (b) the ownership advantages, (c) the timing and distribution of profits and (d) the sharing of risks and loses. Finally, even if the joint venture has been carefully planned and organised and there are no negotiations difficulties, it may still fail because of unexpected political, legal and economic conditions, hostile response from local companies, or difficulties in repatriation of profits.

During the 1990s, joint ventures showed a considerable success and researchers paid much attention to joint ventures as a form of international business. The aspects that were examined include joint ventures as an entry mode (Beamish and Banks, 1987; Woodcock, Beamish and Makino, 1994), criteria for partner selection (Geringer, 1991) and factors that affect profitability and success of joint ventures (Geringer and Hebert, 2000).
1989 and 1991; Makino and Beamish, 1998). Yet, none of these studies includes or focuses on the hotel industry.

2.5.2 Non-Equity Modes of Development

(a) Franchising

Franchising can be divided into product/trade-name franchising and business format franchising. Product and trade-name franchises are those in which dealers (franchisees) enter into a contract with suppliers (franchisors) to sell their products (or product lines), e.g. automobile dealers, soft drink bottlers (Combs and Castrogiovanni, 1994).

Business format franchising on the other hand, encompasses most business operations in addition to the product or service itself and offers a method of operation that includes a strategic plan for growth and ongoing guidance (Alon, 2001).

Franchising in the hotel industry can be classified as business format franchising, since the franchise agreement between a hotel chain (franchisor) and a hotel owner (franchisee) allows the owner to make use of the chain’s name and services in return for a franchise fee and royalties. Under such an agreement the hotel chain (franchisor) has no ownership or financial interest in the hotel and is not directly responsible for its economic success. The owner either operates the hotel or contracts separately with another management company to operate the facility (Gee, 2000).

Hotel companies involved in franchising generally start off as small chains, consisting mostly by company-owned properties. Over time they develop a concept and a brand name that prove successful in attracting customers. When the service developed becomes successful and it can be demonstrated that hotel owners using the brand and operational procedures of the company will also be successful, the hotel company is able to franchise its concept (Rushmore, 2001).

The main advantage of franchising for a hotel company that wants to expand internationally is that it represents an inexpensive, rapid mode of development. The reason is that it usually requires less capital resources compared to acquiring or
developing the property (Gee, 2000). Furthermore, franchising does not require the extensive management structure that is needed to operate a hotel management company. One last cost-saving aspect of franchising is that development responsibilities are shifted to the individual property owner (franchisee).

The main start-up costs for a franchise company consist of the advertising and promotional efforts needed to sell franchises and obtain a critical mass of franchisees required for an economically viable chain, as well as the costs of developing the franchise "package". Depending on the nature of the services provided by the franchisor and the fees charged to the franchisee, this critical mass of properties can range from twenty to fifty (Rushmore, 2001).

In addition to cost advantages, franchising provides the hotel chain with rapid and strong customer recognition and brand royalty. Having hotels in popular world-wide destinations provides potential customers with the opportunity to see the hotel and experience the service offered by the specific brand. Once customers recognise a hotel product and have been satisfied after using it, brand loyalty develops, which results in repeat customer visits and positive word-of-mouth promotion.

Finally, franchising represents a profitable source of revenue for the hotel company, including initial fees paid by the franchisees when they join the franchise system, ongoing royalties, and additional payments for services they provide, such as marketing, advertising, reservations and training (Rushmore, 2001). Many franchise companies also own or manage hotels, and thus franchising allows them to spread the fixed operating costs of those facilities among franchised properties.

Yet, like every mode of international expansion, franchising also has its shortcomings, the most important being the loss of control over daily operations and over the quality of service provided by the franchisees (Stanworth, 1989). Not only is it difficult for a franchisor to enforce its standards, but the process of terminating an unsatisfactory franchise agreement can be quite time-consuming. Moreover, the franchisors may be restricted by their franchisees in terms of further expansion, as franchisees are concerned

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6 From hereon the term "franchising" will refer only to business format franchising, as this is the type of franchising applied in the hotel industry.
about the impact of new hotels, affiliated with the same brand, being developed in the same area.

In addition, the franchisor may face difficulties with the franchisees, as they may have different objectives regarding turnover and profits, which may result in conflicts between the two parties. The relationship can also become strained as franchisees may resent control from the franchisor, which usually cannot terminate the franchisee, but is only able to buy him out. Another area of disagreement between franchisee and franchisor is pricing. The hotel company often encounters difficulties in maintaining uniform room rates and pricing policies, which can confuse customers and adversely affect the image of the brand.

From the owner’s (franchisee’s) perspective, franchise arrangements can offer a number of benefits in terms of obtaining the support of a large, reputable hotel chain (Gee, 2000). The property benefits from chain advertising, access to the franchisor’s international reservation system, group purchasing arrangements and business advice. The fact that a franchised product has been used tested and proven successful saves the franchisees time and cost. Another reason for taking on a franchise is a substantial advantage arising from the technical and operation expertise available from the franchisor.

However, there are also disadvantages that may affect the franchisee, including excessive costs if the incorrect franchise is chosen, the fact that the franchise company has no financial stake in the property and the difficulty of transferring the franchise, if the property is sold to another hotel company. Furthermore, due to the franchisor’s desire to maintain a relatively uniform product worldwide, the franchisee is usually unable to adapt the provided service to the local needs, unless there is an agreement from the hotel chain.

Some of the hotel companies that first offered franchises were Holiday Inn, Howard Johnson, and Ramada Inns (Rushmore, 2001). Those companies, realizing that their name, image, goodwill, operating procedures and reservation systems had value, turned to franchising their names as a rapid, inexpensive and profitable means of expanding their systems. At the same time, hotel developers were drawn to this idea because it gave a new hotel an immediate identity and a set of established systems and procedures that
provided both lenders and investors with confidence that the property would be financially successful.

Until recently, a relatively small number of hotel companies considered franchising as an international expansion strategy, with only exception being the large US companies, such as Holiday Inn, Marriot, Choice and Cendant. However, during the last decade more hotel chains, from different home countries have started to realise the advantages of using franchising for their growth. Moreover, two of those companies, Choice Hotels and Cendant Corp. have become “pure” franchise companies, i.e. almost all their hotels are operated by franchisees. The world’s largest hotel franchising companies are presented in Table 2.2:

### Table 2.2: Hotel Companies with the most Franchised Hotels (end 1999)

<table>
<thead>
<tr>
<th>Company</th>
<th>Total Hotels</th>
<th>Total Franchised</th>
<th>% Franchised</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cendant Corp (U.S.A.)</td>
<td>6,315</td>
<td>6,258</td>
<td>99 %</td>
</tr>
<tr>
<td>Choice Hotels Int’l (U.S.A.)</td>
<td>4,248</td>
<td>4,248</td>
<td>100 %</td>
</tr>
<tr>
<td>Bass Hotels and Resorts (U.K.)</td>
<td>2,886</td>
<td>2,563</td>
<td>89 %</td>
</tr>
<tr>
<td>Hilton Hotels Corp. (U.S.A.)</td>
<td>1,700</td>
<td>1,357</td>
<td>80 %</td>
</tr>
<tr>
<td>Marriott Int’l (U.S.A.)</td>
<td>1,880</td>
<td>998</td>
<td>53 %</td>
</tr>
<tr>
<td>Carlson Hospitality Worldwide (U.S.A.)</td>
<td>616</td>
<td>581</td>
<td>94 %</td>
</tr>
<tr>
<td>Accor (France)</td>
<td>3,234</td>
<td>568</td>
<td>18 %</td>
</tr>
<tr>
<td>Société du Louvre (France)</td>
<td>990</td>
<td>372</td>
<td>38 %</td>
</tr>
<tr>
<td>Starwood Hotels &amp; Resorts (U.S.A.)</td>
<td>716</td>
<td>299</td>
<td>32 %</td>
</tr>
</tbody>
</table>

*Source: Hotels Special Report: Corporate 300, Hotels, July 2000, p. 54*

### Management Contracts

A management contract is an agreement between a hotel management company and a hotel owner, whereby the management company agrees to operate the hotel on a daily
basis and takes responsibility for its business. The hotel owner, on the other hand, has no involvement in the operations, but may be responsible for all working capital, operating expenses, and debt service (Gee, 2000). The management company receives a combination of basic and incentive fees for its services, based on the total revenue and the operating profits respectively, whereas the owner gets the residual income after all expenses.

The property owner can be an individual, financial institution, corporation, insurance company or government. The management company, on the other hand, can be either a first-tier, or a second-tier company (Rushmore, 2001). A first-tier management company manages hotel properties for a third party, assuming control for the day-to-day operations and providing domestic and international recognition through its brand name. Four Seasons Hotels, Marriott International and Hyatt Hotels and Resorts are examples of first tier companies. Second-tier companies also operate hotel properties under a contract, providing everyday supervision and management; the difference from first-tier companies is that they do not provide brand name recognition, but use franchise affiliations to generate customer identification. American General Hospitality, Interstate Hotels and Hospitality Equity Investors are among the largest second-tier management companies. In the context of this study only the first-tier companies will be examined, since brand name and intellectual property are among the most important factors that influence the modal choice of the international hotel companies.

Management agreements are favoured in many international settings, as they allow a hotel chain to establish its presence quickly, with a low level of investment. In fact, currently, hotel companies are requested to contribute working capital in the form of a loan or some other small good-faith investment (Rushmore, 2001). Moreover, the hotel chain has no or very little financial exposure, and essentially covers its operating expenses and makes a small profit from the basic management fee and an even larger profit from any incentive fee. Yet, the most important advantage of a management contract for the hotel company-operator, especially when compared to franchising, is that it allows the hotel chain to maintain quality control over the service provided, and thus offers protection against brand name deterioration.

However, when examining its strategies for expansion and growth, a hotel company needs to take into consideration the fact that management agreements have some
disadvantages as well. Any increase in the value of a hotel generated by the management company over the course of a management contract accrues to the benefit of the owner, when the hotel is sold or refinanced. Moreover, as the contract terms are getting shorter (Jones Lang LaSalle Hotels, 2001), there are cases where a hotel company is unable to renew the contract on a property and thus is unable to benefit from the increased value of the hotel. Compared to franchising, management contracts represent a more risky mode of development in terms of rents for the hotel operator. Although in both cases the hotel company receives fees, in the latter case the fees are much more volatile. The reason is that when the hotel company acts as franchisor, it is compensated with a percentage of total revenue, whereas when the hotel company undertakes the management of the property is compensated through an incentive fee, as well as a basic fee and the volatility of the incentive fee renders management agreements riskier than franchising.

Regarding the property owner, management agreements provide them with the essential operational expertise, necessary for establishing the long-term profitability of their investment, while allowing them to keep ownership benefits, such as depreciation deductions, tax benefits, value enhancement and most importantly possession of the property after the contract expires. In addition, a well-established hotel company (operator) offers the owner immediate national identification and easier capital provision from lenders who require that an established management company be put in charge of the daily operations

Nevertheless, the inability to unilaterally terminate a hotel management contract for poor performance, which may increase his exposure to financial loss, is one of the main disadvantages for the property owner. Even if the contract can be terminated, any delay in the replacement of the management company can severely harm the hotel’s reputation. Finally, the property owner might find it more difficult to sell the property if it has to be sold subject to an existing management contract.

**Management Contract Services and Provisions**

The management contract services can be sold as a package, or separately (as technical service agreements) and usually include the following (Gee, 2000):

- feasibility studies and marketing surveys,
• advice and technical assistance on planning, design and architecture,
• construction co-ordination,
• recruitment and staff training,
• marketing, advertising, promotion and reservation systems,
• management personnel to operate the property and home office supervision and support.

Moreover, a typical management contract includes the following negotiation issues:

• Financial provisions (management fees, equity, loan and working capital contribution, pre-opening budget and financial goals of owner)
• Operations provisions (services provided, quality standards and inspections, pre-opening management services, pricing schedule and operating plan)
• Marketing provisions (marketing, advertising, promotion services and reservation systems)
• Administration provisions (accounting system used, technical services, and legal requirements) and
• General provisions (contract term, renewal and termination options, performance requirements, use of the hotel company’s name and owner’s right of sale)

Recent Trends in Management Contracts

Until the end of the 1970s, the balance of power was in the hands of the management companies. They had the right of approval of plans and specifications and the exclusive right to supervise and manage the property on behalf of the owner. In addition, most of the contracts had at least a 20 year initial term with an option for the hotel company to renew on the same terms for another 10 or 20 year period (Eyster, 1988b). The operators were usually guaranteed a base return as a percentage of gross revenue and were compensated for marketing and promotion, regional office and travel expenses and for the provision of a global reservation system. Thus, any medium-sized, well-operated management company could make some profit before the incentive fee of 10 to 15 percent was added in the negotiations (Bell, 1993).
However, since the 1980s, a significant shift has occurred in the relative bargaining power of owners and operators, as a result of the following developments in the hotel industry (Eyster, 1988a). First, competition among hotel management companies increased due to the emergence of new hotel chains and the mergers of regional and national chains in the US. Second, the owner’s knowledge about the hotel industry and hotel management contracts became more sophisticated and finally, the lenders assumed a more active role in the negotiating process.

The most important developments in the management contract concerned the management fee structure and the initial term and renewal options negotiation (Eyster, 1993 and 1997). As far as management fees are concerned, there was a shift from basic fees only, to a combination of basic and incentive fees, so that the owners could pass some of the risk onto the hotel operators. Moreover, incentive fees began to shift from the gross-operating-profit line to a cash-flow-after-debt-service line or some other negotiated net profit line. According to the most recent survey by Jones Lang LaSalle Hotels (2001), operators are becoming more competitive in their base fees so as to attract owners, while hoping to recoup their earnings via higher incentive fees. Even more interesting is the fact that many American agreements tie the operators’ incentives to a minimum return on investment for the owners (as opposed to a level of gross profits).

The increased bargaining power of owners is also obvious in the negotiation of the initial contract term and renewal options. Although in the European market the most popular contract term was found to be 20 years, in the Asia Pacific it was 12 years, and in America even shorter. Almost half of the American agreements examined by the previously mentioned study indicated an initial term of between 5 and 9 years.

The hotel companies that operate the most properties under management agreements are presented in Table 2.3. As it can be observed, the hotel companies that operated the most hotels are those positioned in the middle and upper segment, such as Marriott International, Hilton and Hyatt Hotels and Resorts. It has to be added that there are a few more hotel companies that operated solely as management companies, like Four Seasons, Shangri-La and Pan Pacific Hotels, but they are not included in the table because they have a much smaller portfolio of hotels and thus are not among the first 20 international hotel chains.
Table 2.3: Hotel chains that manage the most hotels

<table>
<thead>
<tr>
<th>Company</th>
<th>Total Hotels</th>
<th>Hotels Managed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Marriott Int’l</td>
<td>1,880</td>
<td>759</td>
</tr>
<tr>
<td>Société du Louvre</td>
<td>990</td>
<td>565</td>
</tr>
<tr>
<td>Accor</td>
<td>3,234</td>
<td>546</td>
</tr>
<tr>
<td>Starwood Hotels &amp; Resorts</td>
<td>716</td>
<td>204</td>
</tr>
<tr>
<td>Hyatt Hotels &amp; Hyatt Int’l</td>
<td>195</td>
<td>191</td>
</tr>
<tr>
<td>Bass Hotels &amp; Resorts</td>
<td>2,886</td>
<td>175</td>
</tr>
<tr>
<td>Hilton Hotels Corp</td>
<td>1,700</td>
<td>173</td>
</tr>
</tbody>
</table>

Source: Hotels, Special Report: Corporate 300, July 2000, p. 55

(c) Leasing

While the sale-leaseback concept has been extensively applied in the non-hotel property sector for decades, it is only recently that it has been adopted in the hotel sector (Jones Lang LaSalle Hotels, July 2002). A key performance benchmark in the hotel industry is the rate of growth and market penetration on a global basis. Hotel operators are under pressure from their stockholders who demand constant growth. Debt alone cannot finance that growth and therefore operators are facing the need for financing without loading their balance sheets with debt. Selling non-core hotel property assets and leasing them back from purchasers represents an alternative source of much needed capital.

Moreover, listed hotel companies are under pressure from global equity markets to raise cash and cut debt as a means of improving debt/equity ratios and returns on capital. Because in most countries sale-leaseback can be treated as “off-balance sheet”, financial ratios are improved, enhancing the company’s credit profile and widening the range of alternative vehicles available for future financing.

7 Typically this type of leasing is classified as operating leasing and is presented in the International Accounting Standards (IAS) 17.
Sale-leasebacks however, do not come without their drawbacks. Companies may find that property ownership provides them with more flexibility as opposed to sale-leaseback, especially when extensions and renovations are taken into consideration. It could also be the case that companies, which have recently sold property assets, have their credit downgraded as a result. In addition, there is the disadvantage of ownership loss when the lease expires and loss of future asset appreciation.

Still, in Europe such deals have been gaining increasing prominence over the past two years. The highest profile deal was Nomura’s sale-leaseback of the major part of Meridien chain. The Royal Bank of Scotland invested £1000 million of equity in the portfolio and entered into a £1.25 billion sale-leaseback of the hotel assets, enabling Nomura to win the contested public bid to acquire the chain (Jones Lang LaSalle Hotels, July 2002). Recent transactions also involve the sale of eleven Hilton Hotels to Royal Bank of Scotland, in 2001, and the sale of four Novotel Hotels (Accor Group) to a German Fund, in 2000.

(d) Strategic Alliances

The final mode of development available to hotel chains that want to expand in new markets is the formulation of strategic alliances. The fact that capital for development is in shortfall today, creates the need for hotel companies to participate in alliances on a marketing basis. For example, SAS and Radisson have created an alliance, Radisson SAS Hotels, through which SAS hotels can expand more rapidly in Europe and the Middle East. Moreover, Le Meridien and Germany’s Kempinski entered a partnership arrangement, to enhance their presence in Europe. Usually it is the small hotel company that wants to affiliate with the large, well-known hotel chains and tap into their reservation systems. The trend reflects the need for small or regional hotel companies to form partnerships with the world’s established brands if they want to survive the competitive global hotel industry of the new century.
2.6 Conclusions

In this chapter, the development of the international lodging industry during the last few decades was examined. Due to the continuous changes of the environmental conditions that influence the travel and tourism industry, the hotel industry had to adapt itself to suit the times. Concentration, which is the result of mergers and acquisitions, has become a significant phenomenon in the hospitality industry, mainly due to the companies' need to have representation in key markets and access to new markets, but also as a result of saturation in their home market.

Until the 1980s, United States were the most important player in the hotel industry and American hotels chains used to dominate not only the American, but the world hotel industry, as well. However, during the last two decades the extensive merger and acquisition activities have created significant new players that entered the lodging market. European hotel operators, especially British and French, now control some of the well-established brands in the world.

In order to grow internationally, lodging firms need to make decisions regarding the mode of development that best suits the particular conditions. The most common modes of development currently are full ownership, joint ventures, management contracts and franchise agreements. Each mode requires different amounts of resources and implies different degrees of control over a new operation for the international hotel company; therefore the hotel company needs to match the available resources with the preferred levels of risk and control when deciding on the most appropriate mode for a new hotel operation.
CHAPTER 3: RELEVANT THEORIES FOR CORPORATE DEVELOPMENT

3.1 Introduction

The purpose of this chapter is to present and analyse the main theories of corporate development. A systematic examination of the main assumptions and constructs of Transaction Cost Economics and Agency Theory will be given, since these two will provide the theoretical basis for this study. Then, a short discussion on alternative theories that will be excluded from the theoretical framework of this research will be provided. Internalisation Theory, Dunning’s Eclectic Framework and Organisational Capabilities Theory will be examined, since these theories have been used by researchers in several studies regarding entry mode decisions of international firms. Finally, these theories will be compared to Transaction Cost theory and an explanation for their exclusion from the current study will be provided.
3.2 Transaction Cost Economics: An overview

Transaction cost economics (TCE) belongs to the “New Institutional Economics” paradigm, which over time has superseded some parts of traditional neoclassical economics. Whereas the latter viewed the firm mainly as a production function, TCE explicitly considers the firm as a governance structure. Coase (1937) was the first to identify firms and markets as alternative governance structures, which differ in their transaction costs. Williamson (1967, 1975, 1979, 1985, 1996a) considerably extended Coase’s arguments during the last three decades and incorporated them in a theory of the economics of organisation. Williamson’s (1996b, p.138) basic framework features the economic organisation as an effort of “discriminating alignment: transactions, which differ in their attributes, align with governance structures, which differ in their costs and competences, so as to effect a transaction cost economizing outcome”.

Additionally, TCE adopts a contractual approach to the organisation. Simply put, it involves an assessment of the comparative costs of planning, monitoring, adapting and enforcing a certain transaction, given the alternative forms of organisation. The basic issues underlined by this framework are comparability (i.e. one form of organisation is always compared with an alternative form) and feasibility (alternatives should be realistic not hypothetical). In order to retain only the feasible alternatives, transaction cost theory advocates that certain behavioural assumptions should be made. More specifically, Williamson (1996a) makes a distinction between the contracting man and the orthodox man regarding two basic characteristics: bounded rationality and opportunism.

(a) Bounded rationality: Williamson makes use of the concept of bounded rationality in the way that Simon (1961) first defined it: economic actors behave in a way that is "intendedly rational but only limitedly so”. Whereas the economic orthodoxy relies on the fact that economic actors intend to behave rationally in order to achieve their economic goals, the study of institutions relies on the proposition that human beings have also a limited ability to foresee and to acquire knowledge and skills.

In situations where bounded rationality is combined with environmental or behavioural uncertainty, organisations should abandon the market mechanisms and realise the advantages of internal governance, which gives the parties to a transaction the
opportunity to react in a sequential, adaptive way without incurring the hazards of opportunism that spot contracting would pose.

(b) **Opportunism**: The second behavioural assumption relates to the inclination of economic actors not to fulfil their promises. According to TCE not every human being acts opportunistically; what is difficult, is to know from the outset who is trustworthy and who is not. Williamson (1985, p.47) defines opportunism as "self-interest seeking with guile" and suggests that the definition includes actions such as lying, cheating or violating agreements. Opportunism poses a problem to the extent that a relationship is characterised by a small numbers condition (Williamson, 1975) or supported by specific assets, whose value is significantly reduced outside the particular relationship (Rindfleisch and Heide, 1997). Internal organisation is less vulnerable to the hazards of opportunism when a small numbers condition exists *ex ante* or arises during contract execution, since hierarchy is less prone to disputes between parties and is able to resolve most of them by appeal to *fiat*.

As it has already been mentioned, the principal objective of comparative economic organisation is to examine each institutional form not independently, but in relation to feasible alternatives. The main features according to which TCE analyses each transaction are: (a) **asset specificity**, (b) the degree and type of **uncertainty** and (c) the **frequency** with which transactions occur.

(a) **Asset Specificity** refers to the degree to which human or physical assets are locked into a particular use and to the extent they can be redeployed without sacrifice of substantial productive value (Williamson, 1996a). Asset specificity becomes an important issue, when it is combined with the behavioural assumptions presented above and in the presence of uncertainty, because it introduces bilateral dependency into the relationship. That is why the identity and reputation of the parties to a specific transaction regarding their tendency to continue the co-operation is an important issue in the contracting process.

(b) **Uncertainty**: refers to situations arising from random acts of nature or changed consumer preferences (state contingent kind of uncertainty), lack of communication (secondary uncertainty) and most importantly situations characterised by bilateral dependency, where behavioural uncertainty evolves.
(c) **Frequency**: The degree and the recurrence with which a transaction occurs is also a relevant dimension, since the cost of a complicated governance structure could not be recovered in case of a single transaction, whereas it would be justified under situations of high transaction volume.

TCE theory identifies the transaction instead of the individual or the industry as the basic unit of analysis and assesses the comparative costs of planning, adapting, monitoring, and enforcing task completion under different governance structures. The key differences between the three governance structures, i.e. market, hybrids and hierarchies, relate to the form of contract law that supports them, the adaptability of each mode and the use of incentive and control instruments that characterise them.

Table 3.1 summarises the distinctive features of each governance mode and shows that the hybrid mode is located between the market and the hierarchy and is characterised as a more elastic and adaptive governance form compared to the market, but more legalistic and less adaptive than hierarchy.

### Table 3.1: Distinguishing Attributes of Market, Hybrid and Hierarchy Governance Structures

<table>
<thead>
<tr>
<th>Attributes</th>
<th>Governance Structure</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Market</td>
</tr>
<tr>
<td>(a) Instruments</td>
<td></td>
</tr>
<tr>
<td>Incentive Intensity</td>
<td>++</td>
</tr>
<tr>
<td>Administrative Controls</td>
<td>0</td>
</tr>
<tr>
<td>(b) Performance Attributes</td>
<td></td>
</tr>
<tr>
<td>Adaptation (A)</td>
<td>++</td>
</tr>
<tr>
<td>Adaptation (C)</td>
<td>0</td>
</tr>
<tr>
<td>(c) Contract Law</td>
<td>++</td>
</tr>
</tbody>
</table>

*Williamson, 1996a, p.105*

(a) **Contract Law**: In the case of autonomous markets, where there is no dependency between buyers and sellers and the identity of the parties does not matter, *classical contract law* is sufficient, since the terms of the specific transactions are explicitly
Expansion Strategies of International Hotel Firms

specified *ex ante* (Williamson, 1996a). However, when future contingencies cannot be specified at the outset, a different kind of contracting that supports the relation with an additional governance structure should be applied, namely *neoclassical law and excuse doctrine*. Finally, according to Williamson (1996, ch. 4), hierarchy is a more adaptive mode and the type of implicit "contract law" that applies to this kind of organisation is that of *forbearance*, namely a more flexible arbitration form, which allows the dispute outcome to be determined by mitigating factors that are not allowed when disputes are resolved in courts. The rationale for forbearance rests on the fact that parties to a dispute have knowledge that is either impossible or too costly to reveal in a court; hence the parties either settle their differences on their own or let the hierarchy decide on unresolved situations.

(b) **Adaptability:** Apart from contract law that applies to each form of organisation, adaptability is another central problem of economic organisation. Williamson suggests that adaptation can be classified into two types: *autonomous* (A), which has spontaneous origins and can be successfully applied in spot contracting and *coordinated* (C), which is required in cases of contracts that are characterised by strong disturbances and therefore can be applied in cases of a more hierarchical governance.

(c) **Incentives and Co-ordination Instruments:** These adaptation advantages, however, do not obtain without respective costs; in fact, internal organisation weakens incentive intensity and causes bureaucratic costs to rise. Within hierarchical governance, incentive intensity is being considered not as an objective but as an instrument. As far as the hybrid mode is concerned, it is characterised by moderate degrees with respect to adaptability features and incentive intensity (Williamson, 1996a). Finally, in the market mode, high intensity incentives are prevalent.

### 3.3 Agency Theory: An Overview

Starting in the 1970s, the agency theory literature extended the analysis of the risk-sharing problem, which referred to different attitudes towards risk between cooperating parties, to include the agency problem that arises when cooperating parties have different goals and division of labour. Jensen and Meckling (1976) defined the agency
relationship as a contractual arrangement between two (or more) parties, where one, designated as the *agent*, acts on behalf of, or as a representative for the other, designated as the *principal*, who delegates some decision-making authority to the agent in order to act in a certain domain of decision problems.

Agency theory (AT) is mainly concerned with two basic problems that arise in the agency relationship. The first problem arises when the principal’s and the agent’s goals are incongruent and it is difficult for the principal to evaluate the agent’s effort and actions. The problem in that case is that the principal cannot verify whether the agent has behaved appropriately. The second problem concerns risk sharing and arises when the principal and the agent have different attitudes toward risk. Different risk preferences lead the agent to take different actions from what the principal would prefer (Eisenhardt, 1989).

(a) The agency literature refers more often to the first problem, which usually takes two different forms: the problem of *adverse selection* and the problem of *moral hazard*. The adverse selection problem arises due to pre-contractual information asymmetries. The term has arisen from the insurance industry, where the selection of people that purchase insurance is not a random sample of the population, but rather a group of people with private information about their personal situations, that makes it likely they will receive a higher-than-average level of benefit payments under the insurance policy.

As mentioned by Akerlof (1970) in his “Market for Lemons”, the asymmetric information condition, when combined with unconstrained opportunism (which is one of the human assumptions made by agency theory) can lead to the collapse of markets, since there would be no price at all at which the quantity of a good supplied to the market by sellers would be equal to the quantity demanded by buyers. In general, markets may have problems functioning in situations where there is private information that is difficult to verify. And the person who has the private information may lose just as much or more than the person who does not (Noreen, 1988).

Moral hazard usually refers to lack of effort on the part of the agent. More generally it refers to the risk of opportunism, i.e. self-interest seeking with guile, as defined by Williamson (1975). This term also originated in the insurance industry, where it referred to the tendency of people with insurance to change their behaviour in a way that leads to
larger claims against the insurance company. Moral hazard problems may arise in any situation in which someone is tempted to take an inefficient action or to provide distorted information because the individual's interests are not aligned with the group interest and because the action cannot be accurately monitored.

The argument in the principal–agent context is that the agent may simply not put forth the agreed-upon effort. That is, the agent is shirking. Therefore, the principal’s problem is to design a contract that rewards the agent according to the outcome, taking in to account any tendency the agent has to make decisions that are non-optimal for the principal.

(b) Regarding the second problem in the agency relationship, risk sharing between principal and agent, it would still exist, even if there were no problem of asymmetric information between the two parties. Since both principal and agent are assumed to be risk averse there is a need for sharing the risk attaching to outcomes of the agent’s actions. Indeed, if the agent were risk neutral he would bear all the risk; the principal would retain a fixed amount of the outcome and gave the remaining to the agent, who then would not have any dilution of incentives, as for example when the principal is a bondholder. However, since the agent, like all individuals, is averse to sufficiently large risks, "the solution of preserving incentives by assigning all risks to the agent fails, as soon as the risks are large compared with the agent’s wealth" (Arrow, 1985; p.45).

According to Agency Theory, the unit of analysis is the contract that characterises the relationship between the principal and the agent. The aim of the theory is to identify the most efficient contract for the agency relationship, given the assumptions about human nature, namely bounded rationality, self interest with guile and risk aversion, about organisations, i.e. goal conflict between members and about information, i.e. information is a purchasable commodity. Basically, the question becomes whether a behaviour-oriented contract (e.g. salaries) is more efficient that an outcome-oriented one (e.g. commission, stock options).
Table 3.2: Agency Theory Overview

<table>
<thead>
<tr>
<th>Key idea</th>
<th>Principal-agent relationships should reflect efficient organisation of information and risk-bearing costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unit of analysis</td>
<td>Contract between principal and agent</td>
</tr>
<tr>
<td>Human assumptions</td>
<td>Self interest with guile, bounded rationality and risk aversion</td>
</tr>
<tr>
<td>Organisational assumptions</td>
<td>Partial goal conflict among participants (incentive misalignment)</td>
</tr>
<tr>
<td>Information asymmetry</td>
<td>Information is a purchasable commodity and the more information available the better an action can be monitored and evaluated</td>
</tr>
<tr>
<td>Contracting problems</td>
<td>Agency (information asymmetry, moral hazard and adverse selection)</td>
</tr>
<tr>
<td>Problem domain</td>
<td>Relationship in which the principal and agent have partly differing goals and risk preferences (e.g. compensation, regulation, leadership, vertical integration, transfer pricing)</td>
</tr>
</tbody>
</table>

_Eisenhardt, 1989, p. 59, amended by the author_

From its roots in information economics, agency theory has developed along two streams: positivist and principal-agent. Both directions share a common unit of analysis, i.e. the contract, and the same assumptions about human nature, organisations and information. However, they have important differences that are presented in Table 3.3:

Table 3.3: Comparison between Positivist Agency and Principal-Agent Theory

<table>
<thead>
<tr>
<th>FEATURES</th>
<th>POSITIVIST AGENCY THEORY</th>
<th>PRINCIPAL-AGENT THEORY</th>
</tr>
</thead>
<tbody>
<tr>
<td>Relationship</td>
<td>Owner-manager relationship in large corporations</td>
<td>Several types of agency relationship</td>
</tr>
<tr>
<td>Focus</td>
<td>Identifies various contract alternatives</td>
<td>Indicates which is the most efficient</td>
</tr>
<tr>
<td>Approach</td>
<td>Less mathematical</td>
<td>Mathematical, less accessible to organisational scholars</td>
</tr>
</tbody>
</table>
(a) Positivist Agency Theory: The focus of most positivist researchers has been the identification of situations in which the principal and the agent have conflicting goals and the description of governance mechanisms that restrain the agent’s opportunistic behaviour. Also, they study almost exclusively the relationship between the owners and managers of large corporations (Jensen and Meckling, 1976).

According to this theory, there are two mechanisms that can be used to limit the agent’s self-serving behaviour, thus mitigating the agency problem: the use of outcome-based contracts and the use of information systems. The benefit of outcome-based contracts is that they coalign the incentives of principals and agents, since the rewards for both depend on the same actions. For example, Jensen and Meckling (1976) described how increasing the managers’ ownership stake in the firm decreases managerial opportunism. The alignment of interests is beneficial to the performance of the agency relationship, not only because it assures an appropriate level of effort on behalf of the agent, but also because it promotes the right choices. Thus, for example, a corporate executive who thinks that the future of the company lies with a certain product can be expected to place like-minded managers in positions of responsibility.

When incentive alignment is difficult to achieve, monitoring the agent’s behaviour can be another way to mitigate the agency problem. The use of information systems helps the principal to observe the agent’s behaviour; hence the agents know that they cannot deceive the principal, therefore they act in an optimal way for his interests. For example, Fama and Jensen (1983) described the information role that boards of directors play in controlling managerial behaviour.

Moreover, the literature suggests the use of multiple agents as an alternative way of monitoring the agent and deciding whether he has acted in accordance with the principal’s interests (Sappington, 1991). Additional agents can provide valuable information about the activities of any particular agent, especially when the performance of each one is influenced by a common exogenous parameter that the principal cannot observe. In such a case the relative performance of the agents can provide a good indicator of their individual efforts, while controlling for the effects of the common environmental variables.
(b) Principal Agent Research: This stream of agency theory is concerned with a broader range of principal-agent relationships than positivist theory, such as employee-employer, buyer-supplier and consultant-client. Compared to positivist theory, it is based more on applications of information economics, hence less accessible to organisational scholars and includes many more testable implications. In addition, whereas the positivist theory sets out two alternative mechanisms for limiting agent's self-serving behaviour, i.e. outcome-based or behaviour-based contracts, the principal-agent theory is concerned with the determination of the optimal choice of contract, which implies a trade-off between (i) the cost of measuring the agent's behaviour and (ii) the cost of measuring outcomes and transferring risk to the agent.

According to its propositions, the degree of risk aversion of the agent is positively related to preference for a behaviour-based contract and negatively related to preference for an outcome-based contract. Indeed, the less risk averse the agent, the more attractive it is to pass onto him or her, the risk of an outcome-based contract. The opposite is suggested to be the case for the principal, i.e. the degree of risk aversion of the principal is positively related to preference for an outcome-based contract and negatively related to preference for a behaviour-based contract.

Moreover, it is suggested that goal conflict between the principal and the agent is positively related to outcome-based contracts and negatively related to behaviour-based ones. It is obvious that the same relationships are expected in case of outcome measurability: when outcomes are measured with difficulty, outcome-based contracts become less attractive.

Whatever the approach taken, it has to be acknowledged that agency theory has contributed in organisational thinking in two different ways. First, it treats information as a commodity that has a price and can be purchased, the implication being that organisations can invest in information systems in order to control agent opportunism. The second contribution concerns its risk implications: uncertainty not only entails an inability to preplan but also involves a trade-off between risk and rewards. The implication is that the contract between principal and agent is being affected not only by outcome uncertainty but also by differences in their willingness to accept risk.
3.4 Comparison between Transaction Cost Economics and Agency Theory

Both TCE and AT differ from the neoclassical theory of organisation which regards the firm as a production function, since the former considers the firm as a governance structure (Williamson 1975, 1985 and Klein, Crawford and Alchian 1978), while the latter treats it as a nexus of contracts (Jensen and Meckling 1976). As has already been previously discussed, TCE traces its origins to explanations of vertical integration, whereas AT was originally concerned with corporate control. While some believe that these two theories are based in different paradigms, others suggest that the differences are exaggerated. In addition, some scholars consider the theories to be complementary and use them jointly as a basis for their conceptual framework (Contractor and Kundu 1998a).

TCE and AT enjoy important similarities across different dimensions. Firstly, both derive from a “managerial discretion setup” (Williamson, 1996a; p.173); bounded rationality and opportunism are basic assumptions in both theories, although agency theory uses the terms “moral hazard” and “agency costs” when referring to opportunism. Additionally, both follow an efficient contracting orientation towards economic efficiency: an incomplete contracting orientation is employed, since contracting parties are assumed to be aware of the prospective distortions and needs for incentive realignment and governance structures’ refinement.

Those similarities notwithstanding, there are several important differences between transaction costs and agency theory that should be underlined:

(a) Unit of analysis: Whereas TCE regards the transaction as the main unit of analysis, AT considers the individual agent to be the central unit of analysis.

(b) Market characteristics: TCE maintains that it is not possible to write complete contracts due to bounded rationality; for that reason the basic assumption of the theory is that this leads markets to fail, under certain conditions, a situation which induces the firms to produce on their own (i.e. to integrate). On the contrary, agency theory presumes market efficiency and tries to identify the optimum contract for the exchange.
(c) Organisational concern: although both theories adopt an incomplete contracting orientation, AT examines contracts mainly from an *ex ante* incentive alignment point of view, while TCE is more concerned with providing governance structures that can operate *ex post*. Whereas AT is little concerned with disputes resolution, TCE aims in providing mechanisms that facilitate dispute resolution. More specifically, TCE is trying to assess the comparative efficacy of alternative comparative structures for harmonizing *ex post* contractual relations (Williamson, 1985).

(d) Focal costs concern: as a consequence of their organisational focus, the theories in question also differ regarding their concern over costs; while AT has the residual loss as the centre of interest, TCE has the cost of maladaptation as its main focus. The residual loss is defined as the reduction in the welfare of the principal, after monitoring and bonding, as a result of the remaining divergence between the agent’s decisions and those that would maximise the principal’s welfare (Jensen and Meckling, 1976). Residual loss is the key feature, since monitoring and bonding costs are incurred only in the degree to which they yield cost-effective reductions in the residual loss. Therefore, the main issue in agency theory is the *ex ante* alignment of incentives.

On the other hand, although transaction costs have both *ex ante* and *ex post* components, the emphasis in TCE is on the *ex post* costs, which include maladaptation costs when transactions drift out of alignment, haggling costs that arise when efforts to correct *ex post* misalignment are made and setting up and running costs of governance structures to which disputes are referred (Williamson, 1996a).

(d) Process distinctions: AT suggests that natural selection processes are reliably efficacious and relies in the assumption that *ex post* settling up can efficiently control managers. On the other hand, TCE presents two different process arguments; the first is *fundamental transformation*, as was described by Williamson (1985, 1996a), and the second deals with the impossibility of *selective intervention* (Williamson, 1985). Fundamental transformation arises due to asset specificity and refers to a situation where a large numbers bidding condition at the outset is effectively transformed into one of bilateral dependency thereafter. The impossibility of selective intervention explains why internal organisation is not able to beat markets everywhere by combining replication (in situations where markets work well) with selective intervention (in situations where markets do poorly). In the context of this research, impossibility of selective intervention
refers to efforts to replicate high-powered incentives that are efficient in the market mode (i.e. franchising), when transferring transactions to a more hierarchical mode (i.e. management contracts or company ownership).

Table 3.4 provides a summary of the leading differences between transaction costs and agency theory.

**Table 3.4: Summary of differences between TCE and AT**

<table>
<thead>
<tr>
<th>Issues of Controversy</th>
<th>Transaction Costs Theory</th>
<th>Agency Theory</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unit of Analysis</td>
<td>Transaction</td>
<td>Individual Agent</td>
</tr>
<tr>
<td>Market Characteristics</td>
<td>Markets can fail</td>
<td>Markets are efficient</td>
</tr>
<tr>
<td>Organisational Concern</td>
<td>Ex post governance</td>
<td>Ex ante incentives alignment</td>
</tr>
<tr>
<td>Focal Cost Concern</td>
<td>Maladaptation costs</td>
<td>Residual loss</td>
</tr>
<tr>
<td>Process Distinctions</td>
<td>Fundamental Transformation</td>
<td>Natural selection processes</td>
</tr>
<tr>
<td></td>
<td>Impossible selective intervention</td>
<td></td>
</tr>
</tbody>
</table>

*Williamson, 1996a; p.179*

### 3.5 Internalisation Theory

The internalisation theory of market entry asserts that a firm’s involvement in a particular foreign market is gradual and incremental. According to the theory, a firm is likely to enter a specific host market initially by low resource commitment to minimise the risk and the cost of foreign market involvement, e.g. through exporting. As the firm acquires knowledge and experience regarding the foreign market, it tends to shift to higher resource commitment and control mode, that is joint ventures and later on to fully owned subsidiaries abroad.

The theory rests on two fundamental principles: (a) firms choose the least cost location for each activity they perform and (b) firms grow by internalising markets up to the point where the benefits of further internalisation are outweighed by the costs.

At the beginning, joint ventures were not explicitly considered on the spectrum of governance choices, whereas non-equity forms of co-operation such as licensing were
considered to be of lesser interest. Moreover, even when the choice was expanded to include co-operative forms such as licensing (Buckley and Casson, 1976), it was suggested by the research that the multinational firm would usually prefer to internalise transactions via direct equity investment rather than to license its capabilities. However, recent work like that of Buckley and Casson (1996) considers co-operative modes of organisation highly likely as a mode of market entry.

The internalisation perspective (Buckley and Casson, 1976; Rugman, 1980) is closely related to transaction cost theory. It is based on the premise that the greater the danger of a firm losing its specific knowledge, the higher is the incentive for it to internalise transactions. This influences the firm’s ownership preference in international markets. For example, a firm might choose ownership over licensing if the potential of losing specific knowledge (specific assets) is high.

Internalisation as well as transaction cost theory are concerned with the minimisation of transaction costs and the conditions underlying market failure. Both analyse the characteristics of the transaction in order to decide on the most efficient, i.e. cost-minimising, governance mode. The fundamental idea underlying the two approaches is that firms use internal organisation to overcome problems that are caused by market inefficiencies. The primary difference is that the transaction cost approach focuses on the single transaction, while for internalisation theory the unit of analysis is the firm. Another difference is that the focus of internalisation is on the market for know-how, while that of TCE is on more micro-level transaction characteristics such as asset specificity.

3.6 Dunning’s Eclectic Paradigm

The eclectic theory of international production suggests that enterprises with headquarters in one country will have some form of involvement in companies outside their national boundaries whenever they have competitive (or ownership) advantages over firms of other nationalities and they find it economic to combine these assets with advantages located in foreign countries (Dunning, 1980).
The research regarding the choice of market entry mode began in the international business fields with the question of the choice between exporting as opposed to foreign direct investment. Whatever the market entry theory used, there are certain factors that are considered to determine the modal choice. According to Dunning (1993) these factors, or advantages, are classified in three basic categories:

(a) The extent and nature of technological and managerial advantages in comparison to those of the indigenous firms in the country in which they are producing (ownership advantages). In the case of the hotel industry, ownership advantages maybe related to the fact that hotel services are consumed in an unfamiliar environment, where brand awareness guarantees a standard of service quality to the tourist. It could also refer to the ability of an international hotel chain to operate with a superior production function compared to local hotels (Dunning and McQueen, 1981).

(b) The benefits of combining these advantages with immobile factor endowments in a foreign country to provide further value added activities (location advantages). In the context of the hotel industry, location advantages may include general political economic and social factors as well as factors related to tourism, such as tourism infrastructure, size and rate of growth of tourism and availability of hotel inputs.

(c) The advantages of internally controlling and coordinating both the above-mentioned factors with factors owned by the multinational company, rather than selling this right to indigenous firms located in the country of production (internalisation advantages).

Dunning and McQueen (1981) were among the first to notice that ownership and control in the hotel industry are not necessarily correlated with each other. They make a distinction between de jure control, which is a function of ownership, and de facto control, which can be achieved through a non-equity arrangement, such as a management agreement. They define internalisation in the hotel industry as any form of involvement in foreign operations, other than an “arms-length” transaction, which could range from subcontracting to full ownership. “To determine whether and how much internalisation is de facto practiced, one therefore needs to look at the control procedures of equity-based control and the terms of the contract of contract-based control.” (Dunning and McQueen, 1981, p.205)
In the context of the present study, it could be argued that Dunning’s paradigm does not provide a better explanation for the choice among franchising, management contracts and company ownership than TCE does. The explanatory variables of the above mentioned decision (as will be presented in a subsequent chapter) are indeed classified in a similar way to the factors that determine entry mode according to Dunning, namely firm-specific variables (i.e. ownership advantages) and market-specific variables (location advantages). However, instead of providing a third category of advantages (i.e. internalisation advantages), what TCE does, is to provide a more comprehensive theory for justifying when ownership and location advantages favour the use of a “hierarchical” mode of entry (or corporate development) versus a “market” mode.

Therefore it is suggested that Dunning’s paradigm can be regarded as subsumed in the theoretical framework of this study, hence it does not provide additional explanations of the corporate development choice over what is provided by TCE, and thus an extensive presentation of this theory is not a requisite for this study.

3.7 Organisational Capabilities Theory

In contrast to Transaction Cost Economics, the Organisational Capabilities perspective (OC) shifts the attention from the characteristics of the transaction to the capabilities of the firm, and the unit of analysis from the transaction to the firm, which is perceived as a bundle of knowledge. OC theory provides a central role to bounded rationality and to organisational routines in the organisation of economic activity, and considers the firm as a group of transferable resources, which are transformed into capabilities through dynamic firm-specific processes. More specifically, the theory considers as very important the experiences that a firm gains through its past activities, routines and procedures, since these are going to influence its subsequent actions. Therefore, the firm’s capabilities behave as a source of advantages as well as constraints on the firm’s future activities (Madhok, 1997).

According to the OC perspective as presented by Madhok (1996, 1997 and 1998), TCE is unable to give a comprehensive explanation for the existence of the firm and a theory of economic organisation in general. It asserts that TCE basically ignores the essential
concept of the firm as a locus of resources and capabilities and the fundamental processes that take place within the firm.

The starting point of disagreement between the OC perspective and TCE is that the former considers the firm to be the unit of analysis, while for the latter the unit of analysis is the single transaction. As a result, TCE analysis focuses on the characteristics of the transaction, while the OC area of focus is related to firm capabilities. One of the main OC objections to TCE, however, is that opportunism (defined as self-seeking with guile) is not as important as argued by TCE; the assumption that opportunism is a pervasive consideration in the decision to internalise an activity (i.e. to use hierarchy rather than the market as a governance structure) is considered by organisational theorists to be too limiting (Ghoshal and Moran, 1996).

Furthermore, the OC approach asserts that TCE ignores other considerations that are important in corporate development, such as organisational capabilities and synergistic properties, and that it focuses on cost minimisation instead of management of value. The resource-based approach on the other hand “embraces the (positive) value-creating potential of the firm, rather than avoidance of the (negative) effect of opportunism” (Madhok, 1997).

Table 3.5: Comparison of the TC and the OC perspectives

<table>
<thead>
<tr>
<th></th>
<th>The TC perspective</th>
<th>The OC perspective</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Unit of analysis</strong></td>
<td>Transaction</td>
<td>Firm</td>
</tr>
<tr>
<td><strong>Primary area of focus</strong></td>
<td>Transaction characteristics</td>
<td>Firm capabilities</td>
</tr>
<tr>
<td><strong>Key assumption</strong></td>
<td>Opportunism</td>
<td>Bounded rationality</td>
</tr>
<tr>
<td><strong>Source of competitiveness</strong></td>
<td>Efficient management of transactions</td>
<td>Development and exploitation of capabilities</td>
</tr>
<tr>
<td><strong>Primary orientation in the management of know-how</strong></td>
<td>Cost Minimization</td>
<td>Management of Value</td>
</tr>
<tr>
<td><strong>Key consideration to choice of ownership form</strong></td>
<td>TC minimization; fit between transaction characteristics and form of governance</td>
<td>Contributions towards and demands placed on firm’s capabilities</td>
</tr>
<tr>
<td><strong>Temporal orientation</strong></td>
<td>Essentially static and equilibrium-oriented</td>
<td>Essentially dynamic; learning and capability building as developmental processes</td>
</tr>
</tbody>
</table>

However, the OC objection that questions the importance of opportunism is not adopted in this study. Contrary to what is argued by Ghoshal and Moran (1996) it is suggested here that relationship-specific assets cannot reduce the costs of internal organisation (i.e. hierarchy) independent of their effects on opportunism. What differentiates hierarchy from the market is the ability to resolve disputes by fiat, rather than by costly haggling or recourse to costly procedures involving external authorities such as courts.

Moreover, firms employ people rather than just using external contractors to do the job because some tacit information may be hard to communicate except by task-based learning. And the reason why external contractors cannot be allowed to engage in task-based learning is the possible exposure of that knowledge to opportunistic use. Firms on the other hand allow employees to access this “impacted” information because the employment relation offers them some protection against the opportunistic use of such information. Hence, this study is based on the view that opportunism has a central role in the organisational theory in general and the theory of corporate development in particular.

As far as corporate development is concerned, the OC approach argues that entry into foreign markets involves the transfer of knowledge over some duration of time (Madhok, 1996). From this perspective, the firm boundary issue is a capability related one; where the firm already has the appropriate knowledge and possesses the required routines, internalisation will be the preferred mode of undertaking the activity, since incremental costs are marginal.

In contrast, when the firm enters into unfamiliar areas of activity, according to the OC approach the capability constraint becomes important, since the technological and market distance of the target activity is further away from the firm’s centre of knowledge. In that case, collaboration provides useful ways to improve knowledge in certain areas of functioning, where it cannot be developed within an acceptable time period or cost. Thus, in order for a firm to make decisions regarding its ownership mode, the development and deployment of its capabilities should be taken into consideration.

Although the OC approach could provide a complementary theory on the economics of organisation, it would not be useful as an explanation of one important aspect of organisation, namely the choice between market and hierarchy as a governance mode,
which is the main focus of this study. Using this theory, one would have to classify management contracts as a non-equity collaborative agreement (a “market” one), rather than as a “hierarchy” one. However, using transaction cost economics one can easily understand that management contracts can be classified as a hierarchical mode of organisation (the following chapter gives an extensive explanation on this issue).

Finally, it is important to notice that the research question of this study is to identify how international hotel firms decide on the organisational mode of each new hotel outlet, regardless of whether the hotel is being developed in foreign country or not, or whether the firm already has presence in a particular country. Thus, the focus of the study, i.e. the unit of analysis is a particular transaction of the hotel firm (i.e. the development of a new outlet). In contrast to previous studies, what is being examined here is not how a multinational company will enter a foreign market (e.g. through a contractual agreement or by developing a subsidiary in the target country). Thus, the focus of the study is not the firm. Therefore, OC theory is not a key theoretical approach as far as this study is concerned.
3.8 Conclusions

Transaction Cost Economics (TCE) and Agency Theory (AT) are two of the theories that are most commonly used to examine how firms decide on their entry mode or expansion strategies. Besides TCE and AT, there are alternative theories that are often applied by researchers in order to explain what factors influence international firms when they examine alternative modes of entry. The overview of theoretical approaches on the existence of multinational firms presented in this chapter shows that many explanations are possible.

At the beginning, an extensive discussion of the theories that will be used in the context of this study, namely Transaction Cost Economics and Agency Theory, was provided, as well as a comparison between them. Moreover, short introductions to Internalisation Theory, Dunning’s eclectic framework and Organisational Capabilities theory were given, along with a justification for their exclusion from the theoretical framework of this study.

Although both Internalization Theory and Dunning’s framework take the same approach to the entry mode/corporate development decision as TCE, both are excluded from this research. As explained earlier, Internalization Theory presents many similarities to TCE and is considered to be an application of the Transaction Cost theory to the multinational corporation (Rugman, 1986). Therefore it is argued that Internalization Theory would not provide any additional explanations for the modal choice of international hotel firms and thus is not included in the theoretical framework of this research.

Furthermore, compared to Dunning’s framework, TCE provides a more comprehensive theory for justifying when ownership and location advantages favour the use of a “hierarchical” mode of entry (or corporate development) versus a “market” mode instead of providing a third category of advantages (i.e. internalisation advantages). Therefore it is suggested that the arguments provided by Dunning’s eclectic paradigm have already been considered in the theoretical framework of this study as part of the justification provided by Transaction Cost Economics.

Organisational Capabilities theory on the other hand, although it provides a comprehensive explanation for the existence of the firm, will also be disregarded since
using this theory, one would have to classify management contracts as a non-equity collaborative agreement (a “market” one), rather than as a “hierarchy” one.

Finally, as far as Agency Theory is concerned, it is suggested that its inclusion in the study would offer a better understanding of the choice among franchising, management contracts and company ownership, since the relationship between an international hotel company and a property owner / prospective franchisee is a classic principal-agent relationship. Therefore, Agency Theory would act complementarily to Transaction Cost Economics towards a more comprehensive theoretical framework for this research.
CHAPTER 4: MODES OF CORPORATE DEVELOPMENT (MODAL CHOICE) IN THE HOTEL INDUSTRY

4.1 Introduction

Modes of corporate development differ from each other on several dimensions, one of which is the degree of control the firm can exercise. At this stage, a definition of ownership and control, as these concepts will be used in this report should be given. Ownership in international business operations refers to how much of the assets an international firm owns or invests in the facility. On the other hand, control refers to the degree to which the firm controls (or manages) the operation of the established facility.

Traditionally, control has been perceived by researchers as a result of ownership. Thus, it has been suggested that the greater the firm's level of ownership, the greater the control it enjoys over its transactions. However, in some service sectors, such as hotels, control has been de-linked from equity ownership. Contractor and Kundu (1998a) suggest that the fact that non-equity modes of development account worldwide for 65% of foreign operation properties implies that managerial control is not weak in those modes.

It is important to mention at this stage that modal choice is going to be studied in terms of the degree of control over the hotel operations that is provided by each one of the development modes. What is of great interest to the author is the managerial control, not the equity participation in the facility. As a consequence, the following clarification needs to be made: properties that are managed by an international hotel company are not necessarily owned by the same company. It could be that the property is owned by another party and that the hotel company (operator) does not have an equity stake on the property, or owns a small percentage. In the same way, when the international hotel firm acts as franchisor it could be that the hotel property is owned either by the franchisee or by a third party.

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8 Foreign operations as defined in footnote no. 1
When contractual modes are examined according to Transaction Cost Economics, management contracts are considered to be located towards the "hierarchy" pole of the market-hierarchy continuum, since this mode provides the highest degree of control over the facilities, in comparison to the rest of the contractual modes. More specifically, under a management service agreement, control over the daily operations and the intangible assets, i.e. human capital and intellectual property rights (knowledge capital, codified assets) is exercised by the hotel company. In contrast, when the hotel company acts as franchisor, the intangible assets are substantially under the control of the franchisee. Therefore, franchising is considered as a form similar to "subcontracting", and thus is placed towards the "market" pole of the continuum.

In this chapter, the three modes of development that comprise the modal choice in this research, namely company ownership, management contracts and franchising will be presented from a transaction cost, as well as an agency theory perspective. Consequently, an explanation of control as a strategy issue in international hotel corporate development will be provided. The reasons for excluding some variables that have been examined in previous studies and the empirical results from the service sector will be discussed in the last two sections.

Although the main focus of this thesis is the examination and analysis of Modal Choice, the reader first needs to understand how the three expansion modes that will be analysed in this study are placed in the market-hierarchy continuum. As it will be further discussed in the last chapter one of the main contributions of this study refers to the provision of theoretical explanation with respect to the treatment of management contracts as a mode that resembles "hierarchy". Therefore, an extensive analysis of the expansion modes using transaction cost and agency theory is considered to be a necessity at this stage of the thesis. The choice of the explanatory variables that will be included in the theoretical framework of this research will be presented in the next chapter (Chapter 5).
4.2 Modes of Corporate Development: an overview

4.2.1 Franchising

Since the 1980s, franchising has become an important form of international business format, especially in service industries. Apart from major brands originating in the USA, such as Holiday Inn, Marriott and Choice, only a few hotel companies so far consider franchising when planning their development strategy.

Franchising is a contractual arrangement whereby one firm, the franchisor, sells the right to another firm, the franchisee, to operate under a particular trademark and following a set of guidelines (Lafontaine and Masten, 1995). Additionally, when it comes to business format franchising, the franchisor agrees to provide managerial assistance regarding issues such as advertising and promotion, personnel development, operating procedures, whereas the franchisee runs the business in a way that has already been agreed, pays royalties, usually a percentage of sales and sometimes is obliged to buy supplies from the franchisor or from approved suppliers (Rubin, 1978).

Franchising is the solution to many challenges encountered by service industries, such as intangibility, the discretionary nature of service purchases, labour intensity, quality control and small size of firms (Cross and Walker, 1987). Hotel franchising comes in many forms, but the basic premise is that the owner of the property remains in control of the management, while at the same time enjoying the advantages of a large chain in terms of brand name operations guidance and marketing support.

4.2.2 Management Contracts

A management contract is a long-term agreement, of up to ten years or even longer, whereby the legal owner of the property enters into a contract with another firm, in this case an international hotel company that agrees to run the hotel’s daily operations. Usually the property carries the name of the international hotel company and moreover, quality control, daily management, and senior staffing rest with the hotel company, not with the owners.
This arrangement is favoured in many international settings as it allows the international hotel firm to establish a presence without investment in property ownership. Additionally, it provides more stable returns compared to ownership, without real estate investment risk, since the hotel company (the operator) usually receives its fees as a percentage of both the hotel’s revenues and profits (while in the case of an equity joint venture, returns would have been based only on profits). As already mentioned, *management contracts allow for a separation of ownership from the control of the operations*. With such an agreement, the owners act as investors who allow someone else to manage the property. The management companies (international hotel firms) operate in full responsibility and receive fees for providing their expertise. On the other hand the owners’ task usually consists of the provision of the property including all furniture, not to mention that they undertake all legal and financial responsibilities.

The exact arrangements vary considerably among hotel chains. Moreover, it has been recently identified that non-equity involvement in management contracts has become more and more rare, and basic fee percentages continue to decline, the greater the flexibility in fee formulation (Bell 1993, Eyster 1997). This is mainly due to heavy competition among a growing number of management contract operators, increasing participation of owners and lenders and greater equity requirements demanded from the country partners.

### 4.2.3 Company Ownership

The company ownership mode refers to hotel properties that are owned and managed by the international hotel firm, which can either build a new hotel or acquire an existing one. This is the only expansion mode that provides the hotel ownership with full control over the property, the intangible assets and the operations. On the other hand, though it requires high levels of capital investment. Thus, the hotel company that owns a hotel property has the advantage of receiving all the profits, but it also has to face all the related risks. This could be a serious drawback especially when the hotel property operates in a foreign environment, where political and economic risks can be quite high.
4.3 Control as a strategy issue

Until recently control had been perceived as totally conjunct with ownership. Nowadays, though, it is argued by several researchers that there are different mechanisms whereby a firm can exercise control over an alliance (Geringer and Hebert 1989). In the hotel sector, Contractor and Kundu (1998a) classified the means of control in four dimensions: (a) daily operations and quality control in the hotel property; (b) control over the physical assets; (c) control over tacit expertise obtained through the firm’s operations and processes and (d) control over codified assets, including computer reservation systems and most importantly the firm’s recognised brand name.

Table 4.1 gives the allocation of the above mentioned control criteria over the modes of organisation, as classified by Contractor and Kundu (1998a):

Table 4.1: Modes of Organisation and Level of Control

<table>
<thead>
<tr>
<th>Mode</th>
<th>Control</th>
<th>Fully owned property</th>
<th>Partly owned property</th>
<th>Management Service</th>
<th>Franchise</th>
</tr>
</thead>
<tbody>
<tr>
<td>High Ownership Commitment</td>
<td>Strong</td>
<td>a, b, c, d</td>
<td>d</td>
<td>a, d,</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Weak</td>
<td>a, b, c</td>
<td>c</td>
<td>c, d</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Non-Existent</td>
<td></td>
<td>b⁹</td>
<td>a, b¹⁰</td>
<td></td>
</tr>
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Contractor and Kundu, 1998a; p. 330 (modified by the author)

(a: daily operations and quality control  
b: control over physical assets  
c: control over tacit expertise  
d: control over codified assets, i.e. CRS)

As it can be observed in the table, management contracts imply the existence of strong control over daily management and quality control of the hotel property, as well as

⁹ If the management company has a minority equity stake in the property then control over physical assets can be classified as weak.
control over the international hotel company's codified strategic assets, used by the hotel property. Moreover, management contracts provide a certain degree of control over the operator's tacit expertise. However, the control exercised is not strong since local personnel (e.g. staff and middle management) have the opportunity to acquire that knowledge and use it in the future as a basis for launching their own business. In most cases, management service agreements do not provide any control over physical assets\(^{11}\).

In contrast, franchising provides the franchisee with control over daily management and quality control. Furthermore, control over physical and codified assets also resides with the franchisee and not with the international hotel firm. Hence the property owner is also the hotel operator\(^{12}\). However, since the international hotel firm provides training and guidance for the operations, it can be suggested that the franchisor shares some control over tacit expertise.

It should not be assumed, though, that in general the franchisor exercises minimum control; according to Klein (1995), one of the main economic features that distinguishes franchising from other modes of co-operation is the degree of control exercised by the franchisor over the franchisees' operations, including control over product specification, hours of operation and operating procedures. Control over the franchisee becomes even tighter in the case of business format franchising, which covers the entire business format, i.e. quality control, operating standards, marketing strategy, personnel selection.

### 4.4 Modal Choice based on Transaction Cost Economics

In this section, modal choice in the international hotel industry will be presented and extensively explained, using the main concepts and assumptions of transaction cost theory. Although both management contracts and franchising are considered as two forms of organisation that lie somewhere between the "market" and the "hierarchy" pole (as defined in the transaction cost literature), in the current analysis franchising will be

\(^{10}\) If the hotel property is owned by the franchisor (international hotel company) and leased to the franchisee, then the hotel company has a strong control over the physical assets. However, this is rarely the case.

\(^{11}\) There are certain situations, though, where the operator is required or even prefers to participate in the property's equity.
treated as being an organisational mode that lies close to the "market" one, while management contracts are treated as the mode that lies towards the "hierarchy" one, and thus in between company ownership and franchising (but closer to the former), for reasons that will be presented in this section.

(a) In terms of contract law that characterises each organisational mode

Franchising, as a mode of organisation, lies between the market and hierarchy and maintains characteristics of both, i.e. could also be characterised by a "hybrid" form of governance, however it lies significantly closer to the "market" mode of organisation. As can be observed from Figure 4.1 pure franchising is almost a straightforward example of the "market" mode, but business format franchising places restraints on franchisee behaviour and introduces a "hierarchical" element into the relationship. The international hotel company has no control over the physical or intangible assets, and moreover the parties to a franchise relationship are independent companies that have access to courts and do not use fiat and forbearance for dealing with ex post maladaptation.

However, since franchising represents a long-term relationship, where the parties have interdependency, the "pure market" mode of organisation is not applicable. Therefore, it is argued that franchising lies near the "market" mode. Additionally, since most of the features of the transaction can be specified at the outset, the contract law that supports this type of governance is close to the classical one, although some elements of behaviour are enforced by the threat of termination of the franchise agreement (Klein, 1995).

A management contract is considered in general to be a "hybrid" mode of organisation: it refers to a long-term relationship, where the parties are mutually dependent, while still remaining independent companies. However, an international hotel firm that enters a management service agreement with a hotel property exercises in general high amount of control over the latter. It is important to notice that control does not usually refer to physical assets (such as buildings), but to intangible assets (such as human assets), codified assets (e.g. reservation systems) and most importantly the brand name.

12 In rare cases the franchisee is not the owner of the property, since the franchising agreement can refer to leasing of the property from the franchisor, or even a third party. The franchisee may also be a 2nd-tier operating company brought in by the owner.
The management company usually exercises a great degree of control over all these types of assets, when operating a hotel property; therefore it is suggested that the management contract form of organisation could be regarded as a “hybrid” mode that is located towards the “hierarchy” pole. Moreover, the type of contract law that characterises management contracts is the neoclassical one, since the parties in the transaction, namely the hotel (property) owner and the management company (international hotel company) are independent companies that maintain their autonomy but are bilaterally dependent to a non-trivial degree.

The organisational mode that represents “hierarchy” is company ownership, which is characterised by the implicit contract law of internal organisation, what Williamson (1996a) calls forbearance. When disputes arise between an international hotel company and the management team of a particular hotel property (that is owned and operated by the hotel company), it is the hierarchy that decides, by fiat, on unresolved issues.

(b) In terms of asset specificity

As noted in the previous chapter, a central issue in transaction cost analysis involves the notion of asset specificity; hence the parties in a transaction usually develop appropriate safeguards that best protect them against the hazards of opportunism that may arise due to asset specificity. According to Williamson (1985), protective safeguards can take one of the following forms: (i) incentive realignment, which usually has to do with some kind of severance payment or penalty for premature termination, (ii) reference to private ordering instead of court ordering, where allowance is usually made for contract incompleteness and disputes are resolved through different mechanisms, (like, for
example, arbitration) and (iii) embeddedness of the transaction in a more complex trading network, in which case the transaction is incorporated in a broader network of transactions, a fact that makes it difficult for either party to behave opportunistically in respect of that transaction.

In the case of franchising, asset specificity takes the form of sharing an intangible asset, the trademark or brand. A brand name is perhaps the most important intangible asset to protect against potential hazards of post-contractual opportunistic behaviour, since hotel companies, like any other service company, cannot depend upon a patented proprietary technology or process, as a protection against close substitutes (Flandmoe-Lindquist and Jacque, 1995).

When the international hotel company decides to expand using the franchise mode, it undertakes the risk of proprietary knowledge leakage (Hennart, 1988). The franchisee will get the guidance (e.g. training, operating manuals) that will allow him/her to operate the hotel at a high quality level, and as a result he/she may behave in an opportunistic way: when the time for negotiations over contract renewal comes the franchisee can ask for more advantageous contract terms or even refuse to renew the contract, since he has the required knowledge to operate a competing hotel. A strong brand name is an important safeguard against a franchisee’s opportunistic behaviour, since the franchisee’s interest is to stay with a well-know brand.

However, if the hotel company does not possess a strong trademark, there is the alternative of a management service agreement, in which case the daily operations reside with the international hotel firm, not with the property owner. Management service agreements can substitute in a way for the need for ownership linking between the transferor of knowledge (international firm) and the recipient (owner of the hotel property). Although local staff is required for the hotel operations, management positions are held by the “parent” company (i.e. the international hotel company); therefore the amount of tacit knowledge appropriated by the local staff is less, than in case of franchising.

Moreover, a brand name like any other intangible asset generates quasi-rents. As described by Klein, Crawford and Alchian (1978), quasi-rents exist due to a gap between an asset’s value in its current use and its next best alternative. Part of this rent is
potentially appropriable by either the franchisor or the franchisee through post-contractual opportunistic actions. If the franchisee has to invest a significant amount for building the property according to the hotel chain’s requirements, the quasi-rents potentially appropriable by the franchisor are high. If the latter decides to ask for higher fees during the renewal negotiations, the franchisee will find it in his interest to pay those fees, since the value of the building in other uses is sufficiently low in comparison to its use as part of the franchise.

Although at first glance this seems to be a franchisees’ problem, it can also become a problem for the franchisor. High risks of quasi-rents appropriation by the franchisor may create a difficulty for him to attract franchisees, since prospective franchisees may ask for higher rates of return that permit them to fully amortise the value of the specific assets over the duration of the contract. Using management service arrangements, the international hotel company can attract a property owner more easily, since in that case the hotel owner is not the only one to participate in the initial costs. Or again, it can be agreed in the contract that the international hotel company will undertake the investment needed for adapting the property to its global standards.

(c) In terms of the incentives provided by each mode

One crucial economic fact that underlies franchise contracts is that the incentives of the transacting parts do not always coincide. The free riding incentive is one type of behaviour that has been extensively analysed; it is created when franchisees jointly use the same trademark, which is valuable, as it gives the customers a kind of “quality assurance” about the product sold by different franchisees of the chain. This is where the classic externality problem arises: if one franchisee cheats on the quality of the product he will benefit from the full amount of savings from reduced quality, whereas the cost of reduced customer loyalty will be spread to each one of the franchisees (Rubin, 1978).

Usually, the formal contract agreement, (explicit enforcement mechanisms) does not suffice as an enforcement mechanism for the franchisee’s behaviour; a self-enforcement (implicit) mechanism needs to apply which is being facilitated additionally by the formal agreement (Klein, 1995). Hence, some elements of performance will be specified and enforced by an outside party, whereas other elements of behaviour will be enforced by the threat of termination of the transaction agreement (Klein, 1980).
Although it is assumed that the threat of court enforcement of the contract term is sufficient to ensure proper franchisee behaviour, this is usually not feasible, since it is not possible to specify in a legal document all the elements of appropriate behaviour nor is it easy to set exact proxies for behaviour. Such specifications and proxies are necessarily imperfect, since behaviour is complex and difficult to measure and contracts only partly cover the potential future contingencies.

Therefore, a franchise contract is usually designed to ensure proper behaviour through facilitating a self-enforcement mechanism, namely through the threat of contract termination. In that case, court-enforceable contract terms facilitate the creation of sufficient rents to the franchisee, so that the threat of termination of the relationship by the franchisor gives the franchisee an incentive to behave in the agreed way. It is important, therefore, that the contract creates a sufficient future “premium stream”, which will motivate the franchisee to perform as anticipated. The whole process requires the franchisor to monitor the franchisee continuously in order to determine if the latter follows the desired behaviour, before the franchisor decides to terminate the relationship (Klein, 1995).

According to TCE, franchising represents a high-powered incentive, since the franchisee’s compensation varies directly with unit performance. Williamson (1985) asserts that the use of high-powered incentives can reduce the administrative costs caused by direct monitoring of the employee-manager. As a result, the need for monitoring of the franchisee is reduced, since his behaviour and effort is self-enforced. The opposite is true for the manager employed through a management contract or company ownership, as he/she is driven by low-powered incentives and therefore needs to be monitored in order for appropriate effort to be assured.

In accordance with the previous analysis, the international hotel company must trade-off the costs of quasi-rent appropriation and free riding, against the benefits achieved by the use of high-powered incentives of franchising when making the decision among franchising, management contracts or company ownership for the development of a new hotel outlet. It is this trade-off, according to transaction cost theory, that leads a company to choose among owning, managing, or franchising its outlets.
4.5 Modal Choice based on Agency Theory

Agency Theory is the second theory whose basic arguments and concepts will be used for analysis of Modal Choice. Agency theory has been applied extensively in the research regarding the ownership strategy of the firm. Most of the work, however, has been concentrated on the factors that affect the decision of a firm to franchise or to own an outlet. Even fewer are the scholars whose work is focused in the service sector, not to mention the hotel sector.

Fladmoe-Lindquist and Jacque (1995) looked at the factors that determine a service firm’s organisational choice between equity-based control and franchising. Regarding the hotel industry, Contractor and Kundu (1998b) examined the firm specific and location specific variables that influence the hotel company in the decision to franchise. More recently, Erramilli et al., (2002) using a framework that was based on the organisational capabilities theory, examined the factors that influence the choice between management contracts and franchising, as entry modes in the hotel industry. These three studies (Contractor and Kundu, 1998a; 1998b and Erramilli, et al., 2002) are the only ones so far that have included management contracts as an alternative organisational form that a hotel firm should consider when planning its development strategy.

This study will address the issue of organisational choice from a different angle: it is not the question of ownership versus franchising that will be examined; what is going to be compared is the decision of an international hotel company to act as a franchisor as opposed to entering a management service agreement, or developing and operating its own hotel property.

When agency theory concepts are applied, it could be argued that management contracts have certain similarities to ownership, therefore the decision between management contracts and franchising could be based on a similar rationale to the decision between company ownership and franchising. The main reason for this analogy is that when a company uses management contracts, it faces similar advantages and disadvantages that employee-managers bring to the company when it owns the outlet.
Agency Theory provides a valuable theoretical framework that explains the optimal organisational structure for obtaining maximum performance from agents when the principal cannot easily monitor the agent's performance and where the principal and the agent have different attitudes towards risk (Eisenhardt, 1989). Since franchisees-hotel owners are compensated through residual claimancy (outcome-based compensation), on the profits of the international hotel firm, and employees-managers are usually compensated through wages (behavioural-based compensation), each is motivated by different goals and may therefore behave in different ways.

Goal conflict between principals and agents combined with conditions of uncertainty and information asymmetry create at least two basic problems: adverse selection and moral hazard. In the case of franchising, adverse selection occurs when the hotel firm is looking for suitable employee-managers to undertake the activities of new outlets. Since employee-managers are compensated mostly by behaviour-based contracts, i.e. fixed salary, there is a possibility that applicants will have an above-average tendency to overstate their competence, making recruitment particularly hazardous in conditions of information asymmetry. This information asymmetry situation requires the hotel firm to incur costs to differentiate more qualified applicants from the less qualified.

Franchising provides a way to overcome this adverse selection problem, although information asymmetry still exists between the hotel firm and prospective franchisees. (Over-) qualified franchisees have an incentive to signal their capabilities; by buying a franchised hotel a franchisee agrees to be compensated by a residual claim on the profits of that outlet. If the prospective franchisee is qualified, this residual claimancy will provide a better return than the average wage paid to an employee, whereas the opposite will be true if he is less qualified than required. Therefore, qualified individuals will consider buying a franchise as more remunerative than unqualified individuals. Consequently, franchising mitigates the problem of adverse selection and reduces the cost of determining the capabilities of outlet managers.

The second main problem an international hotel firm faces due to asymmetric information is moral hazard. In the context of agency theory, moral hazard exists when the principal cannot measure the agent's performance, and therefore cannot know whether he/she puts in the appropriate effort. When a hotel firm looks into management contracts or company ownership for its expansion, it has to take into consideration that
the use of employee-managers creates the need for more information regarding their behaviour, which implies increased costs of monitoring their effort.

On the other hand, franchising protects the firm against this moral hazard situation, since residual claimancy aligns the franchisee’s goals with those of the hotel firm, and thus motivates the franchisee to put in the required effort. This is not to say that franchisees do not need to be monitored. Agents can engage in two types of moral hazard: suboptimal effort and misdirected effort (Shane, 1996). Since employees are paid a fixed salary they may decide to put only the effort that is required to make sure that they will get paid (suboptimal effort). Additionally they have an incentive to behave in a direction that will allow them to achieve personal goals, like obtaining perks or more free time (misdirected effort).

In contrast, franchisees do not have the incentive to put forth suboptimal effort. The franchisor, though, still has to face the problem of misdirected effort, since the franchisee may decide to focus on profits at the expense of quality maintenance. Therefore franchising provides an advantage over both company ownership and management contracts, only to the extent that it reduces the problem of sub-optimal effort, since it is difficult to protect against misdirected effort.

However, it could be argued that the hotel firm could choose either the management contract or company ownership form, but still partly use residual claimancy; it could actually use a mechanism of paying salaried managers low salaries and large bonuses based on outlet profit. The counterargument that renders franchising a “better” mechanism for incentive alignment is that the purchase of a franchise outlet puts the franchisee’s capital at risk if he/she decides to shirk, creating a much larger downside risk than performance bonuses provide.

Whether the firm will decide to use franchising, management contracts or company ownership will depend on the cost of monitoring employees relative to the cost of establishing a franchise (Jensen and Meckling, 1976). Recently undertaken research has shown that when firms grow rapidly, franchising, which provides residual claimancy, is a superior mode to monitoring employees (Shane, 1996).
Expansion Strategies of International Hotel Firms

Whereas adverse selection and moral hazard are the agency problems associated with the decision of the firm to own the intangible assets of the outlets (i.e. the decision of the international hotel firm to use management contracts or company ownership for its expansion), there are also important problems that are associated with the decision of the firm to use franchising. The most crucial among them is free riding by the franchisee\(^{13}\), while inefficient risk bearing should not be ignored either.

As far as free riding is concerned, it exists when one franchisee allows quality to deteriorate\(^{14}\). Thus, a given customer is less likely to visit again a hotel of the same chain, after receiving low-quality service. While the franchisee in question benefits by the full amount of savings from reduced quality, the costs of lower quality (e.g. costs of customer dissatisfaction) is spread to all franchisees and to the franchisor who will have a less valuable brand name to franchise in the future (Rubin, 1978). Free riding also refers to the franchisee incentive to reduce costs of other inputs, like advertising, if part of the benefits goes to other franchisees.

The danger of free riding is even greater, where repeat customers constitute a small proportion of unit sales. Under these circumstances the franchisee may attract customers because of the recognised brand name of his/her hotel, but deliver inferior quality service. Such a practice may be beneficial to individual franchisees who do not rely upon ‘repeat customers’ (Norton, 1988a, Brickley and Dark, 1987).

Free riding is a problem that can be minimised, if the hotel company uses company ownership or management contracts instead of franchising. As in the case of company ownership, the employee manager has less incentive than a franchisee to offer low quality service, if he is compensated by fixed wage\(^{15}\). If certain circumstances make employee monitoring extremely costly, though, the hotel company can apply the franchise form, while using the method of area franchisee (Brickley and Dark, 1987). If

\(^{13}\) Free riding by the franchisor is also a problem, as he has an incentive to provide less monitoring and to decrease his effort towards advertising or franchisee training. However, since the current analysis focuses on the organisation decision of the franchisor, this becomes a problem only in the extent that it creates a bad reputation that makes it difficult from the franchisor to attract franchisees in the future.

\(^{14}\) Additionally, Mathewson and Winter (1985) make a distinction between what they call horizontal externalities (i.e. free riding on fellow franchisee’s effort) and vertical externalities, which refers to chiselling on the franchisor’s standards. They argue that horizontal externalities are not necessary to explain franchise contracts, since monitoring difficulties may arise for the franchisor even when there is only one territory.

\(^{15}\) However, the manager may have an incentive to provide low-quality (i.e. cheaper) service if a large fraction of his/her income is profit incentive-based.
Expansion Strategies of International Hotel Firms

one franchisee owns all of the units in a market area, a large proportion of costs and benefits of his decision to free ride will be borne by him, therefore his incentive for free riding will be attenuated.

Inefficient risk bearing is the second main problem associated with the decision of the hotel firm to use franchising as opposed to company ownership or management contracts. In comparison to other organisational forms, risk bearing of franchisees differs in two main perspectives (Norton, 1988b). First, when a management agreement is used, the risk bearing function is largely separate from operations. The employee-manager handles the daily operations, whereas the residual risk is borne by the hotel owner. In the case of a franchise agreement, however, a great amount of residual risk for local outlets is borne by the franchisees who are also closely affiliated with the everyday operations. Moreover, the franchisee has a large proportion of his wealth and income tied to the performance of the unit, hence his investment portfolio is relatively undiversified. As a result, inefficient risk bearing can lead to higher required rates of expected compensation, because the franchisee perceives that he undertakes higher risk.

In summary, it can be argued that the organisational form chosen influences the form that agency problems take and the appropriate approaches to control them. Both company ownership and management contracts create an incentive for the manager to shirk on his effort, which therefore requires the hotel company to monitor his behaviour. This monitoring is costly, since it creates the need for the management company to hire individuals to monitor employees' behaviour and to invest in information systems and procedures that improve its ability for monitoring.

Alternatively, the hotel firm can use franchise contracts, thereby making the franchisees residual claimants on the profits of the hotel. Franchising will attenuate the adverse selection and moral hazard problems, but will create incentives for free riding by the franchisee. Which organisational mode the hotel company should choose for its expansion depends on the costs associated with each form, costs that differ according to the specific circumstances.
4.6 The decision to exclude certain variables from the theoretical framework

The purpose of this section is to justify why some independent variables that are included in previous studies have not been considered in the current one. As already analysed in section 4.4., TCE provides convenient means of distinguishing between franchising and management contracts, as opposed to previous studies that have overlooked the fact that these two expansion strategies are characterised by different features that place franchising towards the "market" mode, similar to outsourcing, and management contracts towards the "hierarchy", because of the control they provide over the intangible assets of the hotel firm.

In international hotel firms, intangible assets, including brand strength, are more crucial and have higher asset specificity than the (tangible) hotel property which has lower asset specificity. Thus, leading hotel firms are primarily concerned with extracting rents from their intangible assets and the reason for wanting to own the property is to protect the rent that is derived by owning the intangible assets.

Agency Theory, as presented in the previous section (4.5.) provides additional arguments for choosing franchising over management contracts or company ownership. AT is also closely related to TCE, while other theories on which the variables excluded here are based are either (a) subsumed in TCE or (b) based on hypotheses that contradict the core principles of TCE. (For example, Organisational Capabilities Theory denies the importance of opportunism when writing or enforcing contracts, while opportunism is the main behavioural assumption adopted by the transaction cost theory.) Therefore, the independent variables that will be discussed in the following chapter are derived from TCE and AT, not any other economic or sociological theory.

Based on the literature review, other variables have been identified to influence the modal choice but are not suggested by either TCE or AT. The researcher though has to make a decision whether to include such variables in the research design. Including these independent variables might result in a model which explained more of the variance in the dependent variable, than a model which omits them.
Expansion Strategies of International Hotel Firms

However, the word “explanation” needs to be treated with caution, since in the former case the independent variables in question do not form a part of a coherent theoretical framework. The omission of these independent variables may result in a model that explains less variation but what we will have is an explanation that is part of a robust and coherent theoretical structure. It is often asserted in the philosophy of science that parsimony or simplicity is a virtue in an explanatory theory (Rosenkrantz, 1997). There is a trade-off to be made between including additional independent variables with the aim of increasing the explanatory power of the model and maintaining the theoretical coherence of that model. In the present study, theoretical coherence is a major concern. TCE and AT are closely related (Williamson, 1996; ch.7) and together form a coherent theoretical basis for the study.

The first variable that will not be examined in the context of this study is cultural distance. Cultural distance between the home and host country is a variable that is usually considered to be important, and is thus examined by most of the empirical studies on entry mode decisions. However, it has to be noted that the construct used in the majority of the previous studies, namely Hofstede’s Model, has been questioned and criticised, in some cases very strongly (Hampden-Turner & Trompenaars, 1997; McSweeney, 2002a and 2002b; Sondergaard, 1994).

Undoubtedly, cultural distance exists between different nations. The question is why we would believe that national cultural differences can explain part of the modal choice decisively. Most of the studies so far found no relationship between cultural distance and the decision on organisational form. Additionally, studies in the hotel industry (Contractor and Kundu, 1998a, 1998b; Erramilli et.al. 2002; Zhao and Olsen, 1997) did not confirm a relationship between cultural distance and the decision of a hotel company on how to expand.

In addition, it is quite difficult to accommodate cultural distance in the TCE framework. There are other country-specific variables that accommodate the issues of uncertainty and information impactedness which are included and examined in the study (e.g. country political and economic risk and level of economic development). For all these reasons presented above, it has been decided that the variable “cultural distance” will be excluded from the theoretical framework.
A second factor that is considered to influence the corporate development decision, but will not be included in this study, refers to the level of foreign direct investment (FDI) in the country under examination. However, it can be argued that the effect of the degree of foreign direct investment in a particular country is similar to the effect of country politico-economic risk: lower levels of FDI indicate higher levels of risk, and in some other studies the hypothesis has been examined that a hotel company would in such circumstances prefer to use a hierarchical mode of expansion (as will be explained in the first hypothesis).

In their studies, Contractor and Kundu (1998a and 1998b) did test a hypothesis regarding the effect of level of FDI on the entry mode decision, but did not find support for a positive relationship between a country's ratio of FDI to GDP and the propensity of the hotel firm to use company-run operations (i.e. equity based operations). Furthermore, Terpstra and Yu (1988) suggested that US advertising agencies follow their customers abroad but they did not make any distinction regarding the degree of ownership of foreign operations. Thus, the degree of FDI penetration in a host market is a variable that will not be examined as such in this study.

Finally, "host" market size and growth potential are factors not quite relevant to this study, and therefore will be excluded. In the entry mode literature, market size is one of the main variables that influence the modal choice of the international firm (Agarwal and Ramaswani 1992, Terpstra and Yu, 1988). It is suggested by the previous literature, that the higher the market potential (size and growth) of the target country, the greater the long-term profitability to an equity-based company, compared to contractual arrangements.

In this study, equity ownership per se is not of interest. Rather, as explained in section 4.1, what is of interest is the positioning of a new hotel unit in terms of the market-hierarchy axis. From this perspective, equity ownership and the holding of a management contract are both representative of "hierarchy" while franchising is representative of "the market". Moreover, the holding of a management contract is frequently accompanied by an equity holding in the property by the management company. Thus, while market size and potential might help to explain the choice between equity-based modes and other modes, this choice is not the main focus of this study. This study therefore does not include "host" market size and growth among the independent variables.
4.7. Empirical Evidence from the Service Sector

Although there has been extensive research regarding the choice of organisational mode in general, as well as the choice between franchising and company ownership in particular, only limited research has been conducted as far as the service sector is concerned. Moreover, most of the scholars' interest so far has been directed towards the entry mode decision, and as a result location-specific factors have attracted their attention as influential variables.

Boddewyn et al. (1986) analysed the entry mode choice of multinational service firms. They suggested that service firms rely more on licensing and management contracts, as opposed to manufacturing firms which utilise more foreign direct investment. Additionally, Li and Guisinger (1992) argued that service firms are characterised by unique features that should be taken into consideration, when their international behaviour is analysed. These characteristics refer mainly to the simultaneous production and consumption of some services and to the need for adaptation of the services to local customer taste, which usually requires more effort that in the case of manufacturing products.

Dunning and McQueen (1982) used the 'eclectic paradigm' to examine the international hotel chains with respect to their foreign involvement. The authors argued that international hotel chains prefer to use non-equity forms of organisation for their overseas expansion and identified four categories of involvement: equity interest, leasing agreement, management contracts and franchise or some form of marketing agreement (e.g. reservation systems).

Fladmoe-Lindquist and Jacque (1995) used agency theory and transaction cost economics as their theoretical grounding for their study on control modes used by U.S.-based service firms. Their results indicated that the propensity to franchise internationally is positively related to monitoring costs associated with geographical and cultural distance between franchisor and franchisee, the franchisor's international experience and the degree of the host countries' uncertainty, but negatively related to the service firm's level of brand name asset specificity.
Focusing on the hotel sector, Contractor and Kundu (1998a) worked on the factors that influence the international hotel company's choice of entry mode between company ownership, joint ventures, franchising and management contract. They suggested that, higher equity and control modes were preferred by companies with longer international experience and geographic reach, whereas contractual modes were used in risky nations. In emerging economies, companies prefer high equity modes, since these nations are characterised by higher growth rates and weaker competition, a combination that leads to higher returns (when an equity mode is chosen). They also concluded that, as opposed to the empirical evidence from the manufacturing sector, high equity and control modes were not seen as crucial for large global hotel operations.

Furthermore, in their study regarding franchising versus company ownership as a mode of business expansion, they proposed that franchising is directly related to the level of the host country economic development, the importance of the company's global reservation system (codified assets) and brand name, and indirectly related to the company's experience and extent of global coverage (Contractor and Kundu, 1998b).

Kehoe (1996), tried to explain why three organisational modes in question coexist in the hotel industry, deriving his arguments mainly from agency theory. He concluded that a plausible explanation for the existence of management agreements is based on the availability of low cost capital from non-chain sources, and thus this form would be chosen over company ownership in the case of hotel properties with large capital inputs.

More recently, Dimou (2003) using arguments based on transaction cost economics and agency theory, provided a theoretical framework that identified the factors that influence the choice between the two non-equity modes of development, namely management contracts and franchising. Finally, Erramilli et al. (2002) looked at the same issue, although from a different theoretical angle. Using the Organisational Capabilities perspective they developed a framework for choosing between management contracts and franchising. They, moreover, tested their propositions and confirmed that foreign entrants choose a non-equity mode that offers effective transference of the firm’s capabilities to the host country venture.
4.8. Conclusions

In this study, Transaction Cost Economics and Agency Theory are going to be used for the development of testable hypotheses regarding the choice of organisational mode, since both have been proven to provide a robust theoretical background for this area of research. The author’s research interest is particularly focused on the factors that affect an international hotel firm’s decision to expand using one of the most common modes of development, namely franchising, management contracts and company ownership.

At the same time, using theoretical arguments from both TCE and AT, it is suggested that a management contract is an organisational mode that presents more similarities to company ownership than to franchising, in contrast to what previous studies have argued; indeed, previous researchers considered management contracts and franchising as contractual arrangements that have similar features, namely the characteristics of the “hybrid” mode of organisation (Contractor and Kundu, 1998a; 1998b).

Although at first both franchising and management contracts seem to provide a company with similar advantages and disadvantages, it has been suggested in this chapter that there are important differences between them, regarding the degree of control they provide to the company. Under management contracts the operator maintains ownership and control of the intangibles, including transaction-specific assets, such as pre-opening costs, as well as non-specific codified assets (e.g. computer reservation systems). Under franchising the right to use these intangibles is acquired by the franchisee as part of the franchise “package”. The franchisee incurs the transaction specific pre-opening costs and staff training costs, but gets the opportunity to free-ride on the codified assets, hence franchisor’s need to monitor.

In this chapter, an analysis of the modal choice has been provided. More specifically, a comparison among the three most common modes of development has been presented, using a theoretical justification that derives from two economic theories, i.e. transaction cost economics and agency theory, in order to identify under which circumstances an international hotel company should choose each of these expansion modes. The last section provided an overview of the few published studies that examine the entry mode decision in the service sector, in general and in the hotel industry, more specifically.
5.1 Introduction

A central issue regarding hypothesis formulation in this study is that franchising will be regarded as the “default” choice, i.e. is considered to be normally the preferred option, while the alternative choice is the use of a hierarchical mode of development, i.e. management contracts or company ownership. The reason why franchising is regarded as the default choice is that it represents the “market” mode, whereas management agreements and company ownership represent the “hierarchy” mode\textsuperscript{16}.

According to transaction cost economics, one needs to consider using a hierarchical mode only when the “market” mode of organisation becomes more costly to use. In situations where asset specificity and uncertainty are high, the cost of using the “market” becomes higher than the cost of applying a hierarchical mode. Therefore, in the context of this study, a management contract or company ownership should be favoured over franchising when certain conditions render the latter more costly.

As mentioned previously, in the context of this study, management contracts are considered as a mode closer to “hierarchy” because, when used, they provide the international hotel company with high degree of control over operations and intangible assets, similar to the control that results from the use of company ownership. However, although both management contracts and company ownership provide the hotel company with similar degree of control over the everyday operations, it has to be admitted that (equity) ownership offers stronger control over tacit knowledge and intangible assets. Moreover company ownership offers full control over the physical assets (the hotel property) as well, while in the case of management contracts this type of control is quite limited.

Therefore in the analysis that follows, management contracts are not always treated in the same way as company ownership; it will be clear that while some of the independent...
variables are influencing the choice between “market” and “hierarchy” (i.e. between franchising on one hand and management contracts or company ownership on the other), other variables create a modal choice among three alternatives, namely the market mode (i.e. franchising), the semi-hierarchical one (i.e. management contracts) and the hierarchy mode (i.e. company ownership).

As will be explained in a subsequent section, two models will be applied regarding the empirical testing of the hypotheses: a one-stage and a two-stage model. In the former model it is assumed that the expansion decision is made in one stage, where all the available alternatives are considered (in this case company ownership, management contracts and franchise agreements). In the two-stage model, hotel executives first choose between high- and low- control modes, i.e. between franchising and “non-franchising” and at the second stage a choice is made between the two high-control modes, i.e. management contracts and company ownership.

5.2 The independent variables included in the theoretical framework

On the other hand, the factors that are going to be considered in this research are the following: (i) location-specific: politico-economic (location) risk, legal (property rights) risk, (which is referred to as country risk in the previous literature), and level of economic development of the market (country) under consideration, and (ii) firm-specific: firm size and firm growth, firm’s international experience, firm’s proprietary content and geographical concentration of the firm’s hotel properties.

What needs to be clarified at this stage, is that in the context of this study the unit of analysis will be the hotel brand instead of the hotel company. The reason is that most hotel companies own or operate more than one brand, and these brands are usually located in different market segments of operation (i.e. budget, mid-market or upscale). As it will be explained later in this chapter, hotel brands that operate in different market segments (i.e. budget, mid-market, upscale) are characterised by different levels of asset specificity and idiosyncratic knowledge, and thus have a different strategic behaviour.

\[16\] In fact management contracts represent a “hybrid” mode. However, as has been extensively discussed in previous sections, MCs in the hotel industry have certain characteristics that locate them close to the
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with respect to their corporate development. Although the unit of analysis will be the brand, the terms brand and firm will be used interchangeably in this study.

5.2.1. Location (Country) - Specific Factors

a) Location (Country) Risk

There is a great amount of literature on entry mode that focuses on the influence of country risk on the entry mode choice (Anderson and Gatignon, 1986; Erramilli, 1990; Erramilli and Rao, 1993; Gatignon and Anderson, 1988). Basically, country risk refers to the degree of environmental uncertainty i.e. the extent to which a country’s political, legal and economic environment threatens the stability of a business operation. In the context of this study, we refer to risk of the target market as location risk, not country risk, since we examine not only the entry mode decision with respect to a “foreign” country, but also the company’s decision to undertake new operations in both “foreign” and “domestic” markets.

Previous researchers have examined the influence of location risk on the choice between ownership and franchising, or equity modes and contractual arrangements. Gatignon and Anderson (1988) proposed that equity investment is negatively related to country risk, while Agarwal and Ramaswani (1992) suggested that entry modes with lower resource commitment would be favoured in high-risk countries. However, in their study of several service sector firms, Fladmoe-Lindquist and Jacque (1995) could not provide any evidence of relationship between currency (economic) risk and franchising, and moreover the relationship between political turmoil and franchising was found to be opposite to that expected. Also in the hotel industry, Contractor and Kundu (1998b) found no support for the relationship between country risk and mode of entry.

The first dimension of market uncertainty that is going to be examined in this study is **politico-economic** uncertainty. Political risk arises due to the likelihood of unexpected changes in governmental policies from a friendly to an unfavourable attitude, and also when the political regime is characterised by turmoil. It also refers to the restrictions

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17 By new market we refer to a new geographical market, as well as a new product/service market in an existing geographical market.
concerning the ownership and control of corporate assets, as well as repatriation of profits, interest and royalties. Economic uncertainty refers to currency risk arising from fluctuating exchange rates (between the currency in the country where the hotel company is based and the country where a hotel property is located), which may result in reduced income for the international hotel firm. It also includes situations of local demand variability, where the international hotel company cannot assess whether low performance is caused by low demand in the local markets or lack of managers’ effort.

Transaction cost theory considers external uncertainty as one of the reasons for undertaking a transaction under the hierarchy mode (Williamson 1975, 1985). Yet it is recognised that environmental factors, such as uncertainty, need not alone impede market exchange; it is the combination of uncertainty with asset specificity that causes the “market” to fail (Williamson, 1991). Hence, it is argued that environmental uncertainty itself favours the use of market modes, the reason being that in situations of high uncertainty, higher equity and control modes (hierarchical modes) incur higher switching costs (e.g. exit costs) in case undesirable events occur (Gatignon and Anderson, 1988), and thus a more “flexible” form of organisation (i.e. a low equity ownership mode) is required. Therefore, when there is a high degree of political/economic risk in a potential market, the hotel company should consider a mode of expansion that will allow for flexibility, (i.e. a “switchable” form).

The development modes that are examined here are company ownership, management contracts and franchise agreements. Previous studies suggested that both management contracts and franchise agreements allow for similar degrees of flexibility in comparison to equity ownership. However, in this study it is argued that franchising is a more “flexible” form of organisation than management contracts. Although the latter do not involve the need for high investment, nevertheless, there is still a non-trivial need for resource commitment, i.e. investment in transaction-specific assets, such as managerial staff and staff training, personnel transfer from one country to another, cost of acquiring local information, pre-opening costs and cost of redecoration/refurbishment.

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18 The term flexibility, as used here, has a different meaning from the one that is employed by Williamson (1985, 1991). Williamson contends that flexibility is an advantage of hierarchical organisation, as it allows for adaptation to repeated disturbances.
According to Eyster (1993) and Sangree and Hathaway (1996), management operators’ equity contributions, often in terms of technical services (e.g. architecture, interior design and lighting, food facilities layout and equipment) and pre-opening management assistance (e.g. personnel training, operating systems installation and marketing) have considerably increased during the last decade, compared to what used to be the practice in the 1980s. Moreover, one important finding of Eyster’s (1997) research on management contract terms, was that hotel operators were required to contribute additional pre-opening management fees and/or cash to build a certain equity percentage. The operator equity percentage was found to range from as low as 3 percent up to 50 percent of total equity, however the median was 8 percent.

When it comes to franchising, the amount of resources required for the company’s expansion is significantly reduced, since the marginal cost of adding a franchised outlet to the chain (including training and provision of operating manuals and assistance) is quite low. Franchising represents the low asset-specificity mode, since the franchisor is trading assets already at hand (sunk costs) instead of investing in new and specific assets. Moreover, franchising lowers the cost of acquiring knowledge about local markets, since the company does not have to invest resources to learn about local input suppliers, marketing strategies, consumer preferences and labour market. Search cost theory emphasises the role of franchisees as searchers for information (Minkler, 1992). The acquisition of information may be quite costly and is likely to increase when the unfamiliarity and the political and economic risk in a local market increases.

It has to be admitted that the expected negative impact of politico-economic risk on the use of management contracts is not so strong as in the case of using company-owned outlets; the level of investment is higher in the latter case, and it is more difficult for the hotel company to withdraw its operation from a risky market when the hotel properties are owned. Yet it could be argued that, although management operations imply less investment than company ownership, this investment is high enough to discourage the use of management contracts and dictates a low-specificity mode, i.e. franchising (ceteris paribus).

Agency theory leads to similar predictions regarding the choice of organisational form under environmental uncertainty. More specifically, the theory predicts that franchising would be the preferred mode of organisation in risky markets, since the adverse selection
and moral hazard problems are mainly taken on by the franchisees (Norton, 1988a; Martin, 1988). In risky markets there is a greater possibility of higher demand variability. When demand is not stable the agency costs of monitoring managers rise, because principals cannot cheaply distinguish shirking from low demand (Norton, 1988a). Under the franchising mode, the hotel firm does not need to invest in time and money to identify suitable potential employees or to establish outcome measures for assessing their performance, as would be the case under a management contract (or company ownership).

Finally, franchising would be the preferred mode over a hierarchical mode, in markets that are characterised by demand variability situations, because franchise fees are linked to hotel turnover not profits (Fladmoe-Lindquist and Jacque, 1995). Sales are less volatile over the business cycle compared to profits. However, when it comes to a comparison of franchising with management contracts, this argument is not necessarily valid; it depends on the management contract fee structure. In most situations management contract fees are calculated as percentages of both gross revenues and operating profits (Eyster, 1993). During the last decade, there has been a considerable decrease of base fees, i.e. fees based on turnover, in favour of incentive fees, i.e. fees calculated as a percentage of gross operating profits (Eyster, 1997; Jones Lang LaSalle Hotels, 2001). As a result management fees are considered to be considerably more volatile than franchise fees (since the latter are based solely on the hotel’s turnover) and less volatile than returns from ownership, since the latter are related to profits rather than revenues.

It can thus be concluded, that in markets characterised by a high degree of political and economic instability, hotel firms would be more likely to opt for a lower resource commitment organisational mode of development, which would allow for lower switching costs and less volatile rents in the presence of undesirable situations. Therefore, it is suggested that under these circumstances, franchising rather than company ownership or management contracts would be the preferred mode (i.e. the default mode should be chosen).

It has to be noticed at this point, that franchising is the default choice and thus the preferred choice (other things being equal) not only in situations where the country risk is relatively high, but also in situation where the risk is low. Yet, the point of this
hypothesis is that although franchising would be the preferred expansion mode in low-risk situations, the tendency to use this mode is even higher in moderate- and high-risk countries. Hence the first hypothesis:

**H1:** There is a negative correlation between location political and economic risk and propensity to use higher control modes (i.e. company ownership or management contract) in a hotel property (as opposed to franchising).

The second dimension of location uncertainty that will be examined refers to legal (intellectual property rights) risk. In the context of this study, legal risk refers to both local regulations and policies regarding trademark and intellectual property rights protection, as well as to court enforcement. The less developed the legal system of a host country, the weaker is the protection of intellectual property and brand names and the more difficult is contract enforcement.

However, brand name protection is of great importance to international hotel chains and the use of franchising entails the risk of quality debasement, thus jeopardising the reputation of the hotel company, especially in the local market. If the franchisee behaves in an opportunistic way, by deciding to become a competitor, he/she might apply the knowledge and operating procedures provided by the franchise system. Management contracts do not entail this risk, since the middle and senior management team is employed by the operator, and thus it is more difficult for the local employees to re-deploy the company’s standards and procedures. Finally, protection of brand name and idiosyncratic procedures reaches the highest degree when internal organisation (company ownership) is employed.

Therefore, the hotel company would prefer to expand using franchising in markets that are characterised by low legal risk, where the termination of an unsatisfactory franchise agreement would be easier and less costly and company ownership or management contracts in markets with less advanced legal system.

**H2:** There is a positive correlation between a market’s legal (intellectual property rights) risk and the propensity to use higher control modes (i.e. company ownership or a management contract) in a hotel property (as opposed to franchising).
b) Level of economic development

Recent studies regarding entry mode decisions in the hotel industry have suggested that lower control modes of development are preferred in more economically developed nations (Contractor and Kundu 1998a and 1998b). More specifically, those studies examine the relationship between the level of economic development in “host” countries and levels of equity and control when entry mode is considered. The authors suggest that the more developed a nation in economic terms, the higher the hotel firm’s inclination to use contractual modes of development, as opposed to equity ownership. While in the previous studies, high control modes usually imply high company ownership, in the context of this research high control modes are represented by both ownership and management agreements, and franchising is considered to be the low control mode of expansion.

Transaction cost theory provides several arguments that could support a negative relationship between the level of development in a target market and the degree of control. The first argument refers to the transaction costs incurred when tacit knowledge is transferred from a particular market to a less developed one. International hotel chains usually need to transfer specific knowledge and expertise when a new hotel is about to operate in a different market. The population’s educational level in developing countries is considered to be relatively low, and thus prospective franchisees are usually characterised by lower absorptive capacity, a situation that implies higher costs of adaptation and knowledge transfer.

Williamson (1975) refers to those situations by the term “information impactedness” and argues that such conditions tend to favour “hierarchy” over the “market”. Therefore company ownership or management contracts would be favoured over franchising in less developed markets, since it would allow the international hotel firm to supervise and control more closely the transfer of knowledge and the proper use of its codified assets (e.g. reservation systems, operating procedures).

Another argument, which is put forward by the internationalisation theory as well, refers to the relationship between economic development and level of returns from equity ownership. More specifically, it is suggested that there is a negative relationship between economic development and high ownership/control modes. The reason is that emerging
markets are characterised by weaker competition, faster growth and thus higher returns from equity ownership than from franchising, while management agreements are located in between the two in terms of returns, since management fees are derived as a percentage of both revenues and profits.

H3: There is a negative correlation between the level of economic development of the target market and the propensity to use a higher-control mode (management contract or ownership) in a hotel property (as opposed to franchising).

5.2.2. Firm-Specific Factors

Whether a hotel firm will choose to own, franchise or enter into a management service agreement as a means of corporate development, also depends on firm-specific factors. Research undertaken in various industries has revealed a range of variables that could influence this decision, variables that may differ according to the specific industry under examination. In this research the factors that will be examined are: firm size and growth, international experience, proprietary knowledge and geographic dispersion of hotel properties.

a) Brand Size and Brand Growth

The previous literature offers contradictory findings regarding the relationship between firm size and decisions for expansion. Larger and more experienced firms were found to opt for higher equity entry modes (Agarwal and Ramaswami, 1992). On the other hand, in the hotel industry, Contractor and Kundu (1998a and 1998b) suggested that larger hotel companies would choose lower control modes for their foreign operations. More specifically, regarding the choice between franchising and company ownership, Contractor and Kundu (1998b) concluded that larger hotel companies would have a greater likelihood of using franchising as an entry-mode.

More interestingly, Shane (1998) identified a curvilinear relationship between firm size and mix of franchised and company owned outlets and proposed that this mix is very different for large and small franchise systems. On the other hand, Lafontaine and Shaw (2001) argued that the proportion of company-owned outlets decreases during the first
few years after a company first engages in franchising, but a stable mix of franchised and company outlets is maintained after this period. Azevedo and Silva (2001) also confirmed a stable ownership mix in their study of Brazilian franchisors.

The basic argument in the internationalisation literature is that integration requires higher resource commitment and poses greater risks than a non-equity mode; therefore, larger firms are more likely to go for a high-control form of organisation, whereas smaller firms would prefer to expand using a lower-control mode, such as a minority equity (joint venture) or non-equity mode. However, according to transaction cost economics, it is not the firm size per se that determines whether to contract out or integrate; it is the characteristics of the particular transaction that influence the decision of a small or a large firm to integrate or not. High asset specificity firms would be willing to bear the additional costs of integration (corporate ownership), regardless of their size, whereas firms characterised by low degrees of asset specificity would not be willing to bear those costs, and would opt for an equity-based mode e.g. joint venture, or a contractual mode, e.g. franchising or management contract (other things being equal).

In the context of international hotel companies, asset specificity takes the form of brand name and associated knowledge-based assets, which characterises both small and large firms, although to a different extent. Therefore, in the context of this study, it could be argued that transaction cost economics do not provide any theoretical arguments for the effect of firm size per se on the corporate development decision.

Agency theory on the other hand, provides significant reasoning regarding the influence of firm size on the modal choice. The theory suggests that adverse selection and moral hazard problems grow as a firm becomes larger, therefore the larger a firm is the more likely it would prefer to use franchising as opposed to an ownership mode for its expansion. Moreover, whereas managers' effort needs to be monitored by frequent direct on-site monitoring, franchisees' free riding on quality can be prevented by other means than monitoring, such as quality provision in the contract, minimum required level of input use (e.g. advertising) or multiple ownership by the franchisee, i.e. master franchising (Brickley and Dark, 1987).

While larger brands would favour the use of franchising, a small brand on the other hand would use company-owned outlets to signal the value of its intangible assets (Gallini and...
Lutz, 1992). By investing in its own operation a new franchisor provides a credible commitment to the value of those operations. As the system grows, though, the value of its intangible assets becomes better known, reducing the need for the company-owned-outlet signal (Lafontaine, 1992; Scott, 1995).

In addition to the above arguments that compare franchise agreements to company ownership, one also needs to identify how management contracts influence the corporate development decision of large versus small firms. The signalling argument could equally be applied as a supporting argument for the use of management contracts over franchising, since small companies could very well use managed outlets to signal their quality level. These companies are usually run by capable individuals who used to be successful managers in high-quality hotel properties or ex-managers in well-know hotel brands. These individuals gather their know-how and experience and form small companies that offer management service agreements to national and international hotel firms. In order to attract hotel companies they may offer their services at a lower cost than a well-known management company. After a reputation for maintaining a certain level of quality has been established, these companies could aim for a proportion of franchised outlets, which over time can increase compared to the managed outlets.

Additionally, small hotel companies would choose to use management contracts, since small companies are usually young companies without an established brand name. A company that does not yet have a well-known brand name has difficulty in attracting franchisees, whereas it is easier to attract potential investors/property owners by offering better terms compared to traditional operating hotel companies. When the company becomes larger it acquires broader brand recognition, and thus finds it easier to attract franchisees. Overall, it is proposed that small brands would prefer to use either management contracts or company ownership as means for corporate development, as opposed to larger brands that would opt for franchise agreements. Hence the following hypothesis:

**H4: There is a negative correlation between hotel brand size and the proclivity to use a higher control mode (management contract or company ownership) in a hotel property (as opposed to franchising).**
Yet, an issue that is not easily identifiable when the relationship between brand size and mode of corporate development is examined, is whether a company uses a particular mode because of its size, or whether size is a result of using this organisational mode for expansion. Hence, in the context of this study, one has to be careful when testing a hypothesis regarding the relationship between brand size and franchising. One should be cautious when suggesting that franchising is used by larger brands because they are larger, since it could be that those brands became larger due to the extensive use of franchising for their expansion.

Since the relationship between brand size and choice of organisational mode is still ambiguous, one could additionally examine the relationship between brand growth rate and corporate development, which has not been tested in the hotel industry so far. Previous research in other industries has suggested that when brands use franchising, they grow faster than when they use company ownership (Carney and Gedajlovic, 1991; Shane, 1996).

Transaction cost economics provides an interesting argument regarding the relationship between brand growth and the use of franchising; it is suggested that franchisees may become vulnerable to franchisor opportunism if the system remains stagnant or presents negative growth (Klein and Saft, 1985). The reason is that if the franchise system cannot grow any further, the franchisor may have little incentive to comply with his obligation regarding the required inputs (e.g. advertising or quality monitoring across franchisees). Reduced effort on behalf of the franchisor could lead to brand name devaluation with a twofold effect: sell back of outlets by existing franchisees and refusal of potential franchisees to join the system, since they anticipate opportunistic behaviour on the part of the franchisor.

Minkler and Park (1994) tested the relationship between negative growth (i.e. shrinkage) of franchise systems and number of company-owned outlets in the system, yet their results did not confirm a positive relationship between shrinkage of the franchise system and increased use of company-owned outlets. On the contrary they found that firms with positive growth (rather than firms with negative growth) tend to favour the use of owned outlets as opposed to franchised ones. However, since previous research, along with the theory suggests a positive relationship between growth and franchising, the hypothesis
that will be tested will propose that the faster a brand is growing, the more likely it is that franchising is the prevalent mode of development:

**H5: There is a negative correlation between the hotel brand’s growth rate and proclivity to use higher control modes in a hotel property (as opposed to franchising).**

**b) International Experience**

The effect of a firm’s international experience on its decision regarding the mode of entry or expansion is also controversial. The traditional argument in the FDI literature, which so far focuses mainly on the manufacturing sector, suggests that an inexperienced firm will start its penetration into a new market using non-equity forms, such as exporting or licensing, and as it gains experience it will move to higher control modes, i.e. joint ventures or company ownership (Agarwal and Ramaswami, 1992; Gatignon and Anderson, 1988 and Terpstra and Yu, 1988). A positive relationship between degrees of control and international experience has also been suggested by the more recent study in the hotel industry as well (Contractor and Kundu 1998a). On the other hand, there are studies supporting the opposite direction of the relationship. Fladmoe-Lindquist and Jacque (1995) concluded that service firms are more likely to franchise when they have gained international business experience.

Transaction cost theory suggests that lack of international experience causes high organisational uncertainty, which renders monitoring and performance measurement of employee/managers quite difficult and costly. Due to high costs of monitoring a subsidiary or affiliated investment, the inexperienced (manufacturing or retail) firm would prefer to start with a contractual mode, such as exporting, and then move to higher control modes. Although exporting involves the use of an agent in the host market, and thus raises the issue of monitoring his performance, it still provides a more efficient alternative than franchising or joint ventures. Compared to franchising, it involves less concern about quality assurance and easier monitoring of performance due to less opportunities for free-riding, while compared to joint ventures it requires less capital investment and provides a simpler method of gathering knowledge.
These arguments have been confirmed by previous research (Arderson and Gatignon, 1986; Gatignon and Anderson, 1988). However, while this might be the case in the manufacturing or even the retail sector, most consumer services (e.g. a hotel firm) are site-dependent and cannot use exporting to learn about potential partners and foreign practices (Fladmoe-Lindquist and Jacque, 1995). In this study, it will be argued that a hotel brand with limited international experience would use a high-control mode of development for the following reasons. As explained above, franchising presupposes a heavy investment in sunk costs, in order for the franchise package to be “built”, which usually requires experience to extend internationally. Moreover, more experienced brands accumulate international brand name recognition and may become more desirable as franchisors (Scott, 1995). Last but not least, a hotel company with limited international experience may find it more difficult to attract and select qualified agents (i.e. franchisees), as well as to assess their performance, than to employ staff and monitor its effort, and therefore may prefer to opt for a more hierarchical (high-control) mode. Hence, the following hypothesis:

\[ H6: \text{There is a negative correlation between international experience of a hotel brand and the propensity to use a higher-control mode in a hotel property (as opposed to franchising).} \]

c) Proprietary Content (Market Segment of Operation)

There are two main reasons why market segment of operations influences the decision of a hotel company to use a hierarchical mode of development (i.e. management contract or company ownership) as opposed to a franchise agreement. The first one is derived from the transaction cost literature and refers to the level of proprietary content that characterises the service provided by the international hotel company, as well as the investment in specific assets. The second one has been extensively analysed and empirically tested mainly by agency theorists and concerns the value of the brand name and more specifically the importance of maintaining the brand name quality for the success of the business. The analysis hereafter will provide an explicit reasoning why these two arguments jointly provide the justification of the market segment variable, rather than being two distinct hypotheses that should be tested separately.
According to the first argument, international hotel chains (in their upscale outlets) usually provide highly idiosyncratic services, which are characterised by specialised know-how, high levels of professional skills and managerial expertise, and also services, which require the use of codified assets, e.g. central reservation systems. Services that require professional skills are usually associated with significant human investments. According to transaction cost theory (Williamson 1985), high asset specificity is considered as one of the main features of a transaction that favours “hierarchy” over the “market”. Therefore, the greater the specialised know-how characterising a service, and the required investment in human and high-specific physical assets, the more likely it is that a hierarchical form of organisation will be used for the provision of that service.

Moreover, the transfer of specialised know-how and idiosyncratic knowledge faces the additional problem of “information impactedness”, which also tends to favour “hierarchy” over the “market”. According to Williamson (1975) “information impactedness” refers not only to information asymmetry between the two parties of the transaction, but also to the high costs of achieving information parity, the proclivity of the parties to behave opportunistically and the small numbers contracting situation developed due to the distribution of information among the parties (Williamson 1975, Ch.2).

There is some evidence that firms exert more control as proprietary content increases, but none of this evidence refers to hotel firms or even service industries in general. More specifically, Anderson and Coughlan (1986), in their study of wholly owned versus independent distribution channels of US semiconductor manufacturers, found that high control is often employed for technically sophisticated products, which tend to have higher proprietary knowledge content. Furthermore, Gatignon and Anderson (1988) concluded that proprietary content (measured via R&D expenditure) influences the decision whether to vertically integrate or not, but does not influence the decision as to what type of partnership to select (majority or minority JV), if full ownership is not the preferred mode.

In the context of this study, where the decision between a franchised and a managed or owned outlet is examined, if a hotel firm wants to exercise more control when transferring its specialised knowledge to a new property operation, it would rather own the property or enter a management contract than use a franchise agreement. At this
stage, it will be argued that high proprietary content is not a characteristic of hotels in all market segments; hotel brands placed in the upscale and deluxe market are characterised more by specialised staff and knowledge than hotel brands operating in the budget segment. The reason is that service is usually more basic in the "lower" categories, i.e. budget and mid-market segment, than in upper categories, i.e. upper market and deluxe.

On the other hand, when it comes to "lower market" categories, the features of services provided and the required skills can be codified and transferred using operating manuals, and staff training is also more feasible, therefore franchising can be easily applied. Accordingly, the provision of service in the "upper market" categories requires more training and higher skills than in "lower" categories, a fact that renders the transfer of knowledge more complicated and difficult in the former categories than in the latter.

The lower market segment of limited service units requires a set of standard operating procedures from which there is no reason to deviate, because the service is limited. The upper market segment has its standard operating procedures, but because of the level of more personalised service being offered, staff have to be trained to use their discretion in dealing with guests in individual situations so as to achieve that level of service. This type of knowledge cannot be reduced to standard operating procedures which can be "sold off" as franchise packages, and requires front-line staff of the appropriate quality who can understand the training and apply it intelligently so as to uphold the quality image of the brand (proprietary content, tacit knowledge, information impactedness).

Another reason why hotel companies that operate in the upper and deluxe market would prefer to expand using a hierarchical mode instead of franchising may be connected with quality assurance and free riding issues. Quality assurance is one of the main concerns of every service firm; therefore hotel companies consider quality maintenance as one of the most important issues when a decision for expansion has to be made. High-control modes of expansion are considered to entail less risk regarding quality depreciation.

According to transaction cost theory, when the same brand name is used jointly by many franchisees, the classic externality problem arises: if one franchisee cheats on the quality of the product he/she will benefit from the full amount of savings from reduced quality, whereas the cost of decreased customer loyalty will be spread to each one of the franchisees (Williamson, 1985). Transaction cost theory suggests that when the value of
a brand name is great, there is a high potential for free riding, therefore higher degrees of control are more efficient (Klein, 1980).

Agency theory leads to a similar reasoning: the franchisee has an incentive to free ride on input quality and consequently to pass the costs associated with lost customer confidence to other franchisees in the system and to the franchisor who will have a less valuable trademark to franchise in the future (Brickley and Dark 1987; Caves and Murphy 1976). On the other hand, managers of a company-owned outlet have less incentive than a franchisee to provide cheaper and lower quality services, since they derive no financial benefit from “cheapening” the quality if they are compensated by a fixed salary. Even if they have a profit-related bonus, any financial benefit from increasing profit by “cheapening” quality will be limited, while customer complaints could cost them their jobs.

The danger of free riding is even greater in locations where repeat customers constitute a small proportion of unit sales, e.g. motorways, or tourist areas (Brickley and Dark 1987, Carney and Gedajlović 1991, Norton 1988a). Under these circumstances the franchisee may attract customers using an established brand name, with reputation for high quality service, while providing inferior and cheaper service. Such a practice may be beneficial to franchisees that do not rely upon repeat customers. Therefore, the international hotel firm will be more concerned about free riding on its brand name in locations where its clientele consists mostly of non-repeat customers.

Agency theory provides an additional reason that justifies the existence of company-owned outlets, when quality assurance is of great importance to the franchise system, and that is the franchisor’s free riding. Lafontaine (1992) and Scott (1995) have identified two factors that influence a franchisor’s incentives to monitor and maintain quality across outlets, the percentage of royalty rates and the operation of company owned outlets. When there is a mix of franchised and company owned outlets, it is in the franchisor’s best interest to take all the steps required to maintain the expected quality levels within the brand. “The interdependency of demand across outlets gives franchisors a mechanism to assure franchisees that they will not shirk their monitoring duties and let system-wide quality deteriorates” (Scott 1995, p.75). This situation is also explained in the TCE literature as “hostage posting” (Williamson, 1985).
Lafontaine and Shaw (2001) suggested that if this is a mechanism for providing franchisors with incentives to maintain quality, then the more important the effort of the franchisor to maintain quality and the greater the difficulty of monitoring him/her, the higher the proportion of company owned units should be. Thus, company ownership should be favoured over franchising, the higher the importance of the brand reputation for service quality in the success of the business.

However, the above arguments proposed by agency theory do not always apply in the hotel industry, since there are well known international hotel companies, whose brand names are quite important for their success, yet they rely mostly or entirely on franchising. This applies to most of the economy and mid-market hotel brands, like Days Inn and Holiday Inn respectively, which operate the majority of their outlets through franchising. According to Fladmoe-Lindquist and Jacque (1995) there are industries, such as the hotel and restaurant ones, that are concerned with their brand name reputation more than others. Hence, it is suggested in the context of this study, that the value of a brand name is quite important for the success of the hotel brand regardless of the market segment in which the brand operates, and thus brand name value will not be included as an independent variable that explains the choice between franchising and a higher-control mode.

The agency theoretic argument that is related to this study is the one that refers to free-riding by the franchisees. It is proposed that a hotel firm would be more concerned about free riding in its higher quality brands (i.e. brands that are located in higher market segments) than in the lower ones, because the higher the market where the hotel chain is positioned, the higher the chance for variation between expected and perceived quality and the greater the importance of this difference to the customer. And since the risk of free riding favours the use of “hierarchy”, i.e. management contracts or company ownership, it could be suggested that the higher the level of the category in which a certain hotel company/brand is positioned the greater the concern about quality assurance and thus more likely that “hierarchy” (i.e. management agreement or ownership) will be chosen over the market (i.e. franchising). Thus, it is hypothesised that:
H7: There is a positive correlation between the level of the category (market segment) in which a hotel brand is operating and its proclivity to own the property or use a management contract in a new development (as opposed to franchising).

d) Geographic Concentration

Physical concentration (or dispersion) of operations is the last relevant country parameter influencing the choice between internal organisation and franchising as a mode of hotel corporate development, that is going to be examined for the purpose of this research. According to transaction cost theory, physical dispersion creates what Williamson (1985) calls “internal uncertainty”, since it creates a difficulty in assessing employees’/agents’ performance, therefore increases the costs of “hierarchical” as opposed to “market” modes of expansion. In international operations, distance and time increase the level of uncertainty by widening the information gap.

Geographically dispersed outlets make performance evaluation more difficult and, therefore, control over employees’ effort becomes more desirable. As a result of the high costs of information incurred, an international hotel firm would prefer a mode of expansion that aligns its incentives with the employees’ incentives. Therefore, the more geographically dispersed the hotel properties are, the more likely that franchising would be the preferred mode of corporate development (other things being equal), while the more concentrated the properties are, the more likely that company ownership or management contracts would be chosen over franchising.

Agency theory also supports this prediction. The higher the physical distance between principal and agent, the more difficult it is for the principal to ensure that the outlet manager exercises the required effort and the higher the cost of monitoring his/her behaviour. By making outlet managers residual claimants on the proceeds of their outlets, franchising provides them with the incentive to work harder, since the costs of shirking are mainly borne by them through the reduction of their net income. Studies have shown that firms expanding geographically favour franchising (Brickley and Dark, 1987; Fladmoe-Lindquist and Jacque, 1995; Lafontaine, 1992; Lafontaine and Shaw, 2001; Martin, 1988; Norton, 1988a).
However, in the case of the hotel industry examined in this study, it is doubtful whether management contracts (and ownership) imply the same problems as ownership in other industries. It has to be acknowledged that middle and senior management (of both managed and owned hotels) in well-known hotel chains usually consist of very highly motivated people, who have worked hard in order to reach that position and also have ambitions for their future careers. Hence, there is a general belief that hotel managers have stronger incentives towards desirable behaviour than managers in local fast food or retail outlets. Therefore, it can be proposed that in the case of the hotel industry, the proclivity of hotel managers to shirk (in managed or owned outlets) may be weaker than is predicted by agency theory.

Nevertheless, the prediction by the theory might still hold true when it comes to the relationship between preferred organisational mode and geographic concentration of the hotel units. It could be argued that the more geographically concentrated the properties are, the higher the likelihood that the international hotel company will use management agreements or company ownership for its expansion. The reason is that monitoring of agents/managers requires lower effort and cost than it would, had the outlets been more dispersed, therefore conceding residual claimancy to the franchisee becomes relatively more costly compared to management agreements. Accordingly, the more dispersed the hotel outlets, the more likely that franchising will be preferred over management contracts (or ownership), due to high monitoring costs in the latter case.

Using transaction cost theory, the prediction regarding the relationship between properties’ geographic dispersion and choice between franchising and high-control modes (management contracts or ownership) would be in the similar direction: transaction cost economics would regard franchising as the “default” choice, while a reason must exist for using a hierarchical mode. In fact, one would expect higher monitoring costs if properties were dispersed, plus perhaps absence of various other scale economies that are available with high geographic concentration (e.g. switching staff between properties when required).

Hence, since the literature drawn from both transaction cost economics and agency theory suggests that geographic concentration favours the use of internal organisation (i.e. ownership or management agreements), the same view will be adopted in the next hypothesis:
H8: There is a positive correlation between geographic concentration of hotel properties and propensity to use a higher control mode (management contract or company ownership) in a hotel property (as opposed to franchising).

e) Country of Origin

Previous research has placed a great interest in the cultural distance between the home and the host country as an influencing factor of the entry mode strategy (Agarwal, Erramilli and Chev, 2002; Contractor and Kundu, 1998a and 1998b; Gatignon and Anderson, 1998). Yet none of the studies so far has included any proposition or evidence regarding how the country of origin of an international hotel company influences its entry mode or expansion decision.

During the review of descriptive data it became apparent that Latin-European companies were more inclined in using company ownership rather than franchising compared to Anglo-Saxon companies, suggesting that their focus is on tangible rather than intangible assets\textsuperscript{19}. The purpose of this hypothesis is to examine if this tendency is indeed supported by the statistical analysis. Since, according to TCE one can extract rents form just owning the intangibles, any statistical support of this hypothesis would necessitate a further analysis and discussion with respect to the preference of owning tangible assets (i.e. the hotel property).

A possible explanation could be related to the development of the franchise concept during the previous decade: the first international companies to use low-control modes, like franchising were the North American, as early as in 1950s. They were followed by their Asian-Pacific counterparts, while Continental European companies only fairly recently started to use non-equity arrangements. It could be that hotel companies with longer experience in using franchising, such as the American companies would be more familiar with the use of such agreements and thus more inclined to use franchising, compared to companies with shorter experience, such as the French and Spanish companies (other things equal). Hence the last hypothesis:

\textsuperscript{19} What applies at a company level, it also applies at a brand level, and thus in the context of this hypothesis the words company and brand can be used interchangeably.
**H9:** Anglo-Saxon companies\textsuperscript{20} are more likely to use lower-control modes of development (as opposed to hierarchical modes), compared to Continental European and Asian-Pacific companies.

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\textsuperscript{20} Anglo-Saxon countries usually include the U.S, the U.K or other English-speaking countries that are related to those two, such as countries that belong to the commonwealth (e.g. Canada, Australia). Latin-European countries are those European countries that have Latin roots, such as Spain, Portugal, France and Italy.
5.3. Conclusions

In this chapter, various factors that influence the expansion strategy of international hotel firms (modal choice) were identified. Using Transaction Cost Economics and Agency Theory, several location- and firm-specific variables have been chosen in order to test how these factors favour the use of franchising, management contracts and company ownership. A central issue regarding the hypotheses is that franchising is regarded as the "default" choice, i.e. is considered to be normally the preferred option, while the alternative hypothesis refers to the use of a hierarchical mode of development, i.e. management contracts or company ownership.

More specifically, three location-specific factors were identified: location politico-economic risk, legal risk and level of economic development. It was suggested by the relevant hypotheses that the lower the politico-economic risk, the higher the legal risk and the lower the level of economic development in the target country, the more likely it is that company ownership will be the preferred mode and the less likely that franchising will be chosen, while management contracts would be favoured in situations with medium risk and economic development.

As far as the firm-specific factors are concerned, it was suggested that small hotel brands, with slow growth and little international experience are more likely to expand using company ownership or management contracts while larger brands with high annual growth rates and more international experience would favour franchising (other things equal). Moreover, hotel brands that operate in higher market segments (i.e. upscale, deluxe) are more likely to choose management contracts or company ownership while budget brands would prefer to expand using franchising. Finally, geographical concentration of hotel outlets seems to favour the use of hierarchical modes of development rather than franchising.
CHAPTER 6: RESEARCH DESIGN

In this chapter the research design to be applied will be presented. In the first sections, the population, sampling strategy and data collection method will be presented. Subsequently, the variables' definitions and measures will be introduced and data analysis considerations will be discussed. Finally, the corporate development decision will be modelled and the appropriate software package for the analysis will be chosen.

6.1 Population and sampling strategy

In order to identify the population of this study, the meanings of the terms “hotel company” and “international hotel company” need to be clarified. According to Lewis (1995), a hotel company can actually fit in any of the following three categories:

- Companies involved in constructing, developing and owning hotel buildings,
- Companies involved in managing hotels (with or without holding equity in the hotels under management)
- Franchising companies, which develop hotel chains without being involved in either owning hotel buildings or managing hotels.

The next step is to clarify the term “multinational hotel company”. To be truly international, clearly depends on a combination of several factors. The criteria for inclusion in the Tourism and Travel Intelligence (TTI) listing of the top international hotel companies “The International Hotel Industry”, are the following:

- more than 5000 rooms in total
- at least 10 hotels
- international presence (representation in at least five countries)

The purpose of this study is to identify the factors that influence the choice among franchise agreements, management contracts and company ownership as a mode of international hotel corporate development. Therefore, the population includes all the hotel companies that operate at least one unit under one or more of the following modes: management contract, franchise agreement or company ownership.
Thus, in this study the following types of hotel corporations will be included:

- hotel management companies who own the brand(s) of the hotels they manage
- hotel franchising companies (franchisors),

that operate at least one unit under either franchising, management agreement or company ownership.

It is equally important to refer to the companies that will be excluded from this study, justifying the decision for doing so. Firstly, marketing consortia or affiliations will not be included for two reasons: (a) to avoid double counting of hotel properties since there are quite a few hotels that belong to an international chain and at the same time participate in such alliances for marketing and reservation purposes; and (b) because those affiliations do not function as franchisors, management operators or owners and therefore do not satisfy one of the main criteria for inclusion in the population, i.e. to own, manage or franchise at least one unit. (For those reasons “Best Western” will be excluded, although the TTI has listed it 3rd in the list of the world’s major international hotel groups.)

Furthermore, one should exclude independent management operators, i.e. companies that specialise in providing hotel management services, since those companies do not have their corporations’ or brands’ names attached to the hotel properties, and therefore do not belong to any of the categories mentioned above. The reason why those companies should not be included is that the aim of this study is, among others, to evaluate the effect that brand name has on a hotel firm’s corporate development decision.

Finally, there is another issue that should be clarified, regarding international hotel companies that own several brands. Most of the hotel companies listed as leaders in the “International Hotel Industry” directory are actually companies with more than one brand, each of them aiming in a different market segment. For example, Marriott International owns Marriott Hotels, Resorts and Suites and Ritz-Carlton that operate in the upscale market, Courtyard by Marriott that operates as the moderate-priced three star hotel brand and Fairfield Inn that aims at the budget market.

In this study each brand will be examined separately since it has been suggested that brand type and level of idiosyncratic knowledge are two main firm-specific variables that influence the expansion decision.
One could argue that corporate identity is an important factor that influences the decision for corporate development and thus an additional variable should be included in the model that accounts for the effect of being a brand that belongs to a particular company. Hence, it might be expected that hotel brands within the same corporate portfolio are influenced by certain corporate characteristics that are similar for all its hotel brands regardless of the market segment where these brands operate. For example, one might argue that Accor brands (in this case Sofitel, Novotel, Mercure and Ibis) are not independent of one another as far as the development of new properties of each brand is concerned.

However, there are two reasons why it is suggested that this argument will not influence the model that will be examined in this study: The first and most important is related to the fact that during the last couple of decades hotel brands changed ownership fairly easily and within short periods of time, and thus it would be reasonable to argue that the effect of corporate identity is not significant, since hotel properties that have developed in different years under different company portfolios have been influenced by various corporate environments and not only by the corporate profile of the company that currently owns the brand.

Second, a careful inspection of the data reveals that only three of the companies in the sample own more than two brands, that is Accor (a French company), Six Continents (a British company) and Marriott (a U.S. company). The effect of Accor’s and Six Continent’s corporate identity though is captured by the LATINEUROP variable, the dummy variable that measures the effect of country group of origin (brand origin) on the modal choice, hence there is no need to include an additional company variable that will assess the effect of being a brand under one of these two portfolios. The same is true as far as the effect of Accor’s and Marriott’s corporate identity is concerned. Regarding the effect of being a Marriott as opposed to a Six Continent brand, it can be noticed that both companies are among those that include in their portfolios brands that were developed by different companies during previous decades. Thus, the effect of corporate identity is not significant in either case. (The rest of the companies that are included in the sample have only one or two brands in their portfolio.) For the two previously mentioned reasons, it is suggested that there is no need to include additional dummy variables in the model to represent each company.
Table 6.1 presents the population of the study, namely the international hotel companies that qualify for inclusion in the study according to the previously mentioned criteria. The “No. of Hotels” column refers to the total of hotels of each brand in 1998. The “New Hotel Properties” column refers to the properties that were added in each brand in the period between 1998 and 2000, according to the “International Hotel Industry” Directory (ITT, 2001). The total number of hotel properties that were added during that period was 1510. However, it has to be noted that this number was the result of the comparison between the total of hotels in 1998 and the total in 2000. Yet it is possible that during this period some hotel operations have been terminated, therefore it is likely that the total of the hotels added is higher than the one that was calculated.

Table 6.1: Population of the Study

<table>
<thead>
<tr>
<th>Hotel Company</th>
<th>Hotel Brand</th>
<th>No. of Hotels</th>
<th>No. of Countries</th>
<th>New Hotel Properties</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accor</td>
<td>Sofitel</td>
<td>113</td>
<td>28</td>
<td>31</td>
</tr>
<tr>
<td></td>
<td>Novotel</td>
<td>317</td>
<td>56</td>
<td>12</td>
</tr>
<tr>
<td></td>
<td>Mercure</td>
<td>387</td>
<td>30</td>
<td>253</td>
</tr>
<tr>
<td></td>
<td>Ibis</td>
<td>452</td>
<td>34</td>
<td>86</td>
</tr>
<tr>
<td>Barceló</td>
<td>Barceló</td>
<td>44</td>
<td>10</td>
<td>45</td>
</tr>
<tr>
<td>Carlson</td>
<td>Radisson</td>
<td>361</td>
<td>48</td>
<td>59</td>
</tr>
<tr>
<td></td>
<td>Country Inn</td>
<td>141</td>
<td>7</td>
<td>103</td>
</tr>
<tr>
<td>Choice</td>
<td>Clarion</td>
<td>182</td>
<td>15</td>
<td>-30</td>
</tr>
<tr>
<td></td>
<td>Quality</td>
<td>931</td>
<td>30</td>
<td>-176</td>
</tr>
<tr>
<td></td>
<td>Comfort</td>
<td>2301</td>
<td>24</td>
<td>-384</td>
</tr>
<tr>
<td>Cendant</td>
<td>Days Inn</td>
<td>1801</td>
<td>8</td>
<td>109</td>
</tr>
<tr>
<td></td>
<td>Howard Johnson</td>
<td>505</td>
<td>12</td>
<td>11</td>
</tr>
<tr>
<td>Four Seasons</td>
<td>Four Seasons</td>
<td>32</td>
<td>13</td>
<td>10</td>
</tr>
<tr>
<td>Hilton Int'l</td>
<td>Hilton Hotels</td>
<td>163</td>
<td>49</td>
<td>52</td>
</tr>
<tr>
<td></td>
<td>Scandic</td>
<td>127</td>
<td>9</td>
<td>27</td>
</tr>
<tr>
<td>Hyatt</td>
<td>Hyatt Hotels</td>
<td>183</td>
<td>39</td>
<td>16</td>
</tr>
<tr>
<td>Marriott</td>
<td>Marriott H&amp;R</td>
<td>351</td>
<td>39</td>
<td>17</td>
</tr>
<tr>
<td></td>
<td>Renaissance</td>
<td>75</td>
<td>27</td>
<td>21</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
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<td>-----</td>
<td>---</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Courtyard</td>
<td>415</td>
<td>11</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Ritz Carlton</td>
<td>35</td>
<td>14</td>
<td></td>
</tr>
<tr>
<td><strong>Millennium</strong></td>
<td>Millennium</td>
<td>12</td>
<td>6</td>
<td></td>
</tr>
<tr>
<td><strong>Copthorne</strong></td>
<td>Copthorne</td>
<td>28</td>
<td>5</td>
<td></td>
</tr>
<tr>
<td><strong>NIKKO</strong></td>
<td>Nikko</td>
<td>45/61</td>
<td>19</td>
<td></td>
</tr>
<tr>
<td><strong>Nomura</strong></td>
<td>Le Meridien</td>
<td>99</td>
<td>48</td>
<td></td>
</tr>
<tr>
<td><strong>Shangri-La</strong></td>
<td>Shangri-La</td>
<td>36</td>
<td>10</td>
<td></td>
</tr>
<tr>
<td><strong>Six Continents</strong></td>
<td>Inter-Conti</td>
<td>115</td>
<td>63</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Crowne Plaza</td>
<td>124</td>
<td>39</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Holiday Inn</td>
<td>1472</td>
<td>54</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Express</td>
<td>841</td>
<td>15</td>
<td></td>
</tr>
<tr>
<td><strong>Societe du Louvre</strong></td>
<td>Campanile</td>
<td>359</td>
<td>7</td>
<td></td>
</tr>
<tr>
<td><strong>Sol Meliá</strong></td>
<td>Sol &amp; Meliá</td>
<td>243</td>
<td>24</td>
<td></td>
</tr>
<tr>
<td><strong>Starwood</strong></td>
<td>Sheraton</td>
<td>321</td>
<td>58</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Westin</td>
<td>111</td>
<td>24</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Four Points</td>
<td>103</td>
<td>5</td>
<td></td>
</tr>
<tr>
<td><strong>Tokyu</strong></td>
<td>Pan Pacific</td>
<td>16</td>
<td>10</td>
<td></td>
</tr>
</tbody>
</table>

The population of the study consists of 36 hotel brands (19 hotel companies). If one compared the above table with the respective list of the "International Hotel Industry" directory, one could observe that few major brands are not included in this study. Firstly, Best Western is not included for the reason discussed previously. Also, the Regent brand is excluded. The reason is that Regent Hotels are owned by Carlson Hospitality and managed by various hotel operators, such as Four Seasons. Although Carlson Hospitality owns the properties, the operation of the hotels is undertaken by different hotel companies and thus one of the criteria for inclusion in the study (i.e. that the company should manage or own and operate at least one hotel property) is not satisfied for Carlson in this case. Finally, Club Mediterranee is not included in the population because the hotel operations are only one segment of an integrated business where the tour operator uses its own airline to transfer the club members in the Club Med hotels. Although these hotel properties are owned and operated by Club Med, they are not included in the population, because this hotel company does not face the same competition issues, as do other hotel companies, when examining their expansion strategy.
6.2 Data Collection

The data were gathered from secondary sources, including public statistics (e.g. “The International Hotel Industry” directory published by the European Union- International Travel and Tourism agency), company annual reports, press releases, journals and Internet sites. This directory is the only secondary source focused on the hotel industry that is currently updated (the 2001 edition has been used) and the one that has been used for the most recent hotel studies (Contractor and Kundu, 1998a and 1998b).

Although this directory provides a comprehensive coverage of the business worldwide, it does not show the organisational mode for the properties added in each hotel brand. Thus, the hotel companies’ Internet sites have been searched for information regarding organisational modes and missing data have been completed by personal contact to corresponding positions in each company. More specifically, a letter was sent to the Director of Development (or any other equivalent position) of each one of the population hotel brands, asking information about the organisational mode of each hotel property that had been added in the system between 1998 and 2000.

To make the procedure easier for the person that filled in the required information, the new hotels and the respective countries had been identified in advance, either by using the hotel companies’ web sites and annual reports, or by comparing the 2001 TTI directory with the 1998 one. Thus, the recipient of the letter was provided with a list of the hotels and was asked to identify whether these hotels operated under company ownership, management contract or franchise agreement. Additionally, they were asked to provide the year when the first hotel of the brand operated. Finally, it was clarified that the company ownership mode should also include leased properties, as well as properties in which the hotel company had a major equity stake. (A sample copy of the letter is provided in Appendix 1.) A reply was received from 10 out of the 19 companies. Within those companies there were 19 out of the 36 hotel brands respectively.

At a second stage, the monthly journal “Hotels” was used to gather the required information for the hotel brands on which no reply had been received or for which the received information was not entirely usable. The “Hotels” magazine has a section which provides information about the hotel openings all around the world. Searching the volumes from 1994 onwards, it has been possible to identify the new developments of a
few hotel brands for which no information were available so far and at the same time to confirm and double-check the data provided by the hotel companies.

Table 6.2 presents the hotel brands for which all the required information was gathered through the previously mentioned stages and also gives information on the missing data.

*Table 6.2: The hotel companies and brands used for data analysis*

<table>
<thead>
<tr>
<th>Hotel Company</th>
<th>Hotel Brand</th>
<th>New Hotel Properties (no. of total obs.)</th>
<th>Obs. taken out due to missing data</th>
<th>Final Obs.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accor</td>
<td>Sofitel</td>
<td>19</td>
<td>3</td>
<td>16</td>
</tr>
<tr>
<td></td>
<td>Novotel</td>
<td>12</td>
<td>0</td>
<td>12</td>
</tr>
<tr>
<td></td>
<td>Mercure</td>
<td>13</td>
<td>2</td>
<td>11</td>
</tr>
<tr>
<td></td>
<td>Ibis</td>
<td>16</td>
<td>0</td>
<td>16</td>
</tr>
<tr>
<td>Carlson</td>
<td>Radisson</td>
<td>7</td>
<td>0</td>
<td>7</td>
</tr>
<tr>
<td>Cendant</td>
<td>Howard Johnson</td>
<td>117</td>
<td>5</td>
<td>112</td>
</tr>
<tr>
<td>Four Seasons</td>
<td>Four Seasons</td>
<td>12</td>
<td>1</td>
<td>11</td>
</tr>
<tr>
<td>Hilton Int'l</td>
<td>Hilton Hotels</td>
<td>22</td>
<td>3</td>
<td>19</td>
</tr>
<tr>
<td>Hyatt</td>
<td>Hyatt Hotels</td>
<td>23</td>
<td>4</td>
<td>19</td>
</tr>
<tr>
<td>Iberostar</td>
<td>Iberostar</td>
<td>14</td>
<td>2</td>
<td>12</td>
</tr>
<tr>
<td>Marriott</td>
<td>Marriott H&amp;R</td>
<td>27</td>
<td>2</td>
<td>25</td>
</tr>
<tr>
<td></td>
<td>Courtyard</td>
<td>6</td>
<td>0</td>
<td>6</td>
</tr>
<tr>
<td></td>
<td>Ritz Carlton</td>
<td>10</td>
<td>0</td>
<td>10</td>
</tr>
<tr>
<td>Six Continents</td>
<td>Inter-Conti</td>
<td>26</td>
<td>6</td>
<td>20</td>
</tr>
<tr>
<td></td>
<td>Holiday Inn</td>
<td>83</td>
<td>5</td>
<td>78</td>
</tr>
<tr>
<td></td>
<td>Express</td>
<td>79</td>
<td>0</td>
<td>79</td>
</tr>
<tr>
<td>Shangri-La</td>
<td>Shangri-la</td>
<td>3</td>
<td>0</td>
<td>3</td>
</tr>
<tr>
<td>Sol Meliá</td>
<td>Sol &amp; Meliá</td>
<td>11</td>
<td>1</td>
<td>10</td>
</tr>
<tr>
<td>Starwood</td>
<td>Sheraton</td>
<td>7</td>
<td>1</td>
<td>6</td>
</tr>
<tr>
<td></td>
<td>Westin</td>
<td>19</td>
<td>1</td>
<td>18</td>
</tr>
</tbody>
</table>

During this process, country data was also collected. The International Country Risk Guide was used to identify the politico-economic risk of each country for the years 1996 through 1998 and the UNESCO and United Nations Statistical Yearbooks for 1998 to
2000 were used to collect information on patents filed in each country and on GDP per capita. Since that information was unavailable for some small countries, the total data set had to be reduced by 36 observations, from 526 to 490.

6.3 Measurement of Variables

In this section the measures for the variables presented in the previous chapter will be discussed. For some of the variables, more than one measure could be used. The table at the end of the section (Table 6.3) gives an overview of the variables, the direction of their relationship with the depended variable and the measures that will be used to assess that relationship.

6.3.1 Location-Specific Variables

An issue that needs to be clarified before the measures for the location- (country) specific variables are presented is the fact that there is a lag between the time when the decision to develop a new hotel property is made and the time when the hotel starts its operations. This time period could range from as short as 6 months up to 3 years, depending mainly on the size of the property and the organisational mode used. According to industry specialists, one could argue that on average it takes around two years until the hotel launches its operations. Therefore, when the country variables’ measures are entered in the data set a two-year lag is applied, namely for the hotels that launched their operations in 2000, the 1998 country data were used, and so on for the hotels that first operated in 1999 and in 1998.

a) Political and Economic Risk

Previous studies (Erramilli and Rao, 1993; Gatignon and Anderson, 1988) have used the classification of Goodnow and Hanz (1972) to capture country political and economic risk. Via cluster analysis, based on fifty-nine country descriptions during the decade of the 1960s, they classified one hundred countries into three groups that correspond to high, medium and low country risk.
More recently, Fladmoe-Lindquist and Jacque (1995) used the Frost and Sullivan Country Risk service, which reported the investment risk for eighty-two countries over the time period of January 1988 to June 1989, to capture host countries’ political risk, i.e. the amount of political turmoil in the country, its restrictiveness towards the investment of funds and the transfer of dividends, fees and royalties. They also used the World Currency Yearbook reports on exchange rates for 1982 to 1984 and the Price Waterhouse annual report on exchange rates for the years 1985 to 1989 to calculate the average fluctuation in the foreign exchange rate of each country’s currency.

Finally, Agarwal and Ramaswani, (1992) and Contractor and Kundu, (1998a and 1998b) obtained their data for political and economic risk from Frost and Sullivan International Country Risk Guide (ICRG). This guide assesses a country’s current political, economic and financial risk by assigning risk points to a pre-set group of factors termed political, economic and financial risk components respectively. The highest overall rating (theoretically 100 points) indicates the lowest risk and the lowest score (theoretically 0 points) indicates the highest risk. The International Country Risk Guide presents up-to-date data for various aspects of political, financial and economic risk and moreover it is widely used by researchers in academia as well as in the industry. Therefore, it has been considered for the purpose of this study as the main data source for country political and economic risk. In Appendix 2, a list with the aspects considered for the calculation of ICRG index is provided.

Although country risk is a continuous variable that can take any value between 0 and 100, in this study it will be represented as a qualitative discrete variable: ICRGD1 will indicate countries with moderate and high political and economic risk, ICRGD2 will correspond to countries with low risk and ICRGD3 will denote countries with very low risk. A qualitative representation of the risk variable will make the interpretation of the findings easier, since one will be able to draw conclusions regarding the effect of different risk levels (low/medium/high) on the choice among the three expansion strategies. Moreover, another reason that renders the grouping of the country risk variable necessary is that the distribution of the variable does not resemble a normal distribution and thus is far from being linearly related to the log of the dependent variable (the modal choice). However, it has to be noted that grouping a continuous
variable also has its drawbacks, since certain amount of information regarding the effect of that variable on the dependent variable will be lost.

According to ICRG report, very high and high risk countries are the countries that score between 0 and 59.5, moderate risk counties are the countries with score between 60 and 69.5, low risk countries those with score between 70 and 84.5 and very low risk countries those with score higher than 85. The reason why in this study moderate- and high-risk countries are represented by the same variable (ICRGD1), while low- and very low-risk countries are represented separately is that only few observations in the sample correspond to high and very high risk countries, while most of observations refer to moderate and low risk countries. Thus the moderate and high-risk countries had to be grouped in one variable (ICRGD1).

b) Legal Risk

In the context of this study, legal risk refers to both local regulations and policies regarding trademark and intellectual property rights protection, as well as to court enforcement. To measure the legal protection of intellectual property, the number of patents filed in each country has been used. It could be argued that the fact that numerous patents are filed in a country indicates confidence regarding patent protection and thus confidence regarding intellectual knowledge protection in general.

c) Level of Economic Development

The most common measures for economic development that recent studies have suggested, refer to countries’ Gross Domestic Product, GDP, (Gomes-Casseres 1989, 1990 and Shane 1992), GDP per capita (Contractor and Kundu, 1998a and 1998b) or Gross National Product (GNP) per capita (Agarwal, 1994; Davidson and McFetridge, 1985). In this study, GDP per capita has been used to capture the level of economic development of each country, since GDP growth is not a measure of level but of pace and GDP (or GNP) is not comparable among different countries. The World Development Indicators yearbooks (1998-2000) were used for this data.
6.3.2 Firm-Specific Variables

a) Brand Size

There are several measures that could be used to measure brand size. The most common include worldwide revenues (Contractor and Kundu 1998a and 1998b), number of rooms, number of employees (Gatignon and Anderson, 1988) and total assets. In the context of this study the last two measures could not be used. The “number of employees” measure is not accurate in the case of hotel companies that operate some of their hotel units under management service agreements, since the vast majority of employees in those units are employed by the hotel owner not the hotel operator. The same rationale applies for the “total assets” measure, since it does not include hotel properties that are operated (but not owned) by the international hotel company or properties that are operated under a franchise agreement.

Therefore the most appropriate measures to be used in the current study were “number of hotels worldwide” and/or “number of rooms worldwide”. In both cases, franchised and managed hotels and/or rooms from properties under management and franchise agreements have been included. The reason why the “number of rooms” measure was finally used is that brands in different market segments present substantial differences in terms of the size of the hotels they operate. For example, luxury brands are usually smaller than budget or mid-market brands, while upscale brands usually have the biggest properties in terms of rooms. If the number of hotels were used as the measure of size it could be that brands with comparable number of hotels in their portfolio but significantly larger number of rooms would appear as having similar size. Thus, it is suggested that the “number of rooms” measure will capture the effect of size better than the “number of hotels” measure. Information regarding the number of rooms of each hotel brand has been derived from the “International Hotel Industry” directory.

b) Brand Growth

Brand growth is measured by the increase (or in some cases decrease) in the brand size, i.e. the difference in the number of rooms between two consecutive years. For example, brand growth in 1999 is measured as the difference in the number of rooms of a certain brand between the end of 1998 and the end of 1999. In the current study, hotel brands
are classified in four groups according to the growth they experienced in each year between 1998 and 2000. The cut-off points have been selected using the quartiles of the brand growth distribution: FGR1 refers to brands with annual growth up to 1 percent, FGR2 to brands with annual growth between 1 and 2.5 percent, FGR3 to annual growth between 2.5 and 9.5 percent and FGR4 to annual growth higher to 9.5 percent.

The reason for transforming brand growth to a qualitative, discrete variable is the existence of outliers in the distribution of this variable. Although the median growth is 2.5 percent (the mean is 6.5 percent), there are hotel brands that presented up to 50 percent growth in one year, and thus the growth variable is far from being linearly related to the log of the dependent variable. Therefore, a qualitative variable was constructed in relation to the quartiles of the brand growth distribution. It has to be admitted that the transformation of a continuous variable to a discrete variable will result in losing some information; however one will still be able to draw conclusions regarding the effect of difference brand growth levels on the modal choice.

c) International experience

Previous studies on entry mode choice have quantified international experience using mostly two measures: number of foreign markets entries (Gatignon and Anderson 1988) and/or number of years since a firm started its first foreign operation (Fladmoe-Lindquist and Jacque 1995). In their studies on the hotel industry, Contractor and Kundu (1998a and 1998b) have suggested the use of an additional ratio, namely the number of properties outside the home nation of the firm divided by the global total number. This measure is indeed more appropriate than the time-based measure, since some firms may have expanded internationally faster than others. Moreover, "mere length of time in one cultural setting may not prepare a firm for expansion into another country and culture" (Contractor and Kundu 1998a, p.341).

The current study does not examine “foreign” entries as such and moreover does not regard a certain country as “home” country for each international hotel company\(^1\) for the purpose of measuring international experience. Therefore the ratio used by Contractor and Kundu cannot be applied. Hence, two alternative measures of
international experience were initially considered: the first referred to the "number of countries" in which a hotel brand operates and the second to the "number of years" since its first operation in more than one country. Yet the "number of countries" measure could also be considered as a measure of geographical dispersion therefore the "number of years" was finally selected as measure of international experience. Information regarding this measure was obtained from the "International Hotel Industry" directory, as well as from the companies’ Internet sites and from published data.

d) **Proprietary content (Market Segment of Operations)**

As already discussed in the previous chapter (Hypothesis 7, section 5.2.2), proprietary knowledge is a variable that refers mainly to specialised know-how, professional skills and managerial expertise, as well as to the use of codified assets, e.g. central reservation systems. Services that require professional skills are usually associated with significant human investments. Therefore, yearly training expenditure is a proxy that captures effectively the level of human investment required, and accordingly the degree of proprietary content that characterises an international hotel company. Yet, this type of information is difficult to acquire, since many hotel companies consider it to be confidential. Therefore, a different measure had to be used to capture the effect of proprietary content on the corporate development decision.

In the context of this study, it is suggested that hotel classification could be used as a proxy for the level of proprietary content in the codified assets employed by the hotel company (see the analysis of Hypothesis 7 in section 5.2.2). It can be argued that the higher the rating of a hotel (i.e. five and four star) the more likely that a high level of proprietary content is involved with resultant information impactedness, and thus the higher the likelihood that management contracts or company ownership will be chosen over franchising.

Luxury hotels require their staff to have the capability to respond flexibly to guests’ individual requirements, so as to preserve the ‘glamour’ of the brand. This capability (tacit knowledge?) needs to be transferred via careful staff selection and training (hierarchy mode), rather than by packaged standard operating procedures. This seems to

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21 The hotel product *per se* is truly multinational nowadays and therefore it is quite difficult to define the criteria that one should use in order to identify which country should be regarded as the company’s
be a fairly classic case of information impactedness inhibiting the use of the market mode. The lower market segment of limited service units, on the other hand, requires a set of standard operating procedures from which there is no reason to deviate, because the service is limited.

The hotel classification used in this study is not the "star" rating, because usually hotel brands assign different ratings in different markets. As an example, Holiday Inn can be seen as a four-star, as well as a three-star hotel, according to the specific geographic market or country. Therefore the classification has been slightly broader, i.e. budget, mid-market, upscale and luxury market. Hence in the previous example, Holiday Inn would be classified in the mid-market, since the service provided corresponds to that market, despite the fact that some properties in certain countries are classified as four-star. The above-mentioned data sources have been used as the basis for this measure.

e) Geographic Concentration

Most of the previous studies on franchising examine the influence of distance between each unit and the company's group headquarters on the decision between franchising and company ownership as a mode of corporate development (Brickley and Dark 1987, Norton 1988b). However in the context of this study, this measure cannot be applied since it has been argued that international hotel chains are considered not to have a "home country" that could be used as the basis for distance calculations. An alternative would be to use the regional head offices of each brand instead of the group headquarters. The bigger the average distance of the hotel properties from the respective regional head office to which they are assigned, the more likely that franchising would be used over management agreements. Yet, although it was relatively easy to identify where the regional offices of each brand were located, this was difficult to identify the location of the hotel properties that were added in each hotel brand during the two-year period. The available information on most of the developed properties indicated only the country where each hotel was developed, not the city or area. Thus, the distance from the regional offices could not be calculated.

An alternative to the distance between hotel properties and headquarters of regional offices would be to use a proxy. Previous studies that examined the effect of monitoring
costs on the choice between franchising and company ownership used a dummy variable that took the value of 1 if the company already had an outlet in the country where additional outlets were to be developed and 0 otherwise (Alon, 2000 and Lafontaine, 1992). The idea behind that proxy is that if the hotel property under development were the first in the country, the preferred mode would be one that best aligns the incentives of the managers/agents with the ones of the hotel company, i.e. franchising.

Other studies have used the number of outlets a company owns or operates in each country. In this study a variation of that proxy will be used: geographical concentration is captured by the number of hotels operated by each brand in each country, deflated by the population of the respective country, in order to make the proxy comparable among different countries. The higher the ratio, the more concentrated are considered to be the hotel outlets in the country, and thus the more likely it is that a hierarchical mode of development will be preferred as opposed to franchising.

f) Country Group of Origin

Since the brands in the sample are classified as either “Anglo-Saxon” or “Latin-European”, a dummy variable was used, which takes the value of 1 if the hotel brand originates from the Latin-European country group (Spain or France) and 0 if the hotel brand originates from the Anglo-Saxon country group (U.S.A. or U.K.)\(^{22}\). Anglo-Saxon countries usually include the U.S, the U.K or other English-speaking countries that are related to those two, such as countries that belong to the commonwealth (e.g. Canada, Australia). Latin-European countries are those European countries that have Latin roots, such as Spain, Portugal, France and Italy.

6.3.3 Control Variables

Two control variables were introduced in the model. The first refers to the size of the hotel property, which is measured by the number of rooms (RMS). Previous research in the internationalisation literature has suggested that the bigger the size of a new outlet,
the higher the capital investment required, and thus the more likely it is that a non-equity or shared-equity mode would be the preferred one.

The second variable one would need to control for is a dummy variable (LOCATION) that takes the value of 1 if the new hotel property was developed outside the country where the hotel brand has most of its operations and 0 otherwise. It could be that a hotel brand follows a different development strategy in the country where it operates most of its outlets, compared to other countries. According to the theoretical framework of this study, one need not distinguish between home and host operations. Thus, if hotel brands expand using a different strategy in the country where they have most of their operations, one should control for that effect.

In the following table a summary of the variables, the direction of their relationship to the depended variable and the measures that will be used to assess their influence on the modal choice is presented. Two of the variables (politico-economic risk and legal risk) are expected to show an opposite sign in the regression than it is suggested by the respective hypotheses. The reason is that in both cases, high levels in the scales that are used to capture the effect of politico-economic risk and legal risk indicate very low risk levels. Thus for a negative relationship to be supported, a positive sign should be found in the analysis and visa versa.

6.3.4 Dependent Variable

The dependent variable is the modal choice that is the choice among the three expansion strategies (company ownership, management contracts and franchising) for the development of a new hotel property. The statistical modelling of the dependent variable will be presented in detail in the next section.
### Table 6.3: Measurement of Variables

<table>
<thead>
<tr>
<th>Market-Specific Variables</th>
<th>Direction of the relationship</th>
<th>Measures</th>
<th>Expected Sign</th>
</tr>
</thead>
<tbody>
<tr>
<td>Political-Economic Risk <em>(H1)</em></td>
<td>-</td>
<td>Int’l Country Risk Guide, rating from 0 (v. high risk) to 100 (v. low risk)</td>
<td>+</td>
</tr>
<tr>
<td>Legal Risk <em>(H2)</em></td>
<td>+</td>
<td>Number of patents filed in the country</td>
<td>-</td>
</tr>
<tr>
<td>Level of Economic Development <em>(H3)</em></td>
<td>-</td>
<td>GDP per capita</td>
<td>-</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Firm-Specific Variables</th>
<th>Direction of the relationship</th>
<th>Measures</th>
<th>Expected Sign</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brand Size <em>(H4)</em></td>
<td>-</td>
<td>Number of rooms worldwide</td>
<td>-</td>
</tr>
<tr>
<td>Brand Annual Growth <em>(H5)</em></td>
<td>-</td>
<td>The difference in the number of rooms between two consecutive years</td>
<td>-</td>
</tr>
<tr>
<td>International Experience <em>(H6)</em></td>
<td>-</td>
<td>Number of years since first operation in a second country</td>
<td>-</td>
</tr>
<tr>
<td>Proprietary Content <em>(H7)</em></td>
<td>+</td>
<td>Hotel rating – Market segment (budget/ mid-market / upscale)</td>
<td>+</td>
</tr>
<tr>
<td>Geographic Concentration <em>(H8)</em></td>
<td>+</td>
<td>No. of hotels in the country divided by the population</td>
<td>+</td>
</tr>
<tr>
<td>Country Group <em>(H9)</em></td>
<td>+</td>
<td>Dummy Variable (1 for Latin-European, 0 for Anglo-Saxon brands)</td>
<td>+</td>
</tr>
</tbody>
</table>

### 6.4 Modelling the corporate development decision: The choice among company ownership, management contracts and franchise agreements

A basic statistical method for social sciences is linear regression analysis, which requires a continuous dependent variable and explanatory variables that are either continuous or categorical. However, the classical regression model cannot be applied in situations where the dependent variable refers to characteristics, attitudes, behaviours and decisions that are measured in discrete, nominal, ordinal, or any other non-continuous...
way. In such situations the dependent variable takes a discrete number of mutually exclusive and collectively exhaustive values (Borooah, 2001).

The statistical methods that are used to analyse such data are known as qualitative choice models and present a common characteristic, that is, they all model the probability of an event, namely, how likely the event is to occur (Liao, 1994). Examples of such methods of statistical analysis are “binary data analysis”, “ordered analysis”, or “discrete choice analysis”, such as the logit and probit models.

When we study a random variable $Y$ (dependent variable) using a linear model, we specify its expectation as a linear combination of $K$ independent variables ($X$) as follows:

$$E(Y) = \mu = \sum_{k=1}^{K} \beta_k x_k$$

This is the ordinary linear model which can be used when the normality of the distribution of the random component in $Y$ (i.e. the part that cannot be explained by the independent variables) can be assumed.

However, when the dependent variable is measured in a non-continuous way, the random component in $Y$ does not follow the normal distribution, in which case the ordinary linear model (1) cannot be applied. More specifically, if the dependent variable is a binary outcome (0/1), the random component in $Y$ follows the binomial distribution and the appropriate model to be used for estimation is either logit:

$$E(Y) = \log\left[ \frac{\mu}{1-\mu} \right]$$

or probit:

$$E(Y) = \Phi^{-1}(\mu)$$

where $\Phi^{-1}$ is the inverse of the standard normal cumulative distribution function.

When the dependent variable is a count variable, e.g. number of accidents, number of visits in a theme park, it is assumed that the random component in $Y$ resembles the Poisson distribution and thus the logarithmic model is used:
Finally, when the dependent variable is the outcome of more than two choices, such as modes of commuting to work, modes of entry, consumer choice regarding certain products, the multinomial distribution is assumed for the random component in Y and the *multinomial logit model* is used:

$$E(Y) = \log \left( \frac{\mu_j}{\mu} \right)$$  \hspace{1cm} (5)

where, $j$ indicates the $j$th in $1, \ldots, J$ response categories. This model is an extension of model (2), in which $J$ is equal to 2 (Liao, 1994).

There are four main reasons why the classical linear regression (and the OLS estimator) cannot be applied to estimate models where the dependent variable is non-continuous (Gujarati, 2001). The first refers to the fact that the random component in Y does not follow the normal distribution. Another problem is that the random component is heteroscedastic and thus one needs to find appropriate transformations to make it homoscedastic. Yet, the most important handicap of using the OLS estimator is that there is no guarantee that the estimated probability that the event under examination will occur will lie within the limits of 0 and 1. For example, if the estimated probability $P_i$ is negative, or greater than 1, it will have no practical meaning. Finally, by applying classical regression one would assume that the rate of change of probability per unit change in the value of the explanatory variable is constant and is given by the value of the slope.

On the other hand, when a logit (or probit) model is used, the estimated probabilities will always fall between 0 and 1. Moreover, the probability of an event occurring does not increase linearly with a unit increase in the value of the explanatory variable. Rather, the probability approaches zero (or one) at a slower and slower rate as the value of the explanatory variable gets smaller (or larger) respectively. This is a more realistic pattern of change in the probability compared to linear models.

It has to be noted that, traditionally, polytomous dependent variables have been handled with discriminant analysis. Polytomous logistic regression (i.e. logit and/or probit) may be preferable, however, because its results are more interpretable and there is no
requirement that the predictor set have the multivariate normal distribution (DeMaris, 1992; Fladmoe-Lindquist and Jacque, 1995).

When the corporate development decision is modelled, the dependent variable is a discrete variable, which can take the values of 0, 1 and 2 referring to franchise agreements, management contracts and company ownership respectively. According to the previous discussion, one could assume that the choice among these three modes could be analysed using the multinomial logit model. However, the ordered logit or probit model should be used instead for the following reason: it has already been mentioned in previous chapters that different modes of entry or development are characterised by different degrees of control they provide over the developed property and more specifically that, among the three modes under examination, franchising provides the least control, company ownership the highest, while management contracts are located in between the other two modes. Hence, there is a clear order in the values the dependent variable can take, i.e. value 2 implies more control than value 1 and value 1 implies more control than value 0.

However, although there is a clear ranking among the three categories, this ranking does not form an interval scale, i.e. the differences among adjacent categories cannot be treated as the same. Therefore classical regression could not be applied, since it would treat the difference between 2 and 1 in the same way as the difference between 1 and 0, while actually, the numbers are only a ranking and have no essential significance (Borooah, 2001).

On the other hand multinomial logit models, though they could be used, they would fail to account for the information conveyed by the ordered nature of the data. Ordered logit and ordered probit models are the most commonly used methods for analysing data when the dependent variable is both discrete and ordinal and takes more than two values (Liao, 1994; Maddala, 1983; Greene, 2000)23.

For the ordered logit or probit model to be used to analyse the choice among the three corporate development modes, a critical assumption needs to be made and that is the parallel slopes assumption. What it is assumed is that the coefficients linking each

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23 In the case of a binary outcome (0/1), ordered logit and probit models can be used regardless of whether the dependent variable is ordinal or not (Borooah, 2001).
independent variable to the different choice outcomes will be the same across the three different choices. For example, it is assumed that the market segment where a hotel brand is positioned will affect the likelihood of choosing the franchise mode for a new development in the same degree as it will affect the likelihood of choosing the management contract or the company ownership mode. If the slope coefficients associated with a particular variable are not the same across the three outcomes (modes of corporate development), then the appropriate model to use is multinomial logit, rather than ordered logit or probit models (Borooah, 2001).

Another issue that needs to be considered when the development decision is modelled is whether that decision is made in a single stage, or whether it is a set of sequential decisions, each involving a subset of options. Gatignon and Anderson (1988) suggested that the entry mode decision may be a 2-stage process, where in the first stage the international company decides whether to own the subsidiary outright and if not, in the second stage a choice is made among lower-control options. In their study regarding manufacturing multinational companies, they found that the transaction cost explanation performs better in the 2-stage model rather than in the single stage one.

Accordingly, in the context of this study one could test whether transaction cost economics and agency theory can provide a better explanation regarding the corporate development decision, if that decision is modelled in two stages. More specifically, in line with transaction cost economics, one could suggest that at the first stage a decision is made between “market” and “hierarchy”, namely the international hotel company decides whether to expand using a high- or a low-control mode. If the company prefers a low-control mode franchising should be chosen, which provides the least control over hotel operations (among the three options). If on the other hand, the hotel company opts for a higher-control mode, in the second stage, a choice is made between company ownership and management service agreements.

If the two-stage model is followed, the decision process can be modelled by (1) a binary choice model of whether franchising or non-franchising will be used (the response variable will take the value of 1 for franchising and 2 for non-franchising) and given that a higher control mode has been the preferred option, by (2) a binary model of choice between management contracts and company ownership (the response variable will take the value 1 for management contracts and 2 for company ownership).
Since the binary choice model is a special case of the multinomial (in this study the ordered) logit model, the more general ordered model was examined first, followed by the 2-stage binary model, and the results of both are presented in the next chapter. However, because the binary model is the simplest probability model its specification is presented here first, as this would help one to better understand the specification of the ordered model.

6.4.1 Binary Logit/Probit Model

As the simplest probability model, binary logit and probit models have only two categories in the response variable, i.e. 0 and 1. Binary models are usually denoted as latent variable specifications in which the response variable $y^*$ is linearly related to a set of $k$ explanatory variables, $x_k=(x_{1k}, x_{2k},...,x_{Kk})$ and is defined by the regression relationship:

$$y^* = \sum_{k=1}^{K} \beta_k x_k + \varepsilon \quad (6)$$

In practice, $y^*$ is unobserved and $\varepsilon$ is systematically distributed with zero mean and has its cumulative density function (CDF) defined as $F(\varepsilon)$. The observed dependent variable is determined by whether $y^*$ exceeds a threshold value:

$$y = \begin{cases} 
1 & \text{if } y^* > 0 \\
0 & \text{otherwise}
\end{cases}$$

Then, the probability of observing a value of 1 is denoted by the following relationship:

$$\Pr(\text{obs}(y = 1)) = \Pr(\sum_{k=1}^{K} \beta_k x_k + \varepsilon > 0)$$

$$= \Pr(\varepsilon > -\sum_{k=1}^{K} \beta_k x_k)$$

$$= 1 - F(-\sum_{k=1}^{K} \beta_k x_k) \quad (7)$$

where $F$ is the CDF of $\varepsilon$. 

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The functional form of $F$ depends on the assumption made about the distribution of the random component $\varepsilon$. If the random component is assumed to follow the logistic distribution, then the binary model is known as the logit model, where, substituting $L$ (signifying the logistic distribution) for $F$ in equation (7):

$$\text{Prob}(y = 1) = 1 - L\left(- \sum_{k=1}^{K} \beta_k x_k\right) = \frac{\exp\left(\sum_{k=1}^{K} \beta_k x_k\right)}{1 + \exp\left(\sum_{k=1}^{K} \beta_k x_k\right)}$$ \hspace{1cm} (8)

If the random component is assumed to follow the standard normal distribution, then the binary model is known as the probit model and $\text{Prob}(y = 1)$ is given by the following equation:

$$\text{Prob}(y = 1) = 1 - F\left(- \sum_{k=1}^{K} \beta_k x_k\right) = F\left(\sum_{k=1}^{K} \beta_k x_k\right) = \Phi\left(\sum_{k=1}^{K} \beta_k x_k\right)$$ \hspace{1cm} (9)

### 6.4.2 Ordered Logit/Probit Model

Since the ordered model is an extension of the binary-outcome model, it is built around a latent variable specification in the same manner as the binary model (Borooah, 2001):

$$y^* = \sum_{k=1}^{K} \beta_k x_k + \varepsilon$$ \hspace{1cm} (10)

As with the binary outcome model, $y^*$ is unobserved and thus can be thought of as the underlying tendency of an observed phenomenon, where it is assumed that $\varepsilon$ follows a certain distribution (such as the logistic or the normal distribution) with zero mean.

In the context of this study the dependent variable can take three different values, i.e. $y=0$, $y=1$ or $y=2$. Although $y^*$ is unobserved, what is observed is that

$$y=0 \quad \text{if} \quad y^* < \gamma_1$$
$$y=1 \quad \text{if} \quad \gamma_1 \leq y^* < \gamma_2$$
$$y=2 \quad \text{if} \quad y^* \geq \gamma_2$$ \hspace{1cm} (11)
The $\gamma_1, \gamma_2 \neq 0$ are unknown parameters ($\gamma_1 < \gamma_2$) to be estimated along with the $\beta_k$ of equation (10). Which of the three modes will be chosen by a hotel company for a new hotel development depends on whether or not $y^*$ crosses a threshold. The probabilities of $y$ taking the values 0, 1 and 2 are given by:

$$\Pr ob(y = 0) = \Pr ob(\sum_{k=1}^{K} \beta_k x_k + \varepsilon \leq \gamma_1) = \Pr ob(\varepsilon \leq \gamma_1 - \sum_{k=1}^{K} \beta_k x_k) \quad (11a)$$

$$\Pr ob(y = 1) = \Pr ob(\gamma_1 \leq \sum_{k=1}^{K} \beta_k x_k + \varepsilon \leq \gamma_2) = \Pr ob(\gamma_1 - \sum_{k=1}^{K} \beta_k x_k \leq \varepsilon \leq \gamma_2 - \sum_{k=1}^{K} \beta_k x_k) \quad (11b)$$

$$\Pr ob(y = 2) = \Pr ob(\sum_{k=1}^{K} \beta_k x_k + \varepsilon \geq \gamma_2) = \Pr ob(\varepsilon \geq \gamma_2 - \sum_{k=1}^{K} \beta_k x_k) \quad (11c)$$

The difference between the ordered logit and probit models lies in the assumed distribution of $\varepsilon$. An ordered logit is the result of assuming that $\varepsilon$ is logistically distributed while an ordered probit model is the result of assuming that $\varepsilon$ is normally distributed.

When the random component is assumed to follow the logistic distribution the above probabilities take the follow form:

$$\Pr ob(y = 0) = \Lambda(\gamma_1 - \sum_{k=1}^{K} \beta_k x_k) = \frac{1}{1 + \exp(\sum_{k=1}^{K} \beta_k x_k - \gamma_1)} \quad (12a)$$

$$\Pr ob(y = 1) = \Lambda(\gamma_2 - \sum_{k=1}^{K} \beta_k x_k) - \Lambda(\gamma_1 - \sum_{k=1}^{K} \beta_k x_k) = \frac{1}{1 + \exp(\sum_{k=1}^{K} \beta_k x_k - \gamma_2)} - \frac{1}{1 + \exp(\sum_{k=1}^{K} \beta_k x_k - \gamma_1)} \quad (12b)$$

$$\Pr ob(y = 2) = 1 - \Lambda(\gamma_2 - \sum_{k=1}^{K} \beta_k x_k) = 1 - \frac{1}{1 + \exp(\sum_{k=1}^{K} \beta_k x_k - \gamma_2)} \quad (12c)$$
When it is assumed that the error terms follow a standard normal distribution, the respective probabilities are as follows:

\[
\text{Pr}ob(y = 0) = \Phi(y_1 - \sum_{k=1}^{K} \beta_k x_k) \tag{13a}
\]

\[
\text{Pr}ob(y = 1) = \Phi(y_2 - \sum_{k=1}^{K} \beta_k x_k) - \Phi(y_1 - \sum_{k=1}^{K} \beta_k x_k) \tag{13b}
\]

\[
\text{Pr}ob(y = 2) = 1 - \Phi(y_2 - \sum_{k=1}^{K} \beta_k x_k) \tag{13c}
\]

The estimates of \( \beta_k, \gamma_1 \) and \( \gamma_2 \) are obtained by maximising the following likelihood function using standard iterative methods (equation 14):

\[
\ell(\beta, \gamma) = \sum_{i(y=0)} \log[\text{Pr}ob(y = 0/x_i, \beta, \gamma)] + \sum_{i(y=1)} \log[\text{Pr}ob(y = 1/x_i, \beta, \gamma)] + \sum_{i(y=2)} \log[\text{Pr}ob(y = 2/x_i, \beta, \gamma)]
\]

As mentioned above, an issue regarding ordered models is whether the parallel lines assumption holds, namely whether the \( \beta \) estimates are invariant to the thresholds (in the case of this study, if the \( \beta \) estimates are invariant to \( \gamma_1 \) and \( \gamma_2 \)). When this assumption is valid, the effects of an independent variable \( x \) should be constant regardless of the choice of response category \( j \). (The previous analysis refers only to the ordered model, not the binary one.)

6.4.3 Should the Logit or the Probit model be chosen?

There is little difference between the two CDFs, i.e. the logistic (logit model) and the normal one (probit model). Normally, a logit model has flatter tails compared to probit. That is, the probability \( P_i \) approaches 1 or 0 at a slower rate in logit models than in probit. Given the similarities between logit and probit, either model will give very comparable conclusions in most applications. It is, in fact, easy to go from the one set of estimates to the other. If a probit estimate is multiplied by a factor of approximately 1.6, then the corresponding logit estimate can be obtained.

There are situations, though, where estimates from logit and probit models may differ substantially, and in such cases care must be taken in choosing the more appropriate one.
These are cases with an extremely large number of observations and with heavy
collection of observations in the tails of the distribution. Logit models are more
appropriate for distributions with heavier tails. That is, if movement towards probability
of 0 or 1, after certain values of the regressors have reached, occurs quickly then a probit
model provides a better approximation to the data generation process. Otherwise the
logit model is preferred and more commonly used (Seddighi, Lawler and Katos, 2000).

6.5 Econometric Views (E-Views 4.0) for model estimation

There are several software packages that could be used for the analysis of qualitative
dependent variables. SPSS, E-Views and LIMDEP are among the most commonly used.
Although SPSS is a very user-friendly statistical package, which is widely used by social
scientists, it could not be used for the current analysis, since it requires a maximum of 10
dependent and independent variables (combined). In this study there are nine
independent variables, which means that (if the dependent variable is also included) the
maximum number of variables is reached. Yet, since in several cases, additional
variables may be used in the analysis, SPSS could not be used, due to the above
restriction regarding the number of variables. LIMDEP was another option, however,
due to unavailability of the software could not be considered either.

The Econometric Views software (version 4) is commonly used for discrete choice
analysis, including estimation of binary and ordered choice models. In maximizing the
log likelihood function of (14), it uses the analytical second derivative methods to obtain
the $\beta$ and $\gamma$ parameters, as well as the variance matrix of the estimated coefficients.
There are three parts to specifying an ordered variable model: the equation specification,
the error specification, and the sample specification. First, the name of the ordered
dependent variable followed by the list of the regressors should be specified. Next, one
needs to select among the ordered logit, ordered probit, and the ordered extreme value
models by choosing one of the three distributions for the latent error term. As already
mentioned, for the current analysis the logit model will be applied. Lastly, the estimation
sample should be specified.

Once the estimation procedure converges, E-Views will display the estimation results in
the equation window. The first part of the table contains the usual header information,
including the assumed error distribution, estimation sample, iteration and convergence
information, number of distinct values for y, and the method of computing the
coefficient covariance matrix. Below the header information are the coefficient estimates
and asymptotic standard errors, and the corresponding z-statistics and significance
levels.

The estimated coefficients of the ordered model must be interpreted with caution, since
the signs of the coefficients cannot be interpreted in the same way as in classical
regression. The sign of the estimated β coefficients shows the direction of the change in
the probability of falling in the endpoint rankings (y=0 or y=2) when xi changes. Pr(y=0)
changes in the opposite direction to the sign of β and Pr(y=2) changes in the same
direction as the sign of β. The effects on the probability of falling in any of the middle
rankings (in this case y=1) are given by:

\[
\frac{\partial \Pr(y = k)}{\partial \beta_i} = \frac{\partial F(\gamma_{k+1} - x' \beta)}{\partial \beta_i} - \frac{\partial F(\gamma_k - x' \beta)}{\partial \beta_i} \tag{15}
\]

for k=1,..., M-1. It is impossible to determine the signs of these effects, a priori (Greene,
2000).

The lower part of the estimation output, labeled “Limit Points”, presents the estimates of
the γ coefficients and the associated standard errors and probability values. Just below
the limit points are the summary statistics for the equation. The most important among
those summary statistics are the Akaike information criterion (AIC), the Schwarz
criterion (SC), the Hannan-Quinn (HC), the log-likelihood value and the likelihood ratio
(LR) statistic. The first three (AIC, SC and HC) are the information criteria used for
model selection; one should select the model with the smallest information criteria. The
LR statistic tests the joint hypothesis that all slope coefficients except the constant are
zero and thus is used to test the overall significance of the model. (More details
regarding the use of those criteria will be provided throughout the data analysis section.)
6.6 Conclusions

In this chapter, the elements of the research design were extensively discussed. The population and the sample of the study were identified, along with the type of data and data sources that were used. The main focus of the chapter was on the identification of the appropriate measure for each variable, as well as on how the decision among the three organisational modes could be modelled and tested. More specifically, it has been decided that the appropriate method to test the corporate development decision was the logit model.

Two models are going to be examined (the results of which will be presented in the next chapters): the one-stage ordered logit model and the two-stage binary model. For the first model to be applied, it is assumed that the expansion decision is made in one stage, where the choice is made among all the available alternatives (in this case company ownership, management contracts and franchise agreements). The ordered logit model will be used instead of the multinomial logit one, since the latter would fail to account for the information conveyed by the ordinal nature of the data, and thus would not test for the hypothesis that the three development modes (franchising, management contracts and company ownership) constitute a set of increasing control modes.

For the two-stage model to be applied, it is assumed that the development decision is made in two consecutive stages: at the first stage, the hotel executives choose between high- and low- control modes, i.e. between franchising and “non-franchising” and at the second stage a choice is made between the two high-control modes, i.e. management contracts and company ownership.
CHAPTER 7: DATA ANALYSIS – ORDERED MODEL

7.1 The profile of the sample

Before the main data analysis is performed and the results are presented, it would be useful to present some descriptive statistics and information regarding the sample that will be used for the analysis. As mentioned earlier, the hotel brands in the sample have been classified according to the market segment where each brand operates. Comparing the following table (Table 7.1) to the one presented in the previous chapter (Table 6.2), one could note that this table contains less data than the previous one. More specifically, Shangri-La hotels have been excluded from the luxury category. The reason is that this is the only hotel company that cannot be classified as Anglo-Saxon or Latin-European and moreover cannot form a separate category, since there are only three observations for this company.

Furthermore, one can see that the total number of observation is 487, whereas in the previous table there were 526 observations. This difference is due to missing data regarding mainly country specific information (e.g. country risk or level of economic development). Finally, it has to be mentioned that the four categories in the market segment qualitative variable will be merged into three, namely the luxury and the upscale segment will form one category (luxury/upscale). The reason is that the number of observations in the luxury segment is too small compared to the rest of the categories (only 21 observations) and this could cause problems in the estimation of the model (Liao, 1994).

As can be seen in table 7.1, management contracts have been the prevalent mode of development in the upscale segment, where 67 per cent of the developed hotels operate under a management contract, 24 percent are company owned and only 8.7 percent operate under a franchise agreement. Actually, it is worth mentioning that management contracts are the only mode of development in the luxury segment, as far as this sample is concerned. When it comes to the mid-market segment, the majority of the hotel units have been developed under a franchise agreement (56 percent), while management...
contracts have also been used to a considerable degree (34.5 percent). Finally, regarding the budget sector, the vast majority of the developed hotels consist of franchised units, whereas only a 12 percent of the hotels are operated under a management contract or company ownership.

**Table 7.1: Modes of Development within each Market Segment**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Luxury</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>21</td>
<td>0</td>
<td>0.0%</td>
<td>21</td>
</tr>
<tr>
<td>Ritz-Carlton</td>
<td>10</td>
<td>0</td>
<td>0.0%</td>
<td>10</td>
</tr>
<tr>
<td>4 Seasons</td>
<td>11</td>
<td>0</td>
<td>0.0%</td>
<td>11</td>
</tr>
<tr>
<td><strong>Upscale</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>140</td>
<td>39</td>
<td>27.9%</td>
<td>87</td>
</tr>
<tr>
<td>Hyatt</td>
<td>19</td>
<td>5</td>
<td>26.3%</td>
<td>14</td>
</tr>
<tr>
<td>Marriott</td>
<td>25</td>
<td>7</td>
<td>28.0%</td>
<td>14</td>
</tr>
<tr>
<td>Inter-Continental</td>
<td>20</td>
<td>5</td>
<td>25.0%</td>
<td>10</td>
</tr>
<tr>
<td>Hilton</td>
<td>19</td>
<td>6</td>
<td>31.6%</td>
<td>13</td>
</tr>
<tr>
<td>Radisson</td>
<td>7</td>
<td>3</td>
<td>42.9%</td>
<td>4</td>
</tr>
<tr>
<td>Sofitel</td>
<td>16</td>
<td>9</td>
<td>56.3%</td>
<td>7</td>
</tr>
<tr>
<td>Sheraton</td>
<td>6</td>
<td>1</td>
<td>16.7%</td>
<td>5</td>
</tr>
<tr>
<td>Westin</td>
<td>18</td>
<td>1</td>
<td>5.6%</td>
<td>14</td>
</tr>
<tr>
<td>Sol Melia</td>
<td>10</td>
<td>2</td>
<td>20.0%</td>
<td>6</td>
</tr>
<tr>
<td><strong>Total Lux/ Upscale</strong></td>
<td>161</td>
<td>39</td>
<td>24.2%</td>
<td>108</td>
</tr>
<tr>
<td><strong>Mid-market</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>119</td>
<td>11</td>
<td>9.2%</td>
<td>41</td>
</tr>
<tr>
<td>Holiday Inn</td>
<td>78</td>
<td>1</td>
<td>1.3%</td>
<td>14</td>
</tr>
<tr>
<td>Courtyard</td>
<td>6</td>
<td>0</td>
<td>0.0%</td>
<td>3</td>
</tr>
<tr>
<td>Novotel</td>
<td>12</td>
<td>2</td>
<td>16.7%</td>
<td>10</td>
</tr>
<tr>
<td>Mercure</td>
<td>11</td>
<td>4</td>
<td>36.4%</td>
<td>6</td>
</tr>
<tr>
<td>Iberostar</td>
<td>12</td>
<td>4</td>
<td>33.3%</td>
<td>8</td>
</tr>
<tr>
<td><strong>Budget</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>207</td>
<td>13</td>
<td>6.3%</td>
<td>11</td>
</tr>
<tr>
<td>Express by</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Holiday Inn</td>
<td>79</td>
<td>1</td>
<td>1.3%</td>
<td>9</td>
</tr>
<tr>
<td>Ibis</td>
<td>16</td>
<td>12</td>
<td>75.0%</td>
<td>2</td>
</tr>
<tr>
<td>Howard Johnson</td>
<td>112</td>
<td>0</td>
<td>0.0%</td>
<td>0</td>
</tr>
<tr>
<td><strong>TOTAL SAMPLE</strong></td>
<td>487</td>
<td>63</td>
<td>12.9%</td>
<td>160</td>
</tr>
</tbody>
</table>

Brand names in *italics* indicate Latin-European brands.
Another interesting point refers to how different modes of development are used in a different degree by certain hotel companies regardless of the market segment. What is meant by that is that the overall observation in the sample, according to which upscale brands use more management contracts while budget brands use more franchise agreements, does not hold when some hotel companies are examined separately.

A noticeable example is Accor, which consists of the following brands: Sofitel, Novotel, Mercure and Ibis. It can be seen that this particular hotel company uses mainly company ownership for the development of new units regardless of the fact that among the four brands, only Sofitel is positioned in the upscale market segment and thus the other three brands would be expected to expand mainly through franchise agreements. On the other hand, Six Continents, the company that owns Inter-Continental, Holiday Inn and Holiday Inn Express, follows the basic rule, and thus uses mainly franchise agreements for the expansion of the lower segment brands (i.e. Holiday Inn and Holiday Inn Express), while company ownership and management contracts are the preferred modes for the expansion of its upscale brand, Inter-Continental.

Figures 7.1 and 7.2 provide a better view of the issues raised above, which will be elaborated more in the next section, (where the results of the econometric analysis will be presented).

\[
\text{Figure 7.1 Modes of Development per Segment}
\]

![Modes of Development per Segment](image)

- Franchise Agreements
- Management Contracts
- Company-owned
7.2 Descriptive Statistics

Before we proceed with the econometric analysis of the data and the presentation of the regression model, some descriptive statistics of the sample should be presented and analysed. These statistics usually include frequency distributions of each variable, the correlation matrix that will reveal any multicollinearity issues among the independent variables and coefficients that test the bivariate relationships between each of the independent and the dependent variable. The latter will provide an indication with respect to whether there is actually a relationship between each independent variable and the dependent one, and moreover will give a first impression of how each independent variable relates to the modal choice, i.e. the choice between franchising, management contracts and company ownership as a mode of development of a new hotel property.

7.2.1. Sample Descriptive Analysis

The following table (Table 7.2) presents the main descriptive characteristics of the independent variables, including mean, median, standard deviation and frequency distribution.
Table 7.2: Descriptive Statistics of the Independent Variables

<table>
<thead>
<tr>
<th>Statistics</th>
<th>country risk</th>
<th>legal risk</th>
<th>economic development</th>
<th>brand size</th>
<th>brand growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>N Valid</td>
<td>487</td>
<td>487</td>
<td>487</td>
<td>487</td>
<td>487</td>
</tr>
<tr>
<td>Missing</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Mean</td>
<td>79.4988</td>
<td>6.6255</td>
<td>19,831.43</td>
<td>93,993.83</td>
<td>.06513</td>
</tr>
<tr>
<td>Median</td>
<td>83.0000</td>
<td>3.1471</td>
<td>23,019.00</td>
<td>52,102.00</td>
<td>.03000</td>
</tr>
<tr>
<td>Mode</td>
<td>83.10</td>
<td>3.15</td>
<td>31,746</td>
<td>51,403</td>
<td>.020</td>
</tr>
<tr>
<td>Std. Deviation</td>
<td>7.3470</td>
<td>11.9376</td>
<td>11,300.86</td>
<td>85,100.63</td>
<td>.08689</td>
</tr>
<tr>
<td>Skewness</td>
<td>-.1480</td>
<td>4.857</td>
<td>-.539</td>
<td>1.532</td>
<td>2.456</td>
</tr>
<tr>
<td>Std. Error of Skewness</td>
<td>.111</td>
<td>.111</td>
<td>.111</td>
<td>.111</td>
<td>.111</td>
</tr>
<tr>
<td>Kurtosis</td>
<td>1.806</td>
<td>27.735</td>
<td>-1.257</td>
<td>.788</td>
<td>8.309</td>
</tr>
<tr>
<td>Std. Error of Kurtosis</td>
<td>.221</td>
<td>.221</td>
<td>.221</td>
<td>.221</td>
<td>.221</td>
</tr>
<tr>
<td>Minimum</td>
<td>49.00</td>
<td>.03</td>
<td>290</td>
<td>8,085</td>
<td>-.010</td>
</tr>
<tr>
<td>Maximum</td>
<td>92.80</td>
<td>100.00</td>
<td>36,569</td>
<td>284,350</td>
<td>.500</td>
</tr>
<tr>
<td>Percentiles 25</td>
<td>74.3000</td>
<td>2.7438</td>
<td>8,214.00</td>
<td>51,403.00</td>
<td>.01000</td>
</tr>
<tr>
<td>50</td>
<td>83.0000</td>
<td>3.1471</td>
<td>23,019.00</td>
<td>52,102.00</td>
<td>.03000</td>
</tr>
<tr>
<td>75</td>
<td>83.8000</td>
<td>7.2021</td>
<td>30,316.00</td>
<td>83,563.00</td>
<td>.09000</td>
</tr>
<tr>
<td>100</td>
<td>92.8000</td>
<td>100.0003</td>
<td>36,569.00</td>
<td>284350.00</td>
<td>.50000</td>
</tr>
</tbody>
</table>

Table 7.2: Descriptive Statistics of the Independent Variables (cont’d)

<table>
<thead>
<tr>
<th>Statistics</th>
<th>international experience</th>
<th>market segment</th>
<th>geogr. dispersion</th>
<th>country group of origin</th>
</tr>
</thead>
<tbody>
<tr>
<td>N Valid</td>
<td>487</td>
<td>487</td>
<td>487</td>
<td>487</td>
</tr>
<tr>
<td>Missing</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Mean</td>
<td>27.23</td>
<td>1.91</td>
<td>.8106</td>
<td>1.16</td>
</tr>
<tr>
<td>Median</td>
<td>34.00</td>
<td>2.00</td>
<td>.3000</td>
<td>1.00</td>
</tr>
<tr>
<td>Mode</td>
<td>35</td>
<td>1</td>
<td>.00</td>
<td>1</td>
</tr>
<tr>
<td>Std. Deviation</td>
<td>12.66</td>
<td>.87</td>
<td>1.0068</td>
<td>.37</td>
</tr>
<tr>
<td>Skewness</td>
<td>-.542</td>
<td>.183</td>
<td>1.367</td>
<td>1.880</td>
</tr>
<tr>
<td>Std. Error of Skewness</td>
<td>.111</td>
<td>.111</td>
<td>.111</td>
<td>.111</td>
</tr>
<tr>
<td>Kurtosis</td>
<td>-1.107</td>
<td>-1.641</td>
<td>1.158</td>
<td>1.541</td>
</tr>
<tr>
<td>Std. Error of Kurtosis</td>
<td>.221</td>
<td>.221</td>
<td>.221</td>
<td>.221</td>
</tr>
<tr>
<td>Minimum</td>
<td>4</td>
<td>1</td>
<td>.00</td>
<td>1</td>
</tr>
<tr>
<td>Maximum</td>
<td>49</td>
<td>3</td>
<td>4.24</td>
<td>2</td>
</tr>
<tr>
<td>Percentiles 25</td>
<td>16.00</td>
<td>1.00</td>
<td>3.000E-02</td>
<td>1.00</td>
</tr>
<tr>
<td>50</td>
<td>34.00</td>
<td>2.00</td>
<td>.3000</td>
<td>1.00</td>
</tr>
<tr>
<td>75</td>
<td>37.00</td>
<td>3.00</td>
<td>1.5700</td>
<td>1.00</td>
</tr>
<tr>
<td>100</td>
<td>49.00</td>
<td>3.00</td>
<td>4.2400</td>
<td>2.00</td>
</tr>
</tbody>
</table>
7.2.2. Correlation Matrix

The following table (Table 7.3) gives the correlation matrix among all the independent variables that will be used in the regression models in this and the following chapters. Highlighted are the correlation coefficients that exceed 60%, while it has to be noted that none of these exceeds 70%, suggesting that none of the independent variables should be considered as highly problematic. Regarding the coefficients that exceed 60%, the following comments should be made:

(a) The correlation coefficient between brand size (FSIZE) and brand growth (FGR2) is 67.82%. This means that the size of the brand is highly related to brands that have slow growth (FGR2 represents the annual growth between 1 and 2.5%). That is, large brands are usually brands that are characterized by slow growth rates. This is actually what one would expect for large brands.

(b) The correlation coefficient between FSIZE and MIDMKT is 69%. MIDMKT represents the mid-market brands, and take the value of 1 if the brand is located in the market segment and 0 otherwise, while FSIZE is a continuous variable that measures the size of the brand in terms of rooms. The positive, high coefficient indicates that mid-market brands are possibly larger brands.

(c) Regarding the coefficient between Economic Development (GDP) and country group of origin (C_ORIG), it is found to be -67.74%. GDP is a continuous variable, while C_ORIG takes the value of 0 if the developed hotel property is located in an Anglo-Saxon country group and 1 if it is located in a Latin-European country group. The negative coefficient indicates that there is a tendency for less economic developed countries to be Latin-European countries, and more developed countries to be Anglo-Saxon.

(d) The coefficient between FGR2 and MIDMKT is 61.37%. That is, there is a tendency for brands with slow annual growth (between 1% and 2.5) to be mid-market brands. This coefficient is related to coefficients in the above cases (a) and (b). Slow growth brands (FGR2) tend to be large brands, and large brands tend to be mid-market brands. Thus slow growth (FGR2) brands tend to be located in the mid-market segment.
### Table 7.3: Correlation Matrix

<table>
<thead>
<tr>
<th></th>
<th>ICRGD2</th>
<th>ICRGD3</th>
<th>LEGRSK</th>
<th>GDP</th>
<th>FSIZE</th>
<th>FGR2</th>
<th>FGR3</th>
<th>FGR4</th>
<th>INTEXPY</th>
<th>DHOTELS</th>
<th>MIDMKT</th>
<th>UPLUX</th>
<th>C_ORIG</th>
</tr>
</thead>
<tbody>
<tr>
<td>ICRGD2</td>
<td>1.0000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ICRGD3</td>
<td>-0.5637</td>
<td>1.0000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>LEGRSK</td>
<td>-0.0399</td>
<td>0.2682</td>
<td>1.0000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GDP</td>
<td>0.4144</td>
<td>0.3456</td>
<td>0.1446</td>
<td>1.0000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FSIZE</td>
<td>-0.0769</td>
<td>0.0050</td>
<td>-0.0262</td>
<td>-0.0959</td>
<td>1.0000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FGR2</td>
<td>-0.0852</td>
<td>-0.0153</td>
<td>0.0118</td>
<td>-0.1422</td>
<td>0.6782</td>
<td>1.0000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FGR3</td>
<td>-0.0237</td>
<td>-0.0245</td>
<td>0.0583</td>
<td>-0.0954</td>
<td>-0.2242</td>
<td>-0.3296</td>
<td>1.0000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FGR4</td>
<td>-0.0108</td>
<td>0.0711</td>
<td>0.0723</td>
<td>0.0097</td>
<td>-0.2560</td>
<td>-0.3107</td>
<td>-0.3469</td>
<td>1.0000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>INTEXPY</td>
<td>-0.0309</td>
<td>-0.0110</td>
<td>-0.0580</td>
<td>0.0125</td>
<td>0.2441</td>
<td>0.2682</td>
<td>-0.0368</td>
<td>-0.6459</td>
<td>1.0000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>DHOTELS</td>
<td>0.2648</td>
<td>0.1237</td>
<td>-0.1032</td>
<td>0.5359</td>
<td>0.0512</td>
<td>-0.0604</td>
<td>-0.1808</td>
<td>0.0439</td>
<td>-0.1173</td>
<td>1.0000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>MIDMKT</td>
<td>-0.1400</td>
<td>-0.0258</td>
<td>0.1188</td>
<td>-0.2198</td>
<td>0.6900</td>
<td>0.6137</td>
<td>-0.2372</td>
<td>-0.0147</td>
<td>0.0393</td>
<td>-0.0829</td>
<td>1.0000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>UPLUX</td>
<td>-0.1252</td>
<td>0.0236</td>
<td>-0.0210</td>
<td>-0.1552</td>
<td>-0.2557</td>
<td>-0.0697</td>
<td>0.4399</td>
<td>-0.0980</td>
<td>0.1390</td>
<td>-0.3685</td>
<td>-0.396</td>
<td>1.0000</td>
<td></td>
</tr>
<tr>
<td>C_ORIG</td>
<td>-0.3252</td>
<td>-0.0902</td>
<td>0.2148</td>
<td>-0.6774</td>
<td>0.2107</td>
<td>0.2174</td>
<td>0.0570</td>
<td>0.0477</td>
<td>0.0118</td>
<td>-0.6740</td>
<td>0.2911</td>
<td>0.0737</td>
<td>1.0000</td>
</tr>
</tbody>
</table>

---

*Table continues on the next page*
(e) The coefficient between FGR4 and international experience (INTEXP) is -64.59%. FGR4 represents the brands that are characterized by high annual growth (more than 9.5%). The correlation coefficient suggests that there is a tendency for high-growth brands to have lower international experience. One would expect that companies with lower international experience are companies that are new in the international arena. They may be small or large brands in their country where they started their operation, but since they haven’t got enough international experience, this means that there is opportunity for them to expand worldwide at a quick pace, and thus one would expect brands with low international experience to be brands that have large growth rate.

(f) Finally, the coefficient between geographical concentration (DHOTELS) and C.ORIG is -67.4%. C.ORIG takes the value of 0 for Anglo-Saxon countries and 1 for Latin-European, while the higher the value of DHOTELS the more concentrated the properties of a hotel brand in a particular country. Thus, the coefficient suggests that there may be an association between highly concentrated hotel outlets and Anglo-Saxon countries. Namely, it could be that hotel brands are more concentrated in Anglo-Saxon countries than in Latin-European. However, since DHOTELS is calculated as the number of hotels in a particular country divided by its population, one would expect that there are more hotels per population in Anglo-Saxon countries than in Latin-European, hence the negative correlation coefficient.

7.2.3. Bivariate Relationships

The following table (Table 7.4) presents each of the independent variables, with respect to their nature (level of measurement) and the appropriate approach to analyse their relationship to the dependent variable.

Although most of the above independent variables are interval variables they have to be transformed to ordinal variables in order to examine their relationship to the dependent variable due to the nature of the latter. As mentioned in the previous chapter (Chapter 6) the dependent variable is an ordinal one that takes the value of 1 for franchising, 2 for management contract and 3 for company ownership. If one wants to analyse the relationship between an ordinal and an interval (scale) variable, one needs to transform (drop) the interval one to an ordinal variable and then perform a rank correlation method.
Expansion Strategies of International Hotel Firms (Bryman and Cramer, 1999). Therefore each of the variables politico-economic risk, legal risk, economic development, brand size and growth, international experience and geographical dispersion needs to be collapsed into groups and ranks should be assigned to the groupings. "The chief source of concern with collapsing values of an ordinal or interval variable is that the choice of cut-off points is bound to be arbitrary and will have a direct impact on the results obtained. Accordingly, it may be better to use more than one method of grouping or to employ a fairly systematic procedure like quartiles as a means of collapsing cases into groups" (Bryman and Cramer, 1999; p.188).

Table 7.4: Independent variables and the appropriate bivariate analysis

<table>
<thead>
<tr>
<th>Independent Variable</th>
<th>Type of variable</th>
<th>Appropriate Analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Politico-economic Country Risk</td>
<td>Ordinal (initially interval)</td>
<td>Rank Correlation</td>
</tr>
<tr>
<td>Legal Risk</td>
<td>Ordinal (initially interval)</td>
<td>Rank Correlation</td>
</tr>
<tr>
<td>Economic Development</td>
<td>Ordinal (initially interval)</td>
<td>Rank Correlation</td>
</tr>
<tr>
<td>Brand Size</td>
<td>Ordinal (initially interval)</td>
<td>Rank Correlation</td>
</tr>
<tr>
<td>Brand Growth</td>
<td>Ordinal (initially interval)</td>
<td>Rank Correlation</td>
</tr>
<tr>
<td>International Experience</td>
<td>Ordinal (initially interval)</td>
<td>Rank Correlation</td>
</tr>
<tr>
<td>Market Segment</td>
<td>Ordinal</td>
<td>Rank Correlation</td>
</tr>
<tr>
<td>Geographical Dispersion</td>
<td>Ordinal (initially interval)</td>
<td>Rank Correlation</td>
</tr>
<tr>
<td>Country Group of Origin</td>
<td>Nominal</td>
<td>Cross Tabulation</td>
</tr>
</tbody>
</table>

In the case of this study, the following transformations will be performed in order for the bivariate relationships between independent variables and dependent variable to be examined:

**Country politico-economic risk (ICRG):** originally this is an interval variable that can take any value between 0 (highest risk) and 100 (lowest risk). The grouping will be performed in accordance with the groups that Frost and Sullivan provide for their Composite Risk Rating (see Appendix 2). That is, 1 for very high risk (0 to 49.5), 2 for
high risk (50.0-59.9), 3 for moderate risk (60.0-69.5), 4 for low risk (70-79.5) and 5 for very low risk (80.0-100). The following histogram represents the frequency distribution of the grouped country risk variable.

It can be observed from the histogram of the grouped country risk variable (Figure 7.3.) that this variable follows a non-linear distribution in which case one could not employ a measure of linear correlation, like Pearson’s $r$. However, since the dependent variable is of an ordinal nature, Pearson’s $r$ could not be employed from the outset, rather the Spearman’s $\rho$ or the Kendall’s $\tau$ should be used. Since the latter two are non-parametric methods, it means they make fewer assumptions about variables. Thus, there is no need to transform the grouped country risk variable into a logarithmic scale.

**Figure 7.3: Frequency distribution of the country politico-economic risk grouped variable (ICRGGP)**

![Histogram of ICRGGP](image)

Table 7.5 presents the correlation test between all the ordinal variables (originally interval variables) and the dependent one, i.e. all but the correlation test between organisational mode and country group of origin (which is a nominal variable and thus a different treatment is required) and the correlation test between organisational mode and market segment.
The correlation test between the grouped country risk variable (IRCGGP) and organisational mode (OM) is presented in the third column. As it can be seen, the bivariate correlation is significant at the .01 level, according to both Spearman’s rho and Kendall’s tau, and thus there is an indication that country political and economic risk could be one of the factors that influence the modal choice. The negative sign of the coefficient indicates a negative relationship between mode of development and country risk measure, namely, there is a tendency for the use of lower control modes when the ICRG measure is higher (i.e. when the country risk is lower), opposite to that suggested by H1.

Table 7.5: Bivariate Correlation between ordinal independent variables and dependent variable

<table>
<thead>
<tr>
<th>Org. mode (OM)</th>
<th>Correl. Coef. Kendall’s τ</th>
<th>Correl. Coef. Spearman’s ρ</th>
<th>Sig. (1-tailed)</th>
</tr>
</thead>
<tbody>
<tr>
<td>country risk</td>
<td>-0.238**</td>
<td>-0.259**</td>
<td>0.000</td>
</tr>
<tr>
<td>legal risk</td>
<td>0.075*</td>
<td>0.060*</td>
<td>0.000</td>
</tr>
<tr>
<td>economic</td>
<td>-0.231**</td>
<td>-0.256**</td>
<td>0.000</td>
</tr>
<tr>
<td>developm.</td>
<td>-0.141**</td>
<td>-0.162**</td>
<td>0.000</td>
</tr>
<tr>
<td>brand size</td>
<td>0.339**</td>
<td>0.378**</td>
<td>0.000</td>
</tr>
<tr>
<td>brand growth</td>
<td>-0.187**</td>
<td>-0.214**</td>
<td>0.000</td>
</tr>
<tr>
<td>int’l</td>
<td>geographic</td>
<td>-0.459**</td>
<td>0.000</td>
</tr>
<tr>
<td>experience</td>
<td>dispersion</td>
<td></td>
<td></td>
</tr>
<tr>
<td>N</td>
<td>487</td>
<td>487</td>
<td>487</td>
</tr>
</tbody>
</table>

** Correlation is significant at the .01 level (1-tailed).
* Correlation is significant at the .05 level (1-tailed).

**Legal Risk:** this is also an originally interval variable that can take a value from 0 (highest risk) to 100 (lowest risk). Since there is no objective method of setting the cut-off points, the quartiles procedure will be applied for collapsing values into groups. The figure below (Figure 7.3) presents the frequency distribution of the grouped legal risk variable (LGRSKGP). The rank correlation tests of the relationship between legal risk and model of entry (OM) indicates that relationship between these two variables is significant at .05. However, both Kendall’s tau and Spearman’s rho coefficients have a very small value. Compared to country politico-economic risk, it can be seen that legal risk has a weaker effect on the dependent variable and moreover there is less confidence that the relationship has not arisen by chance. The positive sign of the coefficient
indicates that there is a tendency for the use of higher control modes when the LEGRSK measure is higher (i.e. when legal risk is lower), opposite to what is suggested by \textit{H2}.

\textbf{Level of Economic Development:} as in the case of legal risk, quartiles will also be used for the grouping of the GDP variable. Figure 7.5 presents the frequency distribution of the GDP grouped variable while the fifth column of Table 7.5 shows the coefficients for the bivariate relationship between economic development (GDPGP) and mode of expansion (OM). Both coefficients indicate a strong and significant at .01 relationship suggesting that there is a tendency for the use of higher control mode in countries with low level of development, as it is suggested by \textit{H3}.

\textbf{Figure 7.4: Frequency distribution of the country legal risk grouped variable}

\begin{figure}[h]
\centering
\includegraphics[width=0.5\textwidth]{figure7.4}
\caption{Frequency distribution of the country legal risk grouped variable}
\end{figure}

\begin{figure}[h]
\centering
\includegraphics[width=0.5\textwidth]{figure7.5}
\caption{Frequency distribution of the GDP grouped variable}
\end{figure}
Figure 7.5: Frequency distribution of the GDP grouped variable

Figure 7.6: Frequency distribution of the brand size grouped variable
Brand Size and Brand Growth: Figures 7.5 and 7.6 show the frequency distributions for brand size and brand growth respectively, while the coefficient tests are presented in the 6th and 7th column of table 7.5. Correlation coefficients indicate a strong relationship between both variables and the dependent one, both significant at a .01 level. In accordance with H4, the coefficients of brand size indicate that there is a tendency for the use of lower control modes by larger firms and visa versa. However, regarding the brand growth, the correlation coefficients indicate a positive relationship namely, brands that are characterised by higher growth rates are associated with the use of lower control modes, opposite to the suggestion of H5.

International Experience: the correlation coefficients between the international experience grouped variable and the dependent variable are negative and significant at .01 level indicating that companies characterised by low international experience are associated with the use of higher control modes (such as company ownership) and visa versa. The rank correlation test for the bivariate relationship between experience and mode of development is in line with the suggestion of H6, and thus justifies the inclusion of int’l experience in the regression model.
Figure 7.8: Frequency distribution of the int’l experience grouped variable

Geographical Dispersion: Figure 7.9 presents the frequency distribution of the geographical dispersion grouped variable while the last column of Table 7.5 shows the coefficients for the bivariate relationship between geographical dispersion (GDSPRSGP) and mode of development (OM). Both coefficients indicate a strong negative and significant at .01 relationship, suggesting that there is a tendency for the use of higher control mode in countries where the hotel outlets of a company are dispersed, opposite to what is suggested by H9. Yet, the fact that there is a strong relationship between geographical dispersion and organisational mode, even in the opposite than expected direction, justifies the inclusion of the variable in the subsequent regression analysis.
Figure 7.9: Frequency distribution of the geographical dispersion grouped variable

![Frequency Distribution Graph]

\[\text{Std. Dev} = 1.11\]
\[\text{Mean} = 2.5\]
\[N = 487.00\]

**Market Segment of Operation**: this is an originally ordinal variable that takes the value of 1 for budget hotels, 2 for mid-market and 3 for upscale and luxury properties. The following table (Table 7.6) presents the Kendall’s \(\tau\) and Spearman’s \(\rho\) correlation coefficients of the relationship between market segment and mode of development (organisational mode). The coefficients suggest a very strong and positive relationship between the market segment and the organisational mode. Thus, there is tendency for brands that are located in higher market segment to choose higher control modes for the development of a new hotel property, other things equal, in line with \(H8\).
Figure 7.10: Frequency distribution of the market segment variable

Table 7.6: Bivariate correlation between market segment and dependent variable

<table>
<thead>
<tr>
<th></th>
<th>organisational mode</th>
<th>market segment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kendall's tau_b</td>
<td>Correlation Coefficient</td>
<td>1.000</td>
</tr>
<tr>
<td></td>
<td>Sig. (1-tailed)</td>
<td>.</td>
</tr>
<tr>
<td></td>
<td>N</td>
<td>487</td>
</tr>
<tr>
<td></td>
<td>Correlation Coefficient</td>
<td>.584**</td>
</tr>
<tr>
<td></td>
<td>Sig. (1-tailed)</td>
<td>.000</td>
</tr>
<tr>
<td></td>
<td>N</td>
<td>487</td>
</tr>
<tr>
<td>Spearman's rho</td>
<td>Correlation Coefficient</td>
<td>1.000</td>
</tr>
<tr>
<td></td>
<td>Sig. (1-tailed)</td>
<td>.</td>
</tr>
<tr>
<td></td>
<td>N</td>
<td>487</td>
</tr>
<tr>
<td></td>
<td>Correlation Coefficient</td>
<td>.640**</td>
</tr>
<tr>
<td></td>
<td>Sig. (1-tailed)</td>
<td>.000</td>
</tr>
<tr>
<td></td>
<td>N</td>
<td>487</td>
</tr>
</tbody>
</table>

**. Correlation is significant at the .01 level (1-tailed).

**Country Group of Origin:** it is a nominal (dichotomous) variable that takes the value of 0 for cases where a hotel property is developed in an Anglo-Saxon country and 1 when a hotel property is developed in a Latin-European country. The appropriate statistical approach for the examination of the bivariate relationship between country group of origin and organisational mode is crosstabulation (Table 7.7). It can be observed in the
table that 63% of the “Anglo-Saxon” hotels have been developed using franchising, while the respective percentage for “Latin-European” hotels is only 6.5%. Management contracts are a popular mode of development for both country group origins, although the percentage is higher for Latin-European. Finally, it can be seen, that company ownership is used mainly by Latin-European brands, since only 7.3% of the “Anglo-Saxon” hotels in the sample have been developed as company-owned properties, while the relevant percentage for Latin-European hotels in the sample is 43%.

Table 7.5: Organisational mode / Country group of origin Crosstabulation

<table>
<thead>
<tr>
<th>organisational mode</th>
<th>country group of origin</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>anglo-saxon</td>
<td>latin-european</td>
</tr>
<tr>
<td>franchising</td>
<td>Count</td>
<td>259</td>
</tr>
<tr>
<td></td>
<td>Expected Count</td>
<td>222.3</td>
</tr>
<tr>
<td></td>
<td>% within country group of origin</td>
<td>63.2%</td>
</tr>
<tr>
<td>management contract</td>
<td>Count</td>
<td>121</td>
</tr>
<tr>
<td></td>
<td>Expected Count</td>
<td>134.7</td>
</tr>
<tr>
<td></td>
<td>% within country group of origin</td>
<td>29.5%</td>
</tr>
<tr>
<td>company ownership</td>
<td>Count</td>
<td>30</td>
</tr>
<tr>
<td></td>
<td>Expected Count</td>
<td>53.0</td>
</tr>
<tr>
<td></td>
<td>% within country group of origin</td>
<td>7.3%</td>
</tr>
<tr>
<td>Total</td>
<td>Count</td>
<td>410</td>
</tr>
<tr>
<td></td>
<td>Expected Count</td>
<td>410.0</td>
</tr>
<tr>
<td></td>
<td>% within country group of origin</td>
<td>100.0%</td>
</tr>
</tbody>
</table>

Thus, the crosstabulation between dependent variable and country group of origin suggests that there is a relationship between these two variables: Anglo-Saxon brands show a preference in the use of lower control modes, while the opposite is true for Latin-European brands. However, in order to be confident regarding the existence of this relationship in the population, one needs to perform a significance test (chi-square test). It can be seen in Table 7.8 that the chi-square value is 110.525 with 2 degrees of freedom and the significance level is 0.01. Thus, one could be confident that the relationship between country group of origin and organisational mode could not have arisen by chance.
Table 7.6: Chi-Square Tests

<table>
<thead>
<tr>
<th></th>
<th>Value</th>
<th>df</th>
<th>Asymp. Sig. (2-sided)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pearson Chi-Square</td>
<td>110.525a</td>
<td>2</td>
<td>.000</td>
</tr>
<tr>
<td>Likelihood Ratio</td>
<td>110.694</td>
<td>2</td>
<td>.000</td>
</tr>
<tr>
<td>Linear-by-Linear Association</td>
<td>109.785</td>
<td>1</td>
<td>.000</td>
</tr>
<tr>
<td>N of Valid Cases</td>
<td>487</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

a. 0 cells (0%) have expected count less than 5. The minimum expected count is 9.96.

7.3 Analysis and Results – Original Specification

As already mentioned in the previous chapter the dependent variable is a polytomous one and can take three values, namely 0 for franchise agreements, 1 for management contracts and 2 for company ownership. Since the dependent variable is a qualitative one, the ordered logit model will be used to analyse the corporate development decision. The explanatory variables are either qualitative or quantitative. More specifically, the market segment variable can take three values, 0 for budget hotels, 1 for mid-market and 2 for upscale, and the origin variable (coded as Latin-European) is a dummy variable that takes the value 0 if the brand originates from an Anglo-Saxon country and 1 otherwise, i.e. if it originates from a Latin-European country (France or Spain).

Brand growth, although a continuous variable, in the context of this analysis will be presented as an ordered, qualitative one. The reason this approach has been taken is the existence of outliers in the distribution of this variable. Although the median growth is 2.5 percent (the mean is 6.5 percent), there are hotel brands that presented up to 50 percent growth in one year, and thus the growth variable is far from being linearly related to the log of the dependent variable. Therefore, a qualitative variable was constructed in relation to the quartiles of the brand growth distribution; FGR1 refers to brands with annual growth up to 1 percent, FGR2 to brands with annual growth between 1 and 2.5 percent, FGR3 to annual growth between 2.5 and 9.5 percent and FGR4 to annual growth higher than 9.5 percent. The rest of the explanatory variables are continuous variables and have been presented in detail in the previous chapter (see measurement of variables).
Expansion Strategies of International Hotel Firms

Since there are also qualitative variables in the analysis, one needs to apply the appropriate representation in the model. Thus, in this case, the model that will be estimated takes the following form:

\[ OM = \beta_0 + \beta_1 \text{ICRGD2} + \beta_2 \text{ICRGD3} + \beta_3 \text{LEGRSK} + \beta_4 \text{GDP} + \beta_5 \text{FSIZE} + \beta_6 \text{FGR2} + \beta_7 \text{FGR3} + \beta_8 \text{FGR4} + \beta_9 \text{INTEXP} + \beta_{10} \text{GDSPRS} + \beta_{11} \text{MIDMKT} + \beta_{12} \text{UPSCALE} + \beta_{13} \text{LATEUROP} + \beta_{14} \text{RMS} + \beta_{15} \text{LOCATION} \]  

When a qualitative independent variable takes \( n \) values, it needs to be represented in the model by \( n-1 \) variables. Therefore, the brand growth variable is represented by \( (4-1) \) three variables (FGR2, FGR3 and FGR4), the market segment variable is represented by \( (3-1) \) two variables (MIDMKT and UPSCALE) and the origin variable by the \( (2-1) \) one variable (Hardy, 1993; Liao, 1994). The coefficients of FGR2, FGR3 and FGR4 are actually being compared to the “base” value of FGR1 and the coefficients of MIDMKT and UPSCALE variables are compared to the “base” value of market segment, i.e. BUDGET. In the following sections one will be able to better understand the meaning of the coefficients of qualitative variables.

\( \beta_1 \) & \( \beta_2 \) indicate the effect of low (ICRGD2) and very low risk (ICRGD3) countries on the decision to use F, MC or CO, compared to the base category (ICRGD1), which refers to high/moderate-risk ones.

\( \beta_3 \) & \( \beta_4 \) indicate the effect of legal risk and economic development respectively

\( \beta_5 \) indicates the effect of brand size, (measured by the total number of rooms in the system) on the choice

\( \beta_6, \beta_7, \) & \( \beta_8 \) indicate the effect of brand growth higher than 1\%, 2.5\% and 9.5\% respectively on the choice, compared to the base category, which is a hotel brand with annual growth lower than 1\%.

\( \beta_9 \) indicates the effect of international experience measured in years since the brand assumed operations in a second country.

\( \beta_{10} \) indicates the effect of geographical concentration, measured by the number of hotels the brand operates in each country (divided by the population of that country).

\( \beta_{11} \) & \( \beta_{12} \) indicate the effect of being a mid-market (or upscale) brand on the choice, compared to being a budget brand.
\( \beta_{13} \) indicates the effect on the choice of being a Latin-European brand compared to an Anglo-Saxon brand.

\( \beta_{14} \) & \( \beta_{15} \) (control variables): indicate whether the size of the developed property (RMS) and its location (LOCATION) influences the decision among the three corporate development modes.

The following table (Table 7.9) presents the E-Views estimation output of the above model (1). The last column (antilog \( \beta \)) had to be added, since it is not directly estimated by the software. There are three issues that need to be clarified before proceeding with the interpretation of the output. The first refers to the use of antilog\(^{25}\): the reason why the antilogs were estimated is that in ordered logit (and probit) analysis, the coefficients (\( \beta \)) are not intuitively appealing as in classical regression; the antilog on the other hand gives the marginal effect of an explanatory variable \( x \) on the odds of belonging to one versus the other categories of the dependent variable (Liao, 1994; Hardy, 1993). The second issue is to be raised is also related to the interpretation of the coefficients: as mentioned earlier, when the dependent variable is polytomous the sign of the estimated \( \beta \) coefficients shows the direction of the change in the probability of falling in the endpoint rankings (\( y=1 \) or \( y=3 \)) when \( x_i \) changes. \( \Pr(y=1) \) changes in the opposite direction of the sign of \( \beta \) and \( \Pr(y=3) \) changes in the same direction as the sign of \( \beta \). Yet, the effects on the probability of falling into any of the middle rankings (in this case \( y=2 \)) are not known a priori. The last issue that needs to be clarified refers to the probabilities column: the probabilities of the z-statistics calculated by E-Views always refer to a two-tailed test. Therefore, in order to find if any of the factors are statistically significant under a one-tailed test, the half of the reported probability should be used.

The top section of the E-Views output gives some general information regarding the dependent variable, the model of estimation, the sample size and the convergence estimation. In this study, the dependent variable is the organisational mode that is chosen by the international hotel company for a new hotel outlet (OM), the total sample is 487 and the ordered logit model has been used for the analysis.

\(^{24}\) What is meant by "location" is whether the developed property is located in the country where the hotel brand operates most of its hotel properties or outside that country. In the former case LOCATION takes the value of 0, whereas in the latter the value of 1.

\(^{25}\) The antilog is calculated by exponentiating, i.e. taking the antilogarithm where the base is \( e \).
### Table 7.9: E-Views output of the ordered model (original representation)

<table>
<thead>
<tr>
<th>Coefficient</th>
<th>Std. Error</th>
<th>z-Statistic</th>
<th>Prob.</th>
<th>Antilog β</th>
</tr>
</thead>
<tbody>
<tr>
<td>ICRGD2 (count. Risk)</td>
<td>0.326868</td>
<td>0.419019</td>
<td>0.78008</td>
<td>0.4353</td>
</tr>
<tr>
<td>ICRGD3 (count. Risk)</td>
<td>-0.171659</td>
<td>0.528723</td>
<td>-0.32467</td>
<td>0.7454</td>
</tr>
<tr>
<td>LEGRSK</td>
<td>0.003560</td>
<td>0.010455</td>
<td>0.340523</td>
<td>0.7335</td>
</tr>
<tr>
<td>GDP</td>
<td>0.000019</td>
<td>2.10E-05</td>
<td>0.883924</td>
<td>0.3767</td>
</tr>
<tr>
<td>FSIZE</td>
<td>0.000005</td>
<td>2.58E-06</td>
<td>1.900639</td>
<td>0.0573</td>
</tr>
<tr>
<td>FGR2 (Brand growth)</td>
<td>-0.303993</td>
<td>0.577711</td>
<td>-0.5262</td>
<td>0.5987</td>
</tr>
<tr>
<td>FGR3 (Brand growth)</td>
<td>1.068209</td>
<td>0.488364</td>
<td>2.187321</td>
<td>0.0287</td>
</tr>
<tr>
<td>FGR4 (Brand growth)</td>
<td>0.853355</td>
<td>0.547907</td>
<td>1.55748</td>
<td>0.1194</td>
</tr>
<tr>
<td>INTEXP</td>
<td>-0.011450</td>
<td>0.013346</td>
<td>-0.85793</td>
<td>0.3909</td>
</tr>
<tr>
<td>GDSPRS</td>
<td>-1.405234</td>
<td>0.289238</td>
<td>-4.85839</td>
<td>0.0000</td>
</tr>
<tr>
<td>MIDMKT</td>
<td>0.286917</td>
<td>0.478981</td>
<td>0.599015</td>
<td>0.5492</td>
</tr>
<tr>
<td>UPLUX</td>
<td>2.658030</td>
<td>0.436223</td>
<td>6.093286</td>
<td>0.0000</td>
</tr>
<tr>
<td>LATEUROP</td>
<td>3.285711</td>
<td>0.454182</td>
<td>7.234347</td>
<td>0.0000</td>
</tr>
<tr>
<td>RMS</td>
<td>0.002435</td>
<td>0.000904</td>
<td>2.694397</td>
<td>0.0071</td>
</tr>
<tr>
<td>LOCATION</td>
<td>-0.015563</td>
<td>0.46907</td>
<td>-0.03318</td>
<td>0.9735</td>
</tr>
</tbody>
</table>

The second section includes the estimated coefficients (β), along with their z-statistics and the associated probabilities. As previously explained, a positive sign of a coefficient does not necessarily suggest a positive relationship between the explanatory and the response variable (and the same is true for a negative sign). This is because the ordered model looks at the probability associated with each value of the response variable rather than the relationship between the dependent variable and its determinants.
a) **Brand Size:** The findings suggest that the larger the size of the brand, the higher the probability that company ownership will be used for a new hotel development and the lower the probability that franchising will be used (other things equal), opposite to what is suggested by the relevant hypothesis. The coefficient of FSIZE is very low (0.00001) therefore the effect, although statistically significant, is extremely weak.

b) **Brand Growth:** the results indicate that, compared to the reference category (brands with annual growth lower than 1 percent), hotel brands with annual growth higher than 2.5% are more likely to use company ownership for a new hotel development, as opposed to franchising (ceteris paribus). The effect is opposite to what suggested by the relevant hypothesis and is more significant for brands with growth between 2.5 and 9 percent than for brands with growth higher than 9 percent. It has to be noticed, however, that hotel brands with low annual growth (i.e. between 1 and 2.5 percent) are less likely to use company ownership and more likely to use franchising compared to the reference category, but the effect was not found to be significant.

c) **Geographical Concentration:** As already explained earlier it is hypothesised that, the more dispersed the hotel outlets, the more likely it is that franchising will be the preferred mode of development, due to the fact that the use of franchising aligns the incentives of the franchisee with those of the hotel company and thus economises on monitoring costs. In other words, the more concentrated the hotel outlets, the more likely it is that “non-franchising” (i.e. a higher control mode) will be used.

The results, however, do not support the relevant hypothesis since it is revealed that the more concentrated the hotel outlets of a brand in the target country, the less likely it is that a “non-franchising” mode will be used for the new hotel outlet. The discrepancy between the theory prediction and the findings of this study could be caused by the proxy that has been used to operationalise geographical concentration. The proxy (GDSPRS) is based on the number of hotels in the country (deflated by population) and basically what it is hypothesized based on agency theory is that the more the hotels of a specific brand in the target country (controlled for population), the more likely it is that the new property will be subject to a high control mode (company-owned or company-managed) because the cost of monitoring would be lower. However, one could argue *per contra* that attracting franchisees would not be an easy task in countries where the hotel brand operates only a few hotel properties; on the contrary brand recognition would help
Expansion Strategies of International Hotel Firms

franchisors to expand their systems in countries with more hotel operations. The latter suggestion is consistent with the results of this analysis. The hypothesis based on agency theory is not supported by this study. It should be noted, however, that the composition of the sample may have affected the results, for the following reason: the vast majority of the franchised outlets belong to three brands that have started their operations in the USA and which operate most of their hotels in that country, and the USA is one of the more geographically concentrated markets using the proxy measure employed here. Because using the only available proxy measure of geographical concentration leads to the results reported above, it would appear that geographical concentration is an influencing factor of the corporate development strategy, but not in the sense suggested by agency theory. On the other hand, had a proxy been available that better reflected the distances between properties, a different result regarding the agency theory-based hypothesis might have been obtained.

d) **Market Segment** The coefficient for UPLUX is highly significant and large, suggesting that upscale and luxury hotel brands are indeed more likely to choose company ownership for a new hotel development compared to budget brands, *ceteris paribus*. On the other hand, the coefficient of MIDMKT, although in the hypothesized direction, was not found to be statistically significant, and thus it could not be concluded that being in the mid-market segment, as opposed to the budget segment, has an effect on the expansion decision. Hence, *H6* is partly confirmed.

e) **Country Group (Brand origin):** The effect of brand origin was also found to be highly significant, at a 1% level. According to the results a hotel brand that originates from a Latin-European country group (France or Spain) is more likely to use company ownership (and less likely to use franchising) compared to a brand that originates from an Anglo-Saxon country group (North America or United Kingdom), other things equal.

The rest of the explanatory variables (ICRG, LEGRSK, GDP, INTEXP) as well as the control variable LOCATION are not found to be statistically significant, when the original specification is used. In contrast, the control variable RMS does influence the choice among the three corporate modes of development. More specifically, the results indicate that the bigger the hotel property to be developed, the more likely it is that company ownership will be used, as opposed to franchising. The results provide additional support to previous researchers who opposed the financial constraint
argument and suggested that bigger outlets do not have a negative influence on the use of company ownership.

The third section of the output (limit points) gives the estimated $\gamma$ parameters in the logit model. Highly significant, positive $\gamma$ parameters indicate that the three categories in the response variable are indeed ordered (Liao, 1994), which is the case in this study since both $\gamma$ parameters have a probability less than 5 percent ($p<0.05$). Thus the organisational mode choice is indeed ordered with franchising being the lowest category ($F=1$) and company ownership the highest ($CO=3$). It can be seen in the second section that there is no intercept provided. This is because E-views absorbs the intercept term into its cutoff (limit) points (Borooah, 2001). Thus the intercept is equal to the opposite of the first limit point, i.e. $-\gamma_1$ (Greene, 2000; Laio, 1994). In this case it is $\beta_0 = -\gamma_1 = -4.728022$.

To interpret the results from a logit model meaningfully, the model itself must first fit the data. Put differently, the explanatory variables included in the model must be able to explain the response variable significantly better than the model with the intercept only (Liao, 1994). (This information can be found in the last section of the output.) While in classical regression the F test is used, in a logit model the most commonly used test is the likelihood ratio statistic (LR), which approximately follows the chi-squared distribution. If the LR statistic indicates that the model fits the data significantly better than the model with the intercept only, one can move on to interpret parameter estimates. In the previous table, the LR statistic probability is zero, namely one can reject the null hypothesis that the $\beta$ coefficients of the explanatory variables are jointly zero, which indicates that this model fits the data better than the model with the intercept only.

The next step involves the assessment of predictive efficacy. In classical regression the most common goodness-of-fit measure is $R^2$. However, although a pseudo-$R^2$ is also reported in a logit model output, it would not be right to think of this as the proportion of variance explained by the model. Typically, the $R^2$ reported in logistic regression underestimates the proportion of variation explained by the model (DeMaris, 1992). The $R^2$ reported in this model is 40%. However, some additional criteria for model selection should be used, such as the Akaike Information Criterion (AIC), Schwarz Criterion (SC) and Hannan-Quinn Criterion (HC) which are reported by the E-Views software. The model that best fits the data is the one with the lowest AIC, SC and HQ criteria. The
information criteria of this model will be compared to the criteria of the models that will be assessed later on.

As mentioned earlier, the restriction in using ordered models is that the coefficients (and the antilogs of the coefficients) do not indicate the effect of each of the explanatory variables on each response value; rather they indicate the effect on the odds of choosing one over the rest of the response values combined. That is, as far as this study is concerned, the coefficients only assess the effect on the odds of choosing, say, franchising over management contracts and company ownership combined, or choosing management contracts over franchise agreements and company ownership combined, or company ownership over franchising and management contracts combined.

Since the interpretation using the odds does not provide a clear indication regarding the effect of the explanatory variables on each one of the modes of development, one could calculate the marginal effect on the predicted probabilities of choosing each one of the development modes with a unit change in the explanatory variables26.

The predicted probabilities can be calculated using the following formulae27:

\[
Pr(Y=1) = \Lambda(\gamma_1 - \sum_{k=1}^{15} \beta_k x_k) = 1/[1 + \exp(\sum_{k=1}^{15} \beta_k x_k - \gamma_1)]
\]
\[
Pr(Y=2) = \Lambda(\gamma_2 - \sum_{k=1}^{15} \beta_k x_k) - \Lambda(\gamma_1 - \sum_{k=1}^{15} \beta_k x_k) = 1/[1 + \exp(\sum_{k=1}^{15} \beta_k x_k - \gamma_1)] - 1/[1 + \exp(\sum_{k=1}^{15} \beta_k x_k - \gamma_1)]
\]
\[
Pr(Y=3) = 1 - \Lambda(\gamma_2 - \sum_{k=1}^{15} \beta_k x_k) = 1 - 1/[1 + \exp(\sum_{k=1}^{15} \beta_k x_k - \gamma_2)]
\]

where \(Y=1\) is the choice of franchise agreements, \(Y=2\) is the choice of management contracts, \(Y=3\) is the choice of company ownership, \(k=1,\ldots,15\). \(\gamma_1\) and \(\gamma_2\) are the limit points, in this case (ordered model-original specification) 2.3762 and 5.7959 respectively, \(\beta_k\) are the estimated coefficients (as presented in the estimation output) and \(x_k\) are the mean values of each explanatory variable (expect the one whose effect on the probabilities is being assessed). The \(\Lambda\) function indicates the logistic distribution for the random component \(\varepsilon\).

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26 Only the effect of the explanatory variables that refer to supported hypotheses will be assessed here.

27 These are the formulae for the logit model. For the probit they would be slightly different, since in the case of the logit model, the logistic distribution is assumed for the random component \(\varepsilon\), while for the probit model the standard normal distribution is assumed.
The following tables (Tables 7.10-7.13) give the probabilities for choosing a franchise agreement, management contract or company ownership for a new hotel unit, when each of the statistically significant variables takes several values. More specifically, the continuous variables FSIZE and GDSPRS (brand size and geographical concentration) take five different values that correspond to the quintiles of their distribution, and the qualitative variables FGR2, FGR4, UPLUX and LATEUROP take the values of 0 and 1.

**Table 7.10: The effect of Brand Size on the predicted probabilities of choosing each of the three development modes**

<table>
<thead>
<tr>
<th>(in rooms)</th>
<th>Pr(Y=1)</th>
<th>Pr(Y=2)</th>
<th>Pr(Y=3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>FSIZE = 47,809</td>
<td>67.63%</td>
<td>30.83%</td>
<td>1.54%</td>
</tr>
<tr>
<td>FSIZE = 51,628</td>
<td>67.22%</td>
<td>31.21%</td>
<td>1.57%</td>
</tr>
<tr>
<td>FSIZE = 62,900</td>
<td>65.99%</td>
<td>32.35%</td>
<td>1.66%</td>
</tr>
<tr>
<td>FSIZE = 124,600</td>
<td>58.92%</td>
<td>38.85%</td>
<td>2.23%</td>
</tr>
<tr>
<td>FSIZE = 284,350</td>
<td>39.60%</td>
<td>55.65%</td>
<td>4.75%</td>
</tr>
</tbody>
</table>

Y=1 represents the franchise mode, Y=2 MCs and Y=3 Company ownership.

Although there is a positive relationship between brand size and the probability of using company ownership, the probability per se is very low for any brand size. Moreover, although the higher the size the higher the probability to use management contracts and the lower the probability to use franchising for a new development, it can be noticed that only the biggest hotel brands were found to favour management agreements over franchising. A hotel brand of up to 124,000 rooms has a higher probability to use franchising (as opposed to management contracts and company ownership).

**Table 7.11: The effect of Brand Growth on the predicted probabilities of choosing each of the three development modes**

<table>
<thead>
<tr>
<th>Growth</th>
<th>Pr(Y=1)</th>
<th>Pr(Y=2)</th>
<th>Pr(Y=3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>F</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Growth less than 1%</td>
<td>71.89%</td>
<td>26.85%</td>
<td>1.26%</td>
</tr>
<tr>
<td>Growth between 2.5% and 9%</td>
<td>46.78%</td>
<td>49.64%</td>
<td>3.58%</td>
</tr>
<tr>
<td>Growth higher than 9%</td>
<td>52.13%</td>
<td>44.95%</td>
<td>2.92%</td>
</tr>
</tbody>
</table>
Hotel brands with annual growth higher than 2.5 percent are more likely to use higher-control modes and less likely to use franchising than hotel brands in the reference category (as opposed to the relevant hypothesis). However, as in the case of brand size, the probability of using company ownership is very low (less than 4 percent).

**Table 7.12: The effect of Geographical Concentration\(^{28}\) on the predicted probabilities of choosing each of the three development modes**

<table>
<thead>
<tr>
<th>QUINTILES</th>
<th>no. of hotel outlets/ population</th>
<th>Pr(Y=1)</th>
<th>Pr(Y=2)</th>
<th>Pr(Y=3)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>GDSPRS = 0.02</td>
<td>35.42%</td>
<td>58.95%</td>
<td>5.63%</td>
</tr>
<tr>
<td></td>
<td>GDSPRS = 0.17</td>
<td>40.38%</td>
<td>55.01%</td>
<td>4.61%</td>
</tr>
<tr>
<td></td>
<td>GDSPRS = 0.59</td>
<td>55.00%</td>
<td>42.40%</td>
<td>2.60%</td>
</tr>
<tr>
<td></td>
<td>GDSPRS = 1.59</td>
<td>83.28%</td>
<td>16.07%</td>
<td>0.65%</td>
</tr>
<tr>
<td></td>
<td>GDSPRS = 4.24</td>
<td>99.52%</td>
<td>0.46%</td>
<td>0.02%</td>
</tr>
</tbody>
</table>

\(Y=1\) represents the franchise mode, \(Y=2\) M/Cs and \(Y=3\) Company ownership

Company ownership is negatively related to the geographical concentration of the hotel outlets, opposite to what is suggested by the relevant economic theory. As it was suggested earlier, this finding could be related to the fact that the selected proxy is not the most appropriate to evaluate the effect of monitoring costs on the modal choice. It could also be related to the composition of the sample: the vast majority of the franchised outlets in the sample are operated by three hotel brands, namely Holiday Inn, Holiday Inn Express and Howard Johnson, brands that have started their operations in the U.S. and which operate most of their hotels in that country. The fact that hotel properties are quite concentrated in U.S., due to the demographic nature of the country may have influenced the results towards the opposite direction to what was suggested by the respective hypothesis.

---

28 The higher the GDSPRS value the more concentrated the hotel outlets in a particular country, since the proxy has been calculated by dividing the number of hotels in the country by its population.
Table 7.13: The effect of Market Segment and Country Group of Origin on the predicted probabilities of choosing each of the three development modes

<table>
<thead>
<tr>
<th></th>
<th>Pr(Y=1)</th>
<th>Pr(Y=2)</th>
<th>Pr(Y=3)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>F</td>
<td>M/C</td>
<td>C/O</td>
</tr>
<tr>
<td>Upscale brands</td>
<td>23.17%</td>
<td>67.04%</td>
<td>9.79%</td>
</tr>
<tr>
<td>Budget brands</td>
<td>81.14%</td>
<td>18.10%</td>
<td>0.76%</td>
</tr>
<tr>
<td>Anglo-Saxon brands</td>
<td>73.69%</td>
<td>25.15%</td>
<td>1.16%</td>
</tr>
<tr>
<td>Latin-europ. brands</td>
<td>9.49%</td>
<td>66.72%</td>
<td>23.79%</td>
</tr>
</tbody>
</table>

The findings confirm the relevant hypotheses regarding the positive relationship between operation in higher market segments and the use of high-control modes. Upscale brands (on average) are more likely to use management contracts for a new hotel development, while budget brands are more likely to use franchising. Additionally, it can be inferred that Anglo-Saxon brands are more likely to use franchise agreements than their Latin-European counterparts, while the latter are more likely to use management contracts and company ownership. The results of the last table provide one more indication that there should be a more detailed analysis regarding the effect of country group of origin in different market segments and thus suggest that an interaction term between these two variables should be included in the model.

29 The effect of being in the mid-market category is not presented because the coefficient of mid-market is not found to be statistically significant.
Table 7.14: Regression Analysis: Original Specification (Model 1), Extended Model (Model 2) and Reduced Model (Model 3)

<table>
<thead>
<tr>
<th>Variables</th>
<th>Model 1 Beta</th>
<th>Model 1 t-value</th>
<th>Model 2 Beta</th>
<th>Model 2 t-value</th>
<th>Model 3 Beta</th>
<th>Model 3 t-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>ICRG2</td>
<td>0.327</td>
<td>0.78</td>
<td>1.276</td>
<td>2.29**</td>
<td>0.988</td>
<td>2.33***</td>
</tr>
<tr>
<td>ICRG3</td>
<td>-0.172</td>
<td>-0.33</td>
<td>0.611</td>
<td>0.92</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>LEGRSK</td>
<td>0.004</td>
<td>0.34</td>
<td>-0.008</td>
<td>-0.67</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>GDP</td>
<td>0.000</td>
<td>0.88</td>
<td>0.000</td>
<td>2.28**</td>
<td>0.000</td>
<td>3.26***</td>
</tr>
<tr>
<td>FSIZE</td>
<td>0.000</td>
<td>1.90**</td>
<td>0.000</td>
<td>3.64***</td>
<td>0.000</td>
<td>3.54***</td>
</tr>
<tr>
<td>FGR2</td>
<td>-0.304</td>
<td>-0.53</td>
<td>-0.642</td>
<td>-1.01</td>
<td>-1.004</td>
<td>-2.35***</td>
</tr>
<tr>
<td>FGR3</td>
<td>1.068</td>
<td>2.19**</td>
<td>0.401</td>
<td>0.73</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>FGR4</td>
<td>0.853</td>
<td>1.56*</td>
<td>1.069</td>
<td>1.82**</td>
<td>0.766</td>
<td>1.98**</td>
</tr>
<tr>
<td>INTEXP</td>
<td>-0.012</td>
<td>-0.86</td>
<td>-0.022</td>
<td>-1.48*</td>
<td>-0.023</td>
<td>-1.56*</td>
</tr>
<tr>
<td>GDSPRS</td>
<td>-1.405</td>
<td>-4.86***</td>
<td>-0.699</td>
<td>-2.33***</td>
<td>-0.729</td>
<td>-2.43***</td>
</tr>
<tr>
<td>MIDMKT</td>
<td>0.287</td>
<td>0.60</td>
<td>1.133</td>
<td>1.43*</td>
<td>1.261</td>
<td>1.62*</td>
</tr>
<tr>
<td>UPLUX</td>
<td>2.658</td>
<td>6.09***</td>
<td>5.173</td>
<td>8.30***</td>
<td>5.271</td>
<td>8.98***</td>
</tr>
<tr>
<td>LATEUROP</td>
<td>3.286</td>
<td>7.23***</td>
<td>7.022</td>
<td>8.39***</td>
<td>7.123</td>
<td>8.93***</td>
</tr>
<tr>
<td>RMS</td>
<td>0.002</td>
<td>2.69***</td>
<td>0.002</td>
<td>1.91**</td>
<td>0.002</td>
<td>1.98**</td>
</tr>
<tr>
<td>LOCATION</td>
<td>-0.016</td>
<td>-0.03</td>
<td>1.034</td>
<td>2.04**</td>
<td>0.984</td>
<td>2.12**</td>
</tr>
<tr>
<td>MM_LATEU</td>
<td>-</td>
<td>-</td>
<td>-2.590</td>
<td>-2.37***</td>
<td>-2.848</td>
<td>-2.67***</td>
</tr>
<tr>
<td>UP_LATEU</td>
<td>-</td>
<td>-</td>
<td>-6.333</td>
<td>-6.13***</td>
<td>-6.450</td>
<td>-6.46***</td>
</tr>
<tr>
<td>CRD2_FS</td>
<td>-</td>
<td>-</td>
<td>-0.000</td>
<td>-3.63***</td>
<td>-0.000</td>
<td>-3.50***</td>
</tr>
<tr>
<td>CRD3_FS</td>
<td>-</td>
<td>-</td>
<td>-0.000</td>
<td>-2.51***</td>
<td>-0.000</td>
<td>-2.50***</td>
</tr>
<tr>
<td>FSIZE2</td>
<td>-</td>
<td>-</td>
<td>0.000</td>
<td>0.22</td>
<td>0.000</td>
<td>0.20</td>
</tr>
<tr>
<td>FSIZE3</td>
<td>-</td>
<td>-</td>
<td>0.000</td>
<td>0.45</td>
<td>0.000</td>
<td>0.84</td>
</tr>
<tr>
<td>MIDMKT2</td>
<td>-</td>
<td>-</td>
<td>-1.458</td>
<td>-1.98***</td>
<td>-1.587</td>
<td>-2.18***</td>
</tr>
<tr>
<td>UPLUX2</td>
<td>-</td>
<td>-</td>
<td>-1.160</td>
<td>-1.46*</td>
<td>-1.179</td>
<td>-1.49*</td>
</tr>
<tr>
<td>LATEUROP2</td>
<td>-</td>
<td>-</td>
<td>4.432</td>
<td>4.92***</td>
<td>4.275</td>
<td>4.88***</td>
</tr>
<tr>
<td>LATEUROP3</td>
<td>-</td>
<td>-</td>
<td>0.690</td>
<td>1.23</td>
<td>0.673</td>
<td>1.21</td>
</tr>
</tbody>
</table>

LR-statistic | 421.9256 | 478.8659 | 477.2011 |
Df            | 15       | 19       | 16       |
Probability   | 0.0000   | 0.0000   | 0.0000   |
Pseudo-R^2    | 0.45     | 0.51     | 0.51     |
Akaike info criterion | 1.146   | 1.027    | 1.018    |
Schwarz criterion | 1.274   | 1.208    | 1.173    |
Hannan-Quinn criter. | 1.185   | 1.098    | 1.079    |

Notes: **=p<.1 in a one-tailed test, ***=p<0.05 in a one-tailed test, ****=p<0.01 in a one-tailed test
7.4 Interaction effects between Market Segment/Brand origin and Brand Size/Country Risk – Extended model

In the previous model (1), the simplified assumption is implied that the effect of any single explanatory variable $X_i$ is the same across the range of any other explanatory variable. Occasionally, however, an independent variable has a differential effect on the response variable $Y_i$ across categories or values of a second independent variable $Z_i$, and thus one needs to adjust the model specification to allow for the $X_iY_i$ relationship to vary relative to values of $Z_i$, e.g. the effect of FSIZE might be different for UPLUX, MIDMKT and BUDGET hotels.

From a first inspection of the data base (see the previous chapter), one could detect that hotel companies from different country origins do not follow the same decision patterns for their brands that are positioned in different market segments. That is, one could suggest that the relationship between the expansion decision and the market segment where a hotel brand operates varies, relatively to the country origin of the brand (i.e. whether the hotel brand originates from an Anglo-Saxon or a Latin-European country). For example it would be interesting to identify whether the trend for franchise agreements in the budget and mid-market segment (that has been identified in the probability table) is the same between Latin-European and Anglo-Saxon brands or whether the predicted probabilities for each of the expansion modes between Latin-European and Anglo-Saxon brands remains relatively stable throughout the three market segments.

Moreover, the results of the original specification suggested a positive relationship between brand size and hierarchical modes of development, namely an opposite relationship than the one hypothesized. It would be interesting to identify if this relationship had the same direction, regardless of the level of risk that characterises the country where the new property was going to be developed. Country political and economic risk is usually found to influence the modal choice and to be quite crucial in international business. Therefore, it has been decided to check whether there is an interaction effect between this country variable and brand size, i.e. if there is an effect of country risk on the effect of FSIZE on the modal choice.
In order to test those relationships, the previous model (1) needs to be adjusted for the interaction between the explanatory variables, origin and market segment, and brand size and country risk, as follows:

$$OM = \beta_0 + \beta_1 \text{ICRGD} + \beta_2 \text{ICRGD}^2 + \beta_3 \text{LEGRSK} + \beta_4 \text{GDP} + \beta_5 \text{FSIZE} +$$
$$\beta_6 \text{FGR} + \beta_7 \text{FGR}^2 + \beta_8 \text{FGR}^3 + \beta_9 \text{INTEXP} + \beta_{10} \text{GDSPRS} + \beta_{11} \text{MIDMKT} + \beta_{12} \text{UPSCALE} + \beta_{13} \text{LATINEUROP} + \beta_{14} \text{RMS} + \beta_{15} \text{LOCATION} +$$
$$\beta_{16} \text{MM_LATEU} + \beta_{17} \text{UP_LATEU} + \beta_{18} \text{CRD2_FS} + \beta_{19} \text{CRD3_FS}$$

(2)

The interaction effect between market segment and country group of origin shows how the effect of being in the budget, mid-market or upscale segment on the decision among the three organisational modes differs between Latin-European companies (in this case French and Spanish) and Anglo-Saxon (in this case American and English) companies. The coefficients of the interaction terms ($\beta_{16}$ and $\beta_{17}$) estimate the extent to which the effect of being in any of the three segments differs according to the origin of the brand, or the extent to which the effect of being an Anglo-Saxon rather than a Latin-European brand differs among the three market segments.

What needs to be clarified here is that the coefficients for market segment and origin, $\beta_{11}$, $\beta_{12}$ and $\beta_{13}$ do not have the same meaning and interpretation as the respective coefficients in the original model (1). More specifically, the t-tests for the coefficients of MIDMKT and UPSCALE ($\beta_{11}$ and $\beta_{12}$) are tests for the significant difference between mid-market and budget brands (and upscale and budget brands respectively) for Anglo-Saxon companies. That is:

$\beta_{11}$ gives the difference in the effect of being in the mid-market segment rather than in the budget segment for the reference category, i.e. for Anglo-Saxon companies only and

$\beta_{12}$ gives the difference in the effect of being in the upscale/luxury segment rather than in the budget segment again for the reference category, i.e. for Anglo-Saxon companies only.

Furthermore, the coefficient for LATIN-EUROPEAN ($\beta_{13}$) does not indicate the average effect of being a Latin-European brand rather than an Anglo-Saxon one. In the extended model, it indicates the difference in the effect of being a Latin-European brand operating in the budget segment only, as opposed to an Anglo-Saxon brand operating in the same segment.
Finally, the coefficients of the interaction terms ($\beta_{16}$ and $\beta_{17}$) estimate the differential effect of segment by origin. More specifically,

$\beta_{16}$ indicates the difference in the effect of being in the mid-market rather than in the budget segment for Latin-European relative to Anglo-Saxon companies and

$\beta_{17}$ indicates the difference in the effect of being in the upscale rather than in the budget segment for Latin-European relative to Anglo-Saxon companies.

The t-tests for those coefficients show whether the net effects of market segment are significantly different between Latin-European and Anglo-Saxon companies.

Regarding the coefficient of brand size ($\beta_5$), it measures the effect of brand size on the choice, only for the base category of country risk, i.e. in cases where the country political and economic risk is moderate/high. Furthermore,

$\beta_{18}$ gives the difference in the effect of brand size on the modal choice, in countries where politico-economic risk is low (ICRGD2) relative to countries where the risk is high/moderate

$\beta_{19}$ gives the difference in the effect of brand size on the modal choice, in countries where politico-economic risk is very low (ICRGD3) relative to countries where the risk is high/moderate

Initially, one needs to identify whether allowing differential effects of origin / market segment and country risk / brand size results in a statistically significant improvement of the fit of the model. In order to test that, one should perform a coefficient test (test for omitted variables) in the first model (original specification). Using this test one can add a set of variables to an existing equation and ask whether the set makes a significant contribution to explaining the variation in the dependent variable. The null hypothesis $H_0$ is that the additional set of regressors are not jointly significant. The E-Views output of the omitted variables test is included in Appendix 3. All the necessary information for the evaluation of the extended model is presented in the second column (Model 2) of Table 7.14.

As can be seen in the first section of the respective E-Views output in Appendix 3, the joint coefficients of the added variables are indeed statistically significant (the probability is $p<0.01$) and therefore the interaction effects variables should be added to
the specification. Moreover, the AIC, SC and HC information criteria are lower than in the initial model, suggesting that the extended model has better explanatory power than the initial one. Finally, it should be noted that pseudo-$R^2$ has also been improved by 6%.

As far as the coefficients of the interaction terms are concerned, all four are highly significant (at a 1 percent level), suggesting that there is indeed an interaction effect between origin and market segment, and brand size and country risk. The rest of the coefficients give the following information regarding the effect of the explanatory variables on the modal choice:

a) **Political and Economic Risk**: When the interaction term between brand size and politico-economic risk is introduced in the model, the results provide partial support for the respective hypothesis (H1). More specifically, the positive and significant coefficient of ICRGD2 suggests that the probability to use company ownership would be higher in low-risk countries than in high/moderate risk countries, whereas there would be a higher probability to use franchising in high/moderate risk countries. The coefficient of ICRGD3, although positive, was not found to be statistically significant.

b) **Level of Economic Development**: the higher the level of economic development of the target country, the higher the probability for company ownership to be chosen, opposite to that suggested by the theories of entry mode. However, the coefficient of GDP is extremely low (0.000028), suggesting that the effect of economic development, although opposite than hypothesized, is very weak. One possible explanation for the awkward finding could be that the majority of the observations in this study refer to developed countries.

c) **International Experience**: the extended model supports hypothesis H6 that hotel brands with more years of international experience are more likely to use franchising, other things equal.

d) **Brand Size**: the results of the extended model justify the inclusion of the interaction term in the specification, since the coefficients of the interaction terms CRD2_FS and CRD3_FS are highly significant. The coefficient of FSIZE is highly significant but very low, indicating that the effect of brand size on the choice in cases where the country risk is high/moderate is opposite than suggested, namely, in high-risk countries the larger the brand the higher the probability of using company ownership and the lower the
probability of using franchising. In order to calculate the effect of brand size in low- and very low-risk countries (FSIZE2 and FSIZE3), one needs to add the coefficient of FSIZE to the coefficients of the interaction terms CRD2_FS and CRD3_FS respectively. The coefficients for FSIZE2 and FSIZE3, are not an important factor that influence the modal choice. The t-tests for FSIZE2 and FSIZE3 can be calculated using the following formula (Hardy, 1993):

$$t = \frac{\beta_i + \beta_j \epsilon}{\sqrt{[\text{Var}(\beta_i) + \text{Var}(\beta_j \epsilon) + 2\text{Cov}(\beta_i, \beta_j \epsilon)]}}$$

where, $\beta_i$ refers to a coefficient for brand size and $\beta_j \epsilon$ refers to the coefficient for the product variable between the independent variable ICRGD2 and ICRGD3 respectively and brand size (FSIZE). The variances and covariances needed for the calculations are provided by the E-Views (see Coefficient - Covariance Matrix in Appendix 3, p. 221).

e) **Brand Growth**: The coefficient for brand growth is significant only for brands with annual growth higher than 9.5 percent. More specifically, hotel brands with annual growth higher than 9.5% are more likely to use company ownership for the new hotel development, compared to the reference category (i.e. hotel brands with annual growth less than 1%), opposite to what is suggested by H5. Although the coefficient for FGR2 is negative, i.e. hotel brands with growth between 1 and 2.5% are more likely to use franchising compared to brands with slower growth (as is suggested by H5), the coefficient was not found to be statistically significant.

f) **Geographical Concentration**: as in the original specification, geographical concentration seems to be negatively related to the use of company ownership and positively related to the use of franchising. Again the reason why the findings are not in line with the hypothesis could be related to the fact that most franchised outlets in the sample are based in the U.S., a country where hotel outlets are quite concentrated due to the country’s demographic nature.

g) **Market Segment**: When the interaction terms are included in the model, the interpretation of the market segment coefficients changes. The coefficient for MIDMKT is positive but non-significant, indicating that the effect on the modal choice of being a *mid-market Anglo-Saxon* brand is not statistically different from the effect of being a *budget Anglo-Saxon* brand. The coefficient of UPLUX is positive and highly significant,
Expansion Strategies of International Hotel Firms

suggesting that the odds of using company ownership as opposed to franchising is higher for an upscale Anglo-Saxon brand compared to a budget Anglo-Saxon brand. The relevant information for Latin-European brands is given by the coefficients MIDMKT2 and UPLUX2 which are calculated by summing the coefficient of the respective market segment (MIDMKT or UPLUX) with the coefficients of the interaction terms (MM_LATEU and UP_LATEU respectively). Both coefficients are negative and significant, suggesting that as far as Spanish and French brands are concerned, both mid-market brands and upscale brands are less inclined to use company ownership and more inclined to use franchising compared to budget brands\(^{30}\). Thus, when the interaction effects are introduced, it is revealed that the market segment hypothesis (\(H_6\)) is confirmed only as far as Anglo-Saxon brands are concerned. For Spanish and French brands higher market segments are not associated with the use of higher control modes, as transaction costs economics would predict.

\(h)\) **Country Group (Brand Origin):** The dummy variable LATEUROP also takes a different meaning due to the introduction of the interaction terms. The respective coefficient is positive and highly significant, suggesting that there is a higher probability for budget Latin-European brands to use company ownership and a lower probability to use franchising, compared to their Anglo-Saxon counterparts. In order to identify the difference in the effect on the choice of being a mid-market (or upscale) Latin-European brand relative to an Anglo-Saxon brand, two more coefficients need to be calculated (LATEUROP2 and LATEUROP3) by adding the country group of origin coefficient LATUEROP to the coefficients of the interaction terms MM_LATEU and UP_LATEU respectively. Both LATEUROP2 and LATEUROP3 are positive, but only LATUEROP2 is statistically significant, indicating that mid-market brands that originate from Spain or France have a higher probability to use higher control modes and lower probability to use franchising compared to mid-market brands originating from Anglo-Saxon countries. For upscale brands the same could not be argued with confidence. Overall, the effect of the country group on the modal choice is significant for two out of the three market segments: budget and mid-market brands that originate from Spain and France are more likely to use higher control modes than American and British brands. Therefore

\(^{30}\) However, it has to be noticed that the result may be driven by the structure of the sample, since the only budget Latin-European brand in the sample is Ibis, which happens to have 16 new outlets, all company-owned.
the hypothesis for country group of origin ($H9$) is supported by the results of the extended model.

Finally, when the extended model is examined, both control variables (RMS and LOCATION) seem to have a positive (and significant at a 5 percent level) effect on the choice. As in the original specification, it is suggested that the bigger the hotel property, the higher the probability that company ownership will be used for its development. Moreover, the results of the extended model reveal that when the property is developed in the country where the hotel brand has most of its operations, it is more likely that franchising will be the preferred option, while if the hotel is developed in any other country, a hierarchical mode of development will be chosen, other things equal.

One final issue that needs to be addressed is whether the non-significant variables should be dropped from the model specification. One argument is that if one believed a priori that a variable had a legitimate place in the equation specification, then one should persist with this belief and include it in the model. Another argument, however, is that because the purpose of estimation and prediction is to confront equation specification with data, to base prediction on the coefficient estimates obtained from the full specification may be misleading, since it would allow variables, whose legitimacy in the specification has been explicitly “rejected” by the data, to influence the predictions (Borooah, 2001).

In this study, the non-significant variables will be dropped from the specification and the respective information criteria will be compared to the ones of the extended model in order to find out whether the reduced model provides a better fit on the data than the previous ones. Thus, in the following model only the variables that were found to be significant are included. To estimate the reduced model, one could either re-estimate the model after dropping the insignificant variables or run a coefficient test for redundant variables in the previous model specification (extended model). The second option has been adopted here, since by running this coefficient test, one can identify whether the excluded variables have indeed a zero joint coefficient. The output of the reduced model is included in Appendix 3, and the main information is presented in the third column of Table 7.14 above.
The log likelihood ratio for the coefficients of the dropped variables is 1.6648 with probability 0.645, indicating that the joint coefficient of ICRGD3, LEGRSK and FGR3 is not significantly different from zero, therefore these variables could be excluded from the model estimation. Additionally, the information criteria (AIC, SC and H-Q) have been improved compared to the previous two models, suggesting that the reduced model has a better explanatory power. (The pseudo- $R^2$ remained at the same levels as in the previous specification).

Besides the improvement in terms of information criteria, the reduced model partly confirms one more hypothesis, the one that examines the effect of brand growth on the modal choice. More specifically, the coefficient of FGR2 is found to be negative and statistically significant at a 1 percent level, indicating that there is a higher probability of using franchising and lower probability of using company ownership for hotel brands with growth between 1 and 2.5%, compared to the reference category, i.e. brands with growth less than 1 percent. Thus the relevant hypothesis ($H5$) is partly confirmed (i.e. only as far as slow-growth hotel brands are concerned).

The marginal effect on the predicted probabilities of choosing each one of the development modes with a unit change in the explanatory variables could also be calculated for the reduced model\textsuperscript{31}. The following tables (Tables 7.15-7.22) give the probabilities for choosing a franchise agreement, management contract or company ownership for a new hotel unit, when each of the statistically significant variables take several values. Again, the continuous variables FSIZE1, FSIZE2, INTEXP, GDP and GDSPRS (size, international experience, level of economic development and geographical concentration) take five different values that correspond to the quintiles of their distribution, and the qualitative variables ICRGD2, FGR2, FGR4, MIDMKT, UPLUX and LATEUROP take the values of 0 and 1.

\textsuperscript{31} Since the reduced model provides support for all the hypotheses that are also confirmed by the extended model, there is no need to calculate the predicted probabilities for both the extended and the reduced model.
In low-risk countries there is a somewhat higher probability of using company ownership or management agreements and a lower probability of using franchising compared to a high-risk country. The findings regarding country risk support the relevant hypothesis HI.

The lower the level of economic development, the higher the probability of choosing franchising, while the probability of using a management agreement or company ownership franchising is positively related to the level of economic development.
### Table 7.17: The effect of Brand Size on the predicted probabilities of choosing each of the three development modes in high/moderate-risk and low-risk countries

<table>
<thead>
<tr>
<th>QUINTILES</th>
<th>High-Risk countries</th>
<th>Pr(Y=1) F</th>
<th>Pr(Y=2) M/C</th>
<th>Pr(Y=3) C/O</th>
</tr>
</thead>
<tbody>
<tr>
<td>FSIZE1 = 47,809</td>
<td>62.67%</td>
<td>36.09%</td>
<td>1.24%</td>
<td></td>
</tr>
<tr>
<td>FSIZE1 = 51,628</td>
<td>61.52%</td>
<td>37.18%</td>
<td>1.30%</td>
<td></td>
</tr>
<tr>
<td>FSIZE1 = 62,900</td>
<td>58.05%</td>
<td>40.45%</td>
<td>1.50%</td>
<td></td>
</tr>
<tr>
<td>FSIZE1 =124,600</td>
<td>38.58%</td>
<td>58.18%</td>
<td>3.24%</td>
<td></td>
</tr>
<tr>
<td>FSIZE1 =284,350</td>
<td>7.52%</td>
<td>71.93%</td>
<td>20.55%</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>QUINTILES</th>
<th>Low-Risk Countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>FSIZE2 = 47,809</td>
<td>25.46%</td>
</tr>
<tr>
<td>FSIZE2 = 51,628</td>
<td>22.27%</td>
</tr>
<tr>
<td>FSIZE2 = 62,900</td>
<td>14.56%</td>
</tr>
<tr>
<td>FSIZE2 =124,600</td>
<td>0.98%</td>
</tr>
<tr>
<td>FSIZE2 =284,350</td>
<td>0.00%</td>
</tr>
</tbody>
</table>

*Y=1 represents the franchise mode, Y=2 MCs and Y=3 Company ownership*

Although there is a positive relationship between brand size and the probability of using company ownership in both high- and low-risk countries, it can be noticed in the above table that in high-risk countries, only very large companies would choose high-control modes over franchising, whereas in low-risk countries, even small and medium-sized brands would favour the use of higher control modes. In other words, for brands of similar size (e.g. FSIZE=51,628), the probability of using franchising is higher in high-risk countries than in low-risk countries. This is in line with the hypothesis regarding the effect of country risk on the modal choice, according to which, the higher the country politico-economic risk, the higher the probability to use franchising and the lower the probability to use company ownership. Namely, in high-risk countries the probability of using franchising is higher than the probability of using company ownership for all but the very large brands.
Table 7.18: The effect of Brand Growth on the predicted probabilities of choosing each of the three development modes

<table>
<thead>
<tr>
<th>Growth less than 1%</th>
<th>Pr(Y=1)</th>
<th>Pr(Y=2)</th>
<th>Pr(Y=3)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>F</td>
<td>M/C</td>
<td>C/O</td>
</tr>
<tr>
<td>Growth less than 1%</td>
<td>71.89%</td>
<td>26.85%</td>
<td>1.26%</td>
</tr>
<tr>
<td>Growth between 1% and 2.5%</td>
<td>80.91%</td>
<td>18.33%</td>
<td>0.76%</td>
</tr>
<tr>
<td>Growth higher than 9.5%</td>
<td>52.13%</td>
<td>44.95%</td>
<td>2.92%</td>
</tr>
</tbody>
</table>

Y=1 represents the franchise mode, Y=2 MCs and Y=3 Company ownership

Hotel brands with annual growth between 1 and 2.5 percent are more likely to use franchising than the hotel brands in the reference category (in line with the respective hypothesis). However hotel brands with rapid growth (higher than 9 percent) are less likely to use franchising than hotel brands with a very slow growth rate. It could be that high growth is the effect of using franchising extensively, rather than the use of franchising is the preferred mode in cases where brands are characterised by high growth rates. As in the case of brand size, the probability of using company ownership is very low (less than 3 percent).

Table 7.19: The effect of International Experience on the predicted probabilities of choosing each of the three development modes

<table>
<thead>
<tr>
<th>QUINTILES</th>
<th>(in years)</th>
<th>Pr(Y=1)</th>
<th>Pr(Y=2)</th>
<th>Pr(Y=3)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>INTEXP = 8</td>
<td>F</td>
<td>M/C</td>
<td>C/O</td>
</tr>
<tr>
<td></td>
<td>INTEXP = 27</td>
<td>49.64%</td>
<td>48.27%</td>
<td>2.09%</td>
</tr>
<tr>
<td></td>
<td>INTEXP = 35</td>
<td>60.41%</td>
<td>38.23%</td>
<td>1.36%</td>
</tr>
<tr>
<td></td>
<td>INTEXP = 38</td>
<td>64.72%</td>
<td>34.15%</td>
<td>1.13%</td>
</tr>
<tr>
<td></td>
<td>INTEXP = 49</td>
<td>66.28%</td>
<td>32.66%</td>
<td>1.06%</td>
</tr>
</tbody>
</table>

Y=1 represents the franchise mode, Y=2 MCs and Y=3 Company ownership

More years of international experience are associated with higher probability of choosing franchising for the development of new hotel operations and lower probabilities of choosing management contracts or company ownership (other things
equal). In addition, as can be seen in the last column of Table 7.19, the effect of international experience on the probability of choosing company ownership is small at all levels of experience.

Table 7.20: The effect of Geographical Concentration\(^{32}\) on the predicted probabilities of choosing each of the three development modes

<table>
<thead>
<tr>
<th>QUANTILES</th>
<th>(no. of hotel outlets/ population )</th>
<th>Pr(Y=1) (F)</th>
<th>Pr(Y=2) (M/C)</th>
<th>Pr(Y=3) (C/O)</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDSPRS= 0.02</td>
<td>35.42%</td>
<td>58.95%</td>
<td>5.63%</td>
<td></td>
</tr>
<tr>
<td>GDSPRS= 0.17</td>
<td>40.38%</td>
<td>55.01%</td>
<td>4.61%</td>
<td></td>
</tr>
<tr>
<td>GDSPRS= 0.59</td>
<td>55.00%</td>
<td>42.40%</td>
<td>2.60%</td>
<td></td>
</tr>
<tr>
<td>GDSPRS= 1.59</td>
<td>83.28%</td>
<td>16.07%</td>
<td>0.65%</td>
<td></td>
</tr>
<tr>
<td>GDSPRS= 4.24</td>
<td>99.52%</td>
<td>0.46%</td>
<td>0.02%</td>
<td></td>
</tr>
</tbody>
</table>

\(Y=1\) represents the franchise mode, \(Y=2\) MCs and \(Y=3\) Company ownership

Company ownership is negatively related to the geographical concentration of the hotel outlets, opposite to what is suggested by the relevant economic theory. As it was argued earlier, the reason for this unexpected finding could be related to the composition of the sample: 90 percent of the franchised outlets in the sample are operated by three hotel brands that started their operations in the U.S. and which operate most of their hotels in that country. The fact that hotels properties are quite concentrated in the U.S. may have influenced the results towards the opposite direction to what was suggested by the respective hypothesis.

\(^{32}\) The higher the GDSPRS value the more concentrated the hotel outlets in a particular country, since the proxy has been calculated by dividing the number of hotels in the country by its population.
Table 7.21: The effect of Market Segment on the predicted probabilities of choosing each of the three development modes for Anglo-Saxon and Latin-European Brands

<table>
<thead>
<tr>
<th></th>
<th>Pr(Y=1)</th>
<th>Pr(Y=2)</th>
<th>Pr(Y=3)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>F</td>
<td>M/C</td>
<td>C/O</td>
</tr>
<tr>
<td>A-S Budget brands</td>
<td>87.3%</td>
<td>12.4%</td>
<td>0.3%</td>
</tr>
<tr>
<td>A-S Mid-Market brands</td>
<td>66.1%</td>
<td>32.8%</td>
<td>1.1%</td>
</tr>
<tr>
<td>A-S Upscale brands</td>
<td>3.4%</td>
<td>59.3%</td>
<td>37.3%</td>
</tr>
<tr>
<td>L-E Budget brands</td>
<td>0.2%</td>
<td>9.3%</td>
<td>90.5%</td>
</tr>
<tr>
<td>L-E Mid-Market brands</td>
<td>22.1%</td>
<td>37.1%</td>
<td>40.8%</td>
</tr>
<tr>
<td>L-E Upscale brands</td>
<td>19.5%</td>
<td>50.4%</td>
<td>30.1%</td>
</tr>
</tbody>
</table>

Y=1 represents the franchise mode, Y=2 MCs and Y=3 Company ownership

It is clear from Table 7.21 that the higher the market segment where an Anglo-Saxon company operates, the higher the probability that company ownership will be the preferred mode for a new hotel property, and the lower the probability that franchising will be chosen. On the other hand though, the opposite is true as far as Latin-European brands are concerned. Brands in the mid-market as well as the upscale segment are more likely to use franchising and less likely to use company ownership compared to brands that operate in the budget segment.

---

33 The probabilities for upscale Latin-European brands have not been calculated, since the respective coefficient was not found to be statistically significant.

34 The fact that P(Y=1) for upscale L/E brands is not higher than the one for mid-market brands is not a mistake. The reason is that both upscale and mid-market probabilities are compared to the budget ones. There is no continuous relationship between market segment and the use of each mode.
Table 7.22: The effect of Country Group of Origin on the predicted probabilities of choosing each of the three development modes\textsuperscript{35}

<table>
<thead>
<tr>
<th></th>
<th>Pr(Y=1)(F)</th>
<th>Pr(Y=2)(M/C)</th>
<th>Pr(Y=3)(C/O)</th>
</tr>
</thead>
<tbody>
<tr>
<td>A-S Budget brands</td>
<td>87.3%</td>
<td>12.4%</td>
<td>0.3%</td>
</tr>
<tr>
<td>L-E Budget brands</td>
<td>0.2%</td>
<td>9.3%</td>
<td>90.5%</td>
</tr>
<tr>
<td>A-S Mid-Market brands</td>
<td>66.1%</td>
<td>32.8%</td>
<td>1.1%</td>
</tr>
<tr>
<td>L-E Mid-Market brands</td>
<td>22.1%</td>
<td>37.1%</td>
<td>40.8%</td>
</tr>
</tbody>
</table>

\(Y=1\) represents the franchise mode, \(Y=2\) MCs and \(Y=3\) Company ownership

As can be seen in the above table, there is a clear preference for the use of franchising as far as budget Anglo-Saxon brands are concerned and a preference for company ownership as far as budget Latin-European brands are concerned. In the mid-market segment, it can be seen that Spanish and French brands are more inclined to use company ownership compared to American and British brands, while the use of franchising is the preferred choice for the latter. As far as the upscale segment is concerned, there is no statistical difference in the modal choice between Anglo-Saxon and Latin-European brands.

\textsuperscript{35} The probabilities for upscale Latin-European brands have not been calculated, since the respective coefficient was not found to be statistically significant.
7.5 Discussion of the results of the ordered model

The discussion of the results will be based on both the original model and on the model that includes the interaction effects between (a) the market segment where a hotel brand operates and the country group of origin and (b) the brand size and the country politico-economic risk. Consequently, the discussion will lead in a conclusion regarding the form of the ordered model that gives the best results.

In the original model (the model that does not include any interaction terms) none of the country-specific variables was found to influence the choice among the three modes of development. Regarding the effect of legal risk, the reason why it was not found to influence the modal choice could be the fact that a proxy has been used for its measurement. Although in the context of this study legal risk refers to local regulations and policies regarding trademark and intellectual property rights protection, it could be that the use of "patents filed" in each country was not the appropriate one to capture the level of protection of intellectual property rights (in the hotel industry, at least).

The effect of economic development in a particular country was also not supported, although previous studies both in the manufacturing and in the service sector have provided results that confirm the negative relationship between a nation’s economic development and the use of high-control modes. The same is the case for the effect of political and economic risk.

Regarding the firm-specific variables, the results of the original model reveal that brand size and growth do influence the modal choice, though in the opposite than expected direction. Both coefficients are significant at a 5 percent level; yet the coefficient of FSIZE is very close to zero, suggesting that although statistically significant, brand size has a very weak effect on the modal choice. As already mentioned in the theoretical framework, the effect of size on the entry/development mode is controversial. In line with the theoretical framework of this study, it is argued that there is a negative association between brand size and high-control modes, yet the results suggest that, although there is a very little effect of brand size on the modal choice, this effect is in the opposite direction to that suggested by the hypothesis.
Although the results reveal that the probability of choosing company ownership is very low for any brand size, still, when it comes to the comparison between franchise agreements and management contracts, it was found that all but the very large brands would prefer to use franchising for a new development. The largest brands prefer management contracts. These results may be an indication that franchising is a means for brand growth: hotel companies use franchising until they reach a very large size, at which stage their rate of growth slows down (smaller international brands would tend to be faster-growing than the very large ones). After that stage, management contracts become the preferred mode for new properties. A further reason for that could be that property owners would prefer to give a management contract to an established hotel management company that already had a well-known brand name and world-wide recognition.

When the effect of brand growth is examined, the findings indicate that it is the slower growing brands that prefer franchising for a new hotel property, contrary to what is suggested by the respective hypothesis.

The hypotheses that were strongly supported by the ordered logit model are the ones that test the effect of market segment where a brand is positioned and country group of origin of the brand. More specifically it was found that in higher market segments of operation (upscale and luxury segments), it is more likely that a high-control mode of development will be preferred (as opposed to franchising). Hence, the results are in line with the main transaction cost argument, that upscale hotel brands would expand using a hierarchical mode. The services provided by upscale and luxury brands require specialised knowledge and managerial expertise both of which are associated with high levels of human asset specificity, a situation that favours the use of higher-control modes.

More specifically, the lower market segment of limited service units requires a set of standard operating procedures from which there is no reason to deviate, because the service is limited. The upper market segment has its standard operating procedures, but because of the level of more personalised service being offered, staff have to be trained to use their discretion in dealing with guests in individual situations so as to achieve that level of service. This type of knowledge cannot be reduced to standard operating procedures which can be ‘sold off’ as franchise packages, and requires front-line staff of the appropriate quality who can understand the training and apply it intelligently so as to
uphold the quality image of the brand (proprietary content, tacit knowledge, information impactedness). The vulnerability of the brand to failures in this respect, the information impactedness and the moral hazard aspects of franchising, are the major reasons why franchising is rarely used in this market segment.

As for the country group of origin, the findings indicate that Anglo-Saxon brands are less likely to use company ownership and more likely to use franchising, than their Latin-European counterparts. Hence, the results are in line with the hypothesis that American and British hotel companies, which are more familiar with the use of low-control modes, are less willing to invest equity capital for their expansion and that they try to maximize the return on their knowledge-based assets. Spanish and French companies, on the other hand are more reluctant to use franchising, since they became involved with this expansion mode more recently than their American and British counterparts. In addition, it appears that for those companies high control is still associated with equity participation rather than with management contracts.

The last hypothesis refers to the effect of geographic concentration of the hotel outlets in a particular country on the modal choice, and has not been confirmed by the results of the analysis. As already explained in the section about the measurement of variables, geographic concentration of outlets is very difficult to estimate, therefore a proxy has been used instead. More specifically, the “number of hotels divided by the country’s population” measure has been used. It could be the case that this proxy cannot capture the effects of outlet concentration (or dispersion) on the monitoring costs and on the expansion decision, hence the awkward findings regarding H8. In addition, as was argued earlier in this chapter, the fact that most franchised hotels in the sample are U.S.-located may influence the results of the study, since U.S. hotels are quite concentrated36.

The extended ordered model included in the model specification the interaction effects between country politico-economic risk / brand size and market segment / country group of origin. The results of that model specification indicate that there is a strong interaction effect between the market segment where a brand is positioned and the country group of origin of that brand, as well as the interaction between brand size and country risk.

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36 Concentration is measured as the number of hotel outlets in a country divided by the country’s population. Since the U.S. has a large number of hotels (per capita) it is considered to have a high geographic concentration index.
The reduced model (which came from the extended model after the exclusion of the non-significant variables) revealed some interesting results regarding mainly the market segment and the country group of origin hypotheses, i.e. the hypotheses that were strongly supported by the original model.

In particular, it can be noticed that the market segment hypothesis is supported only as far as the Anglo-Saxon brands are concerned; for Latin-European brands, the findings indicate that both mid-market and upscale brands would prefer to use franchising rather than company ownership for a new hotel property (other things equal). Yet an interesting observation is that management contracts are the preferred option the higher the market segment also for Latin-European brands. Thus, the main difference between Anglo-Saxon and Latin-European brands refers to the expansion strategy followed by budget brands: Spanish and French budget brands choose mainly company ownership for a new hotel property, while American and British brands prefer to expand using franchising. The same trend can be observed also in the mid-market segment, but not in the same extend as in the budget one. Finally, there is no significant difference as far as the upscale brands are concerned: management contracts are the prevalent mode of development for both American/British and Spanish/French brands, while company ownership is also used to a great extend, and franchising is the least preferred option.

Besides the additional information on the market segment and country group of origin variables, the reduced model provided support for the effect of two more variables (compared to the original model), country politico-economic risk and brand growth. More specifically, the results indicated that in low-risk countries there is a higher probability that management contracts or company ownership will be used for a new hotel development and a lower probability that franchising will be the preferred mode (compared to high/moderate-risk countries), in line with the theory propositions. Yet, in both risk levels, the probability of using company ownership is very low (less than 3%).

With respect to the brand growth hypothesis, the reduced model suggests that, compared to brands with annual growth less than 1 percent, brands with growth between 1 and 2.5 percent are more likely to use franchising and less likely to use company ownership or management contracts. In other words, brands with higher growth would choose franchising for a new hotel development as opposed to company ownership or a management contract. However, when it comes to brands with very high annual growth
(higher than 9 percent), the results indicate that they would more likely choose company ownership or management contracts as opposed to franchising (compared to the very-slow growth brands). Thus, the brand growth hypothesis is only partly confirmed.

A possible explanation for the awkward findings as far as the higher-growth brands are concerned can be related to sample and the time frame of the study: during the data collection, it was noticed that in the time frame under examination (i.e. 1998-2000), there were hotel companies that expanded using takeovers, like Accor for example which bought a hotel chain in Brazil and converted it to Mercure Hotels. Takeovers of large hotel chains within one year might have biased the results of the analysis. The results might have been different if a longitudinal analysis had been undertaken instead of a cross-sectional one.

In conclusion, one could suggest that when the corporate development decision is made at one stage, namely the decision is made among franchising, management contracts and company ownership, transaction cost economics and agency theory provide sufficient reasoning on what factors influence that decision and why. The reduced model (i.e. the model that includes the interaction effects between independent variables and excludes the non-significant variables) provides the strongest support for the examined hypotheses. Table 7.23 below gives a summary of the results of the ordered model (the reduced specification) regarding the nine hypotheses of this study. Once again, the reason why the results of the reduced model are presented in this table is that the reduced specification fits the data better than the other two specifications. It has to be noted that, since there are variables that have been found to influence the expansion decision but in the opposite direction from the one suggested by the respective hypotheses, a separate column has been created for those variables.
Table 7.23: Summary of the results of the ordered model (reduced specification)\textsuperscript{37}

<table>
<thead>
<tr>
<th>Hypotheses</th>
<th>Supported\textsuperscript{38}</th>
<th>Rejected</th>
</tr>
</thead>
<tbody>
<tr>
<td>Negative correlation between political and economic risk and use of high control modes</td>
<td>✓ ✓</td>
<td></td>
</tr>
<tr>
<td>Positive correlation between legal risk and use of high control modes</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Negative correlation between the level of economic development of the target market and the propensity to use a high-control mode</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Negative correlation between hotel brand size and the proclivity to use a high control mode</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Negative correlation between hotel brand growth and the proclivity to use a high control mode</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Negative correlation between brand’s int’l experience and the proclivity to use a high control mode</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Positive correlation between the market segment in which a hotel brand operates and the use of a high control mode (only for Anglo-Saxon brands)</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Positive correlation between geographic concentration of hotel properties and the use of a high control mode</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Latin-European companies are more likely to use company ownership, while Anglo-Saxon are more likely to use franchising</td>
<td>✓ ✓</td>
<td></td>
</tr>
</tbody>
</table>

A final interesting remark regarding the ordered model is that the findings of this model provide an indication that a two-stage analysis might be more informative on the expansion strategy of international hotel firms. More specifically, the effect of most explanatory variables on the predicted probabilities (Tables 7.3?-7.15?) has the same direction as far as both management contracts and company ownership are concerned. For example, when the effect of geographical concentration (GDSPRS) on the predicted

\textsuperscript{37} The results of the final (i.e. the reduced) model are presented in the table

\textsuperscript{38} A single mark (✓) refers to hypotheses that were partly confirmed, while a double mark (✓ ✓) refers to those that were strongly confirmed.
probabilities of choosing each of the three modes is examined Tables 7.13?, it can be seen that while the probability of choosing franchising is positively related to the degree of geographical concentration, the opposite is true for both management contracts and franchising. Namely, in most cases, the probability of choosing either a management contract or company ownership for a new hotel property is in the same direction in both cases and in the opposite direction to the probability of choosing franchising.

This is actually a starting point for considering that the choice is between franchising and non-franchising rather than among the three development modes. Thus, one should consider the application of a two-stage model, instead of the one-stage ordered model. At the first stage the decision concerns the level of desired control over the hotel operations. If high-control is required then a hierarchical mode should be considered, whereas franchising should be the preferred mode if a low-control mode is more desirable. In the second stage, a decision is made between the two hierarchical modes of development, management contracts and company ownership. In the next chapter, the results of the two-stage model will be presented and discussed.
CHAPTER 8: ANALYSIS – THE TWO STAGE BINARY MODEL

As already presented in the previous chapter, the two stage model takes the form of two sequential binary logit models. At the first stage the choice between “market” and “hierarchy” is examined, namely the choice between franchising and “non-franchising” (management contracts and company ownership).

8.1 Results of the First Stage (Choice between franchising and “non-franchising”)

All the developed hypotheses of this study are actually tested in the first stage of the model, the stage where the decision between the use of a “market” versus a “hierarchical” mode is made, as this is the stage that assesses the explanatory power of transaction cost economics and agency theory. At the second stage, the choice between management agreements and company ownership will be examined. It has been explained earlier that management contracts is a mode of development that resembles company ownership in terms of the control provided to the international hotel company, and thus is considered as a mode that lies towards the “hierarchy”, rather than the “market” mode. Thus, at the second stage of the model, the variables that influence the choice between the two hierarchical modes of development will be examined.

The results of the second stage will actually provide some additional information regarding the ability of transaction cost economics and agency theory to explain the modal choice when this choice refers to the hierarchical alternatives. Thus, the results of the second stage will have an exploratory nature rather than an inferential ability. That is, the ability of the second stage to test the validity of the TCE and AT theories will be quite limited.
8.1.1 The Original Specification

The binary model takes the same form as the ordered model, the only difference being that the response variable, i.e. the modal choice (OM) now takes only two values, Y=1 or Y=2:

\[
OM = \beta_0 + \beta_1ICRGD2 + \beta_2ICRGD3 + \beta_3LEGRSK + \beta_4GDP + \beta_5FSIZE + \\
\beta_6FGR2 + \beta_7FGR3 + \beta_8FGR4 + \beta_9INTEXP + \beta_{10}GDSPRS + \beta_{11}MIDMKT + \\
\beta_{12}UPSCALE + \beta_{13}LATINEUROPEAN + \beta_{14}RMS + \beta_{15}LOCATION
\]  

(1)

where:

\( \beta_1 \) & \( \beta_2 \) indicate the effect of low-risk (ICRGD2) and very low-risk countries (ICRGD3) on the decision to use franchising as opposed to non-franchising, compared to the base category, which is the high (and moderate) risk one.

\( \beta_3 \) & \( \beta_4 \) indicate the effects of legal risk (LEGRSK) and level of economic development (GDP) respectively on the modal choice.

\( \beta_5 \) indicates the effect of brand size on the choice.

\( \beta_6, \beta_7, \) & \( \beta_8 \) indicate the effect of brand growth between 1 and 2.5% (FGR2), 2.5 and 9% (FGR3) and over 9.5% (FGR4) on the choice between franchising and non-franchising, compared to the base category, which is hotel brands with annual growth lower than 1%.

\( \beta_9 \) indicates the effect of international experience measured in years since the first operation in a country other than the original was established.

\( \beta_{10} \) indicates the effect of geographical concentration, measured by the number of hotels in each country (divided by the population of the country).

\( \beta_{11} \) & \( \beta_{12} \) indicate the effect on the choice of being a mid-market (or upscale) brand, compared to being a budget brand (reference category).

\( \beta_{13} \) indicates the effect on the choice of being a Latin-European brand compared to being an Anglo-Saxon brand.

\( \beta_{14} \) & \( \beta_{15} \) (control variables) indicate whether (i) the size of the developed property (RMS) and (ii) its location (LOCATION), namely whether the developed hotel will be developed in the country where the hotel brand operates most of its hotel properties (LOCATION=0) or in another country (LOCATION=1), influence the decision between the two corporate development modes.
The first column of the following table presents the main information in the E-Views output, regarding the first stage of the model, i.e. the choice between franchising and “non-franchising”.

The main difference between the binary and the ordered E-Views output is that in the binary model, the sign of the estimated coefficients does show the direction of the change in the probability of falling into any of the two categories of the response variable. Thus, a positive coefficient sign indicates that an increase in the explanatory variable will increase the probability of choosing “non-franchising” (Y=1) over franchising (Y=0), while a negative sign indicates a negative effect of the respective explanatory variable on the response variable. Therefore, the interpretation of the estimated coefficients is more straightforward in the binary model, than it is in the ordered one.

To start with the interpretation of the output, one should identify whether the model with the explanatory variables fits the data better than the model with the intercept alone. Since the probability of the LR statistic is zero, one can reject the null hypothesis that the model does not have greater explanatory power than the “intercept only” model. An additional goodness-of-fit statistic would be the McFadden $R^2$. It can take any value between 0 and 1 and its value increases as the fit of the model improves. In this case the McFadden $R^2$ is 0.68, which indicates a very sufficient goodness-of-fit.
Table 8.1: Regression Analysis for the first stage of the binary model: Original Specification (Model 1), Extended Model (Model 2) and Reduced Model (Model 3)

<table>
<thead>
<tr>
<th>Variables</th>
<th>Model 1</th>
<th>Model 2</th>
<th>Model 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>ICRG2</td>
<td>-0.282</td>
<td>1.170</td>
<td>1.494</td>
</tr>
<tr>
<td>ICRG3</td>
<td>-0.622</td>
<td>1.408</td>
<td>1.650</td>
</tr>
<tr>
<td>LEGRSK</td>
<td>-0.005</td>
<td>-0.012</td>
<td>-0.63</td>
</tr>
<tr>
<td>GDP</td>
<td>0.000</td>
<td>0.000</td>
<td>0.58</td>
</tr>
<tr>
<td>FSIZE</td>
<td>0.000</td>
<td>0.000</td>
<td>2.10**</td>
</tr>
<tr>
<td>FGR2</td>
<td>0.262</td>
<td>0.328</td>
<td>0.36</td>
</tr>
<tr>
<td>FGR3</td>
<td>1.602</td>
<td>1.596</td>
<td>1.412</td>
</tr>
<tr>
<td>FGR4</td>
<td>1.575</td>
<td>1.559</td>
<td>1.370</td>
</tr>
<tr>
<td>INTEXP</td>
<td>-0.034</td>
<td>-0.044</td>
<td>-0.035</td>
</tr>
<tr>
<td>GDSPRS</td>
<td>-1.644</td>
<td>-1.330</td>
<td>-1.510</td>
</tr>
<tr>
<td>MIDMKT</td>
<td>1.056</td>
<td>0.848</td>
<td>1.284</td>
</tr>
<tr>
<td>UPLUX</td>
<td>3.309</td>
<td>3.827</td>
<td>3.534</td>
</tr>
<tr>
<td>LATEUROP</td>
<td>3.610</td>
<td>3.630</td>
<td>3.249</td>
</tr>
<tr>
<td>RMS</td>
<td>0.008</td>
<td>0.008</td>
<td>0.009</td>
</tr>
<tr>
<td>LOCATION</td>
<td>-0.471</td>
<td>0.073</td>
<td>0.09</td>
</tr>
<tr>
<td>MM_LATEU</td>
<td>0.957</td>
<td>0.848</td>
<td>1.284</td>
</tr>
<tr>
<td>UP_LATEU</td>
<td>-1.424</td>
<td>-0.82</td>
<td></td>
</tr>
<tr>
<td>CRD2_FS</td>
<td>-0.000</td>
<td>-2.22**</td>
<td>-0.000</td>
</tr>
<tr>
<td>CRD3_FS</td>
<td>-0.000</td>
<td>-1.91**</td>
<td>-0.000</td>
</tr>
<tr>
<td>FSIZE2</td>
<td>0.000</td>
<td>0.18</td>
<td>-0.000</td>
</tr>
<tr>
<td>FSIZE3</td>
<td>-0.000</td>
<td>0.10</td>
<td>-0.000</td>
</tr>
<tr>
<td>MIDMKT2</td>
<td>1.805</td>
<td>1.35</td>
<td></td>
</tr>
<tr>
<td>UPLUX2</td>
<td>2.403</td>
<td>1.56*</td>
<td></td>
</tr>
<tr>
<td>LATEUROP2</td>
<td>4.588</td>
<td>3.25***</td>
<td></td>
</tr>
<tr>
<td>LATEUROP3</td>
<td>2.206</td>
<td>1.56*</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Model 1</th>
<th>Model 2</th>
<th>Model 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>LR-statistic</td>
<td>457.17</td>
<td>467.3</td>
<td>464.9</td>
</tr>
<tr>
<td>Df</td>
<td>15</td>
<td>19</td>
<td>13</td>
</tr>
<tr>
<td>Probability</td>
<td>0.000</td>
<td>0.000</td>
<td>0.000</td>
</tr>
<tr>
<td>McFadden-R²</td>
<td>0.681</td>
<td>0.696</td>
<td>0.692</td>
</tr>
<tr>
<td>Akaike info criterion</td>
<td>0.506</td>
<td>0.502</td>
<td>0.482</td>
</tr>
<tr>
<td>Schwarz criterion</td>
<td>0.644</td>
<td>0.674</td>
<td>0.603</td>
</tr>
<tr>
<td>Hannan-Quinn criter.</td>
<td>0.560</td>
<td>0.569</td>
<td>0.529</td>
</tr>
<tr>
<td>H-L Statistic</td>
<td>8.6702</td>
<td>10.1562</td>
<td>6.0508</td>
</tr>
<tr>
<td>Probability χ²</td>
<td>0.3709</td>
<td>0.2542</td>
<td>0.6415</td>
</tr>
<tr>
<td>Andrews Statistic</td>
<td>134.1598</td>
<td>184.3007</td>
<td>169.2490</td>
</tr>
<tr>
<td>Probability χ²</td>
<td>0.0000</td>
<td>0.0000</td>
<td>0.0000</td>
</tr>
</tbody>
</table>

Notes: * = p < .1 in a one-tailed test, ** = p < 0.05 in a one-tailed test, *** = p < 0.01 in a one-tailed test
Furthermore, E-Views carries out two goodness-of-fit tests for binary models: the Hosmer-Lemeshow (H-L) and Andrews tests. The idea underlying these tests is to compare the fitted expected values to the actual values by group. If these differences are "large", one rejects the model as providing an inefficient fit to the data. The tables that present the H-L and Andrews tests are included in Appendix 4. The chi-squared statistics for both tests, along with their respective probabilities, are reported at the end of the tables. If the probabilities of both statistics are lower than 0.05, one can suggest that the model fits the data well. If only one of the tests has p<0.05, one could not argue with confidence that the model provides a good fit to the data. As far as the original model is concerned, the H-L and Andrews statistics are 8.6702 and 134.1598 respectively, with probability p<0.001 only for the Andrews test. According to the H-L test the original specification of the first stage of the model (i.e. the specification that does not account for interaction effects) does not fit the data well, while according to the Andrews test the opposite is true. Thus, in this case, the two goodness-of-fit tests do not lead to the same conclusion and cannot be used to assess whether the model fits the data well.

Regarding the effect of the explanatory variables on the decision of a hotel company to expand, this will be assessed by examining both the coefficients (as well as the associated probabilities) and the antilogs of the coefficients. The antilog gives the marginal effect of an explanatory variable \( x \) on the odds of belonging to one versus the other category of the dependent variable (Liao, 1994; Hardy, 1993). In the first column of Table 8.1 (Model 1), one can observe that five of the explanatory variables, brand growth and international experience, geographic concentration, market segment of operation and brand origin are statistically significant at least at the 10 percent level, while the control variable RMS is also found to significantly influence the choice between franchising and non-franchising at the 1 percent level.

More specifically, when the original specification is examined, the following explanatory variables are found to be statistically significant, although not all of them in the hypothesised direction:

a) **Brand Growth**: as in the ordered model, brand growth was found to significantly influence the modal choice, for hotel brands with annual growth higher than 2.5 percent, although in the opposite direction than the one hypothesised. According to the results of the first stage, hotel brands with annual growth between 2.5 and 9.5 percent are 5.2
times more likely to choose non-franchising over franchising for their development, compared to the reference category (i.e. brands with growth lower than 1 percent). Likewise, brands with growth higher than 9.5 percent are 5.6 times more likely to choose non-franchising (as opposed to franchising) compared to the reference category. Thus, the higher the annual growth of an international hotel company, the more likely that management contracts or company ownership would be the preferred mode of development, as opposed to franchising (see Appendix 4 for the E-views tables, as well as the antilogs). Hence H4 is not supported by the original specification of the 1st stage binary model (in line with the results of the original specification of the ordered model).

b) International Experience: The coefficient of INTEXP indicates that there is a negative relationship between international experience and mode of development. More specifically, an increase in international experience by one more country would reduce the odds of choosing a hierarchical mode of development (as opposed to franchising) by a factor of 0.966, or would increase the odds of using franchising (as opposed to non-franchising) by 1.035, i.e. by 3.5 percent. Thus H6 is supported.

c) Geographical Concentration: The results of the first stage are in line with the results of the ordered model. More specifically, it is found that the effect of geographical concentration is highly significant, although in the opposite direction than it is suggested by the relevant theory. The results revealed that the more concentrated the hotel outlets in a particular country (i.e. the higher the GDSPRS index) the more likely it is that franchising will be the preferred mode of development. As it was suggested in the previous chapter, it could be that the proxy used to estimate the effect of geographical concentration is not an appropriate measure to capture the effect of monitoring costs on the modal choice. Also, the results may be driven by the fact that most of the franchised properties are in the USA, where hotel properties are quite concentrated. (It has to be reminded that the GDSPRS index is calculated based on the number of hotels per capita in a each country. Thus, high GDSPRS indicates high concentration of properties in terms of number of hotels.)

d) Market Segment (significant at the 10% for the mid-market segment and 1% level for the upscale segment): using the antilogs β, the results indicate that, on average, a hotel brand that operates in the mid-market segment is 2.9 times more likely to choose a non-franchise agreement (as opposed to franchising), compared to a budget brand, while
an upscale brand is 27.4 times more likely to choose a high-control mode (over franchising) compared to a budget brand. Hence, H7 is strongly confirmed. (The results are similar to those of the ordered model.)

e) **Country Group of Origin**: The effect of brand origin was also found to be highly significant (at 0.001 level). According to the results, a hotel brand that originates from a Latin-European country (France or Spain) is 37 times more likely to use a non-franchising mode compared to a brand that originates from an Anglo-Saxon country. (Results similar to the results of the ordered model.)

The rest of the explanatory variables (ICRG, LEGRSK, GDP and FSIZE) are not found to be statistically significant, when the original specification is used and the same is true for the control variable LOCATION, i.e. whether a new hotel is developed in the country where the hotel brand operates most of its outlets or in another country does not influence the choice between franchising and non-franchising for the development of a new property. On the contrary the size of the outlet (control variable RMS) does influence the choice between franchising and non-franchising. More specifically, the results indicate that the bigger the hotel property to be developed, the more likely it is that a hierarchical mode of development will be used. Also, budget hotels are more likely to be small than upscale or luxury properties. Thus, there might be a correlation between market segment of operation (MKTSGM) and size of the developed property (RMS).

A final step in the analysis of the first stage binary model involves the marginal effect on the predicted probabilities of choosing each one of the development modes with a unit change in the explanatory variables. For the probabilities calculation, the following formulae will be used (Liao, 1994):

\[
Pr ob(Y = 1) = 1 - L(\sum_{k=1}^{K} \beta_k x_k) = L(\sum_{k=1}^{K} \beta_k x_k) = \frac{\sum_{k=1}^{K} \beta_k x_k}{1 + \sum_{k=1}^{K} \beta_k x_k}
\]  
(2)

\[
Pr ob(Y = 0) = 1 - Pr ob(Y = 1) = \frac{1}{1 + \sum_{k=1}^{K} \beta_k x_k}
\]  
(3)
where $Y=0$ is the choice of franchise agreements and $Y=1$ is the choice of non-franchising, $k=1,...,15$ are the explanatory variables, $\beta_k$ are the estimated coefficients (as presented in the estimation output) and $x_k$ are the mean values of each explanatory variable (expect the one whose effect on the probabilities is being assessed). The $L$ function indicates the logistic distribution for the random component $\epsilon$.

The following table gives the probabilities of choosing a franchise agreement as opposed to “non-franchising” when each of the statistically significant variables takes different values. More specifically, the continuous variables INTEXP and GDSPRS (international experience and geographical concentration) take five different values that correspond to the quintiles of their distribution, and the qualitative variables FGR3, FGR4, MIDMKT, UPLUX and LATEUROP take the values of 0 and 1.

Table 8.2: The effect of Brand Growth on the predicted probabilities of choosing franchising as opposed to a non-franchising development mode

<table>
<thead>
<tr>
<th>Growth less than 1% (base category)</th>
<th>$Pr(Y=0)$</th>
<th>$Pr(Y=1)$</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>23.0%</td>
<td>77.0%</td>
</tr>
<tr>
<td>Growth between 2.5% and 9.5%</td>
<td>5.7%</td>
<td>94.3%</td>
</tr>
<tr>
<td>Growth higher than 9.5%</td>
<td>5.8%</td>
<td>94.2%</td>
</tr>
</tbody>
</table>

$Y=0$ represents franchising, while $Y=1$ represents a “non-franchising” mode

It can be noticed in the above table, that hotel brands with annual growth higher than 2.5 percent are even more likely to use a hierarchical mode of development as opposed to franchising, compared to hotel brands in the reference category. Even for hotel brands with slow growth (the reference category), the effect of growth rate on the probability of using franchising is relatively low.
The use of hierarchical modes is negatively related to the geographical concentration of the hotel outlets, opposite to what is suggested by the relevant economic theory. Very dispersed brands (GDSPRS=0.02) are more likely to use a hierarchical mode of development, while very concentrated brands (GDSPRS=4.24) are more likely to use franchising for a new hotel property. Since the proxy is calculated by dividing the number of hotels in a country by its population, one could argue that the results support a certain rationale, since a hotel brand with more outlets in a particular country may find it easier to attract franchisees. An additional reason for the unexpected results could be the U.S effect, as it was presented in the previous chapter: the fact that most franchised outlets in the sample are located in the U.S., a country where the no of hotel outlets per capita is in fact quite high, may bias the effect of geographical concentration on the expansion decision.

The use of hierarchical modes is negatively related to the geographical concentration of the hotel outlets, opposite to what is suggested by the relevant economic theory. Very dispersed brands (GDSPRS=0.02) are more likely to use a hierarchical mode of development, while very concentrated brands (GDSPRS=4.24) are more likely to use franchising for a new hotel property. Since the proxy is calculated by dividing the number of hotels in a country by its population, one could argue that the results support a certain rationale, since a hotel brand with more outlets in a particular country may find it easier to attract franchisees. An additional reason for the unexpected results could be the U.S effect, as it was presented in the previous chapter: the fact that most franchised outlets in the sample are located in the U.S., a country where the no of hotel outlets per capita is in fact quite high, may bias the effect of geographical concentration on the expansion decision.

**Table 8.4: The effect of International Experience on the predicted probabilities of choosing franchising versus non-franchising**

<table>
<thead>
<tr>
<th>QUINTILES</th>
<th>(in years)</th>
<th>Pr(Y=0)</th>
<th>Pr(Y=1)</th>
</tr>
</thead>
<tbody>
<tr>
<td>INTEXP= 8</td>
<td>6.10%</td>
<td>93.90%</td>
<td></td>
</tr>
<tr>
<td>INTEXP= 27</td>
<td>11.00%</td>
<td>89.00%</td>
<td></td>
</tr>
<tr>
<td>INTEXP= 35</td>
<td>14.00%</td>
<td>86.00%</td>
<td></td>
</tr>
<tr>
<td>INTEXP= 38</td>
<td>15.30%</td>
<td>84.70%</td>
<td></td>
</tr>
<tr>
<td>INTEXP= 49</td>
<td>20.80%</td>
<td>79.20%</td>
<td></td>
</tr>
</tbody>
</table>

Y=0 represents franchising, while Y=1 represents a non-franchising mode.
The hypothesis regarding the effect of international experience on the modal choice (H6) is also supported in the binary model: the more the international experience of a hotel brand, the higher the probability to choose franchising for its expansion and the lower the probability to use management contracts or company ownership.

**Table 8.5: The effect of Market Segment and Origin on the predicted probabilities of choosing franchising versus non-franchising**

<table>
<thead>
<tr>
<th></th>
<th>Pr(Y=0)</th>
<th>Pr(Y=1)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Upscale brands</td>
<td>1.70%</td>
<td>98.30%</td>
</tr>
<tr>
<td>Mid-market brands</td>
<td>14.40%</td>
<td>85.60%</td>
</tr>
<tr>
<td>Budget brands</td>
<td>32.50%</td>
<td>67.50%</td>
</tr>
<tr>
<td>Latin-europ. Brands</td>
<td>0.60%</td>
<td>99.40%</td>
</tr>
<tr>
<td>Anglo-Saxon brands</td>
<td>18.10%</td>
<td>81.90%</td>
</tr>
</tbody>
</table>

*Y=0 represents franchising, while Y=1 represents a non-franchising mode*

The findings in Table 8.5 support the relevant hypothesis regarding the positive relationship between operation in higher market segments and the use of high-control modes. The higher the market segment, the higher the probability that a hierarchical mode of development will be used for a new hotel property. In the upscale segment, the probability for franchising to be used is only 1.7 percent while the respective probability for a budget brand is 32.5 percent. Furthermore, hotel brands that originate from Spanish or French countries are more likely to use high-control modes compared to their Anglo-Saxon counterparts, (although the probability to use a high-control mode is higher than the probability to use franchising in both cases). Hence both hypotheses (H7 and H9) are supported in the first stage of the binary model and the results are in line with those of the original specification of the ordered model.
8.1.2 Interaction Effects between Market Segment/Country Group of Origin and Brand Size/Country Risk (The Extended Model)

In the extended model, the interaction effects between (i) market segment and country group of origin of the hotel brand and (ii) country political and economic risk and brand size are accounted for. The extended model to be tested takes the following form:

\[
OM = \beta_0 + \beta_1ICRGD2 + \beta_2ICRGD3 + \beta_3LEGRSK + \beta_4GDP + \beta_5FSIZE + \\
\beta_6FGR2 + \beta_7FGR3 + \beta_8FGR4 + \beta_9INTEXP + \beta_{10}GDSRPS + \beta_{11}MIDMKT \\
+ \beta_{12}UPSCALE + \beta_{13}LATINEUROPEAN + \beta_{14}RMS + \beta_{15}LOCATION + \\
\beta_{16}MM_LATEU + \beta_{17}UP_LATEU + \beta_{18}CRD2_FS + \beta_{19}CRD3_FS
\] (4)

When the interaction effects are introduced into the model, all the information criteria (HC, AIC and SC) are being improved compared to the original model, while the same is true for the McFadden R-squared index. Yet again, the goodness-of-fit tests performed by E-Views, i.e. the H-L and Andrews tests give contradictory results, thus, by using these tests, one could not be confident regarding how well the extended model fits the data (see Appendix 4 for the goodness-of-fit output).

When the extended model is tested the following explanatory variables are found to be significant:

a) **Brand size**: while the results of the original specification presented earlier did not indicate any relationship between the size of the brand and the corporate development choice, the extended model suggests that there is a positive relationship between brand size and the choice of non-franchising, when country risk is moderate to high, an opposite direction than the one suggested by the relative hypothesis \((H_4)\). However, the results of the interaction effects between size and country risk suggest that as the political and economic risks of a country get lower, the relationship between brand size and choice becomes negative, i.e. larger hotel companies would prefer to use franchising for their expansion, as it is proposed by the respective hypothesis. The coefficients of the interaction terms CRD2_FS and CRD3_FS are statistically significant at the 5 percent level, suggesting that in countries characterised by low- or very low risk, the effect or brand size is different than in high/moderate risk counties. The coefficient of FSIZE3 (effect of brand size in very low-risk countries) is negative, although very small, suggesting that in very low-risk countries, the bigger the hotel brand the higher the
b) **Brand Growth:** Regarding the effect of annual brand growth on the expansion strategy, the results are in line with those of the original specification and the ordered model. More specifically, hotel companies with annual growth between 2.5 and 9.5 percent are 5 times more likely to expand using “non-franchising” compared to the reference category (i.e. the hotel companies with growth less than 1 percent), while brands with annual growth higher than 9.5 percent are 4.8 times more likely to use “non-franchising” compared to the reference category.

c) **International Experience:** As in the original specification international experience is found to significantly influence the choice between franchising and non-franchising modes of development. Moreover, when the extended model is examined, international experience is significant at the 5 percent level (as opposed to the 10 percent in the original specification) and the coefficient is higher than the one in the original specification: one more year of international experience causes a 4.5% increase in the probability of using franchising (as opposed to a hierarchical mode of expansion). Hence **H6** is supported by the results of the extended model.

d) **Geographical Concentration:** The negative and significant coefficient for GDSPRS indicates that the more concentrated the hotels in a particular country, the higher the probability that the new hotel property will be franchised (again opposite than hypothesized by **H8**).

e) **Market Segment:** When the interaction term between market segment and brand origin is incorporated in the model, the respective hypothesis (**H7**) is confirmed, though only for upscale brands compared to budget ones. More specifically, the coefficient for MIDMKT is positive but non-significant, indicating that the difference in the effect on the expansion decision of being a mid-market as opposed to a budget Anglo-Saxon brand is not statistically significant. On the other hand it is confirmed that upscale Anglo-Saxon brands are 46 times more likely to use a high-control mode as opposed to franchising (compared to budget brands). Furthermore, the interaction terms MM_LATEU and UP_LATEU were not found to be significant, suggesting that the
difference in the effect of being in the upscale (or mid-market) rather than in the budget segment for Latin-European companies relative to Anglo-Saxon ones is not significant. Namely, there is no statistical difference in the way upscale and mid-market Latin-European and Anglo-Saxon brands choose between franchising and non-franchising for a new hotel development. Indeed, MIDMKT2 (the coefficient for mid-market Latin-European brands) is found to be non-significant, whereas UPLUX2 (the coefficient for upscale Latin-European brands) is found to be significant at the 5 percent level, suggesting that upscale brands originating from Spain or France are more likely to choose a non-franchising mode for a new hotel property, compared to a budget brand (as was the case for American and British upscale brands. Overall, when the interaction effects are taken into account the market segment hypothesis is confirmed: market segment is indeed an influencing factor for the expansion strategy of both Anglo-Saxon and Latin-European brands and higher market segments are associated with the use of higher-control modes of development.

f) **Country Group (Brand Origin):** The effect of brand origin was found to be highly significant (at 0.001 level), as in the original specification. According to the findings of the extended model, a budget hotel brand that originates from a Latin-European country (France or Spain) is 38 times more likely to use a non-franchising mode (as opposed to franchising) compared to a budget brand that originates from an Anglo-Saxon country (North America or United Kingdom). In order to identify the effect of origin on the development strategy of mid-market (or upscale) brands, the relevant coefficients and their t-values need to be calculated. The effect of being a mid-market Latin-European as opposed to a mid-market Anglo-Saxon brand is given by the sum of the LATEUROP and MID_LATEU coefficients, while for the upscale brands it is given by the sum of LATEUROP and UP_LATEU. In both cases, the coefficient is positive (LATEUROP2=4.58 and LATEUROP3=2.206), and significant suggesting that, as in the budget segment, Latin-European mid-market and upscale brands are more likely to use a high-control mode compared to Anglo-Saxon upscale brands. Thus, when the interaction terms are incorporated in the model it is revealed that the effect of origin is indeed significant (as suggested also by the original specification), thus **H9** is strongly supported.
8.1.3 The Reduced Model

In the previous chapter, where the results of the ordered model were presented, a reduced model was also assessed, i.e. a model where all the non-significant explanatory variables were dropped from the specification. A reduced specification should also be examined in the case of the binary model. If one excludes the variables that were not found to be statistically significant and reassessed the model, one finds that the results are slightly better than the results of the extended model. More specifically, as can be seen in the third column of Table 8.1 (Model 3), the information criteria AIC, H-C and SC are improved.

g) Political and Economic Risk: the reduced model provides support for one more hypothesis \((H1)\), according to which the higher the country risk the more likely that a low-control mode would be chosen for the development of a new hotel outlet. It can be seen that the coefficients for ICRGD2 and ICRGD3 are positive and significant at the 5 percent level, indicating that the lower the politico-economic risk of a country, the higher the probability that a high-control model of development will be used, other things equal. The probability of using non-franchising is 4.5 times higher in low-risk countries compared to high- and moderate-risk countries (the reference category) and 5.2 times higher in very-low risk countries compared to the reference category.

Finally, the previously presented equations (2) and (3) will be used to calculate the predicted probabilities for the significant explanatory variables.

**Table 8.6: The effect of Country Politico-economic Risk on the predicted probabilities of choosing franchising as opposed to a “non-franchising” development mode**

<table>
<thead>
<tr>
<th></th>
<th>Pr((Y=0))</th>
<th>Pr((Y=1))</th>
</tr>
</thead>
<tbody>
<tr>
<td>High-Risk Countries (base category)</td>
<td>5.3%</td>
<td>94.7%</td>
</tr>
<tr>
<td>Low-Risk Countries (ICRGD2=1)</td>
<td>1.2%</td>
<td>98.8%</td>
</tr>
<tr>
<td>Very Low-Risk Countries (ICRGD3=1)</td>
<td>1.0%</td>
<td>99.0%</td>
</tr>
</tbody>
</table>

\(Y=0\) represents franchising, while \(Y=1\) represents a non-franchising mode.
Although the higher the political and economic risk of a country the higher the probability of using franchising and the lower the probability of using management contracts or company ownership, the effect of risk on the probability of using franchising is very low even in high/moderate-risk countries.

**Table 8.7: The effect of Brand Growth on the predicted probabilities of choosing franchising as opposed to a non-franchising development mode**

<table>
<thead>
<tr>
<th>Growth</th>
<th>Pr(Y=0)</th>
<th>Pr(Y=1)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Growth less than 1% (base category)</td>
<td>7.8%</td>
<td>92.2%</td>
</tr>
<tr>
<td>Growth between 2.5% and 9%</td>
<td>2.0%</td>
<td>98.0%</td>
</tr>
<tr>
<td>Growth higher than 9%</td>
<td>2.1%</td>
<td>97.9%</td>
</tr>
</tbody>
</table>

*Y=0 represents franchising, while Y=1 represents a non-franchising mode*

It can be noticed in the above table, that hotel brands with annual growth higher than 2.5 percent are more likely to use a non-franchising mode of development, compared to hotel brands in the reference category. Even for hotel brands with slow growth (the reference category) the effect on the probability of using franchising is very low.

**Table 8.8: The effect of Geographical Concentration on the predicted probabilities of choosing franchising versus non-franchising**

<table>
<thead>
<tr>
<th>Quintiles</th>
<th>(no of outlets/population)</th>
<th>Pr(Y=0)</th>
<th>Pr(Y=1)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Q1</td>
<td>GDSPRS= 0.02</td>
<td>1.2%</td>
<td>98.8%</td>
</tr>
<tr>
<td>Q2</td>
<td>GDSPRS= 0.17</td>
<td>1.5%</td>
<td>98.5%</td>
</tr>
<tr>
<td>Q3</td>
<td>GDSPRS= 0.59</td>
<td>2.9%</td>
<td>97.1%</td>
</tr>
<tr>
<td>Q4</td>
<td>GDSPRS= 1.59</td>
<td>11.8%</td>
<td>88.2%</td>
</tr>
<tr>
<td>Q5</td>
<td>GDSPRS= 4.24</td>
<td>87.9%</td>
<td>12.1%</td>
</tr>
</tbody>
</table>

*Y=0 represents franchising, while Y=1 represents a non-franchising mode*

Franchising is positively related to the geographical concentration of the hotel outlets, opposite to what is suggested by the relevant economic theory. Very dispersed brands (GDSPRS=0.02) are more likely to use a hierarchical mode of development, while very
concentrated brands (GDSPRS=4.24) are more likely to use franchising for a new hotel property. The proxy is calculated by dividing the number of hotels in a country by its population, and thus one could argue that the results follow a certain rationale, since a hotel brand with more outlets in a particular country may find it easier to attract franchisees.

Table 8.9: The effect of International Experience on the predicted probabilities of choosing franchising versus non-franchising

<table>
<thead>
<tr>
<th>QUINTILES</th>
<th>(in years)</th>
<th>Pr(Y=0)</th>
<th>Pr(Y=1)</th>
</tr>
</thead>
<tbody>
<tr>
<td>INTEXP= 8</td>
<td></td>
<td>2.0%</td>
<td>98.0%</td>
</tr>
<tr>
<td>INTEXP= 27</td>
<td></td>
<td>3.9%</td>
<td>96.1%</td>
</tr>
<tr>
<td>INTEXP= 35</td>
<td></td>
<td>5.1%</td>
<td>94.9%</td>
</tr>
<tr>
<td>INTEXP= 38</td>
<td></td>
<td>5.7%</td>
<td>94.3%</td>
</tr>
<tr>
<td>INTEXP= 49</td>
<td></td>
<td>8.1%</td>
<td>91.9%</td>
</tr>
</tbody>
</table>

Y=0 represents franchising, while Y=1 represents a non-franchising mode

The hypothesis regarding the effect of international experience on the modal choice (H6) is also supported in the binary model: the greater the international experience of a hotel brand, the higher the probability of choosing franchising for its expansion and the lower the probability of using management contracts or company ownership.

Table 8.10: The effect of Market Segment and Country Group of Origin on the predicted probabilities of choosing franchising versus non-franchising

<table>
<thead>
<tr>
<th></th>
<th>Pr(Y=0)</th>
<th>Pr(Y=1)</th>
</tr>
</thead>
<tbody>
<tr>
<td>A/S Upscale brands</td>
<td>45.9%</td>
<td>54.1%</td>
</tr>
<tr>
<td>A/S Mid-market brands</td>
<td>94.3%</td>
<td>5.7%</td>
</tr>
<tr>
<td>A/S Budget brands</td>
<td>97.5%</td>
<td>2.5%</td>
</tr>
<tr>
<td>L/E Upscale brands</td>
<td>22.1%</td>
<td>77.9%</td>
</tr>
<tr>
<td>L/E Budget brands</td>
<td>29.6%</td>
<td>70.4%</td>
</tr>
</tbody>
</table>

Y=0 represents franchising, while Y=1 represents a non-franchising mode

39 The probabilities for mid-market Latin-European brands are not presented since the coefficient for MIDMKT2 was not found statistically significant.
The coefficients of MIDMKT, UPLUX and LATEUROP in the reduced model have the same interpretation as in the original specification, namely, they indicate the effect of the choice of being a mid-market, upscale or Latin-European brand respectively. The reason is that the interaction terms MM_LATEU and UP_LATEU have been dropped from the analysis, since their coefficients were not found to be statistically significant in the extended model. Since the reduced model does not include any interaction variables (country risk / brand size or market segment / country group of origin), the above mentioned variables do not have the same interpretation as in the extended model. Therefore, one cannot calculate predicted probabilities for different brand origins.

In order for these probabilities to be calculated, the coefficients of the extended model were used. As can be seen in Table 8.10, the higher the market segment where a brand operates the higher the probability that a high-control mode will be the preferred option for both Anglo-Saxon and Latin-European brands. Hence $H7$ is strongly supported. The results also indicate that on average Spanish and French brands are more likely to use management contracts or company ownership compared to their American and British counterparts (in every market segment), providing support also for hypothesis $H9$. 


8.2 Results of the second stage of the analysis (choice between management agreements and company ownership)

8.2.1 The original specification

The second stage of the decision refers to the choice between the two hierarchical modes of development, namely the choice between management contracts and company ownership. A binary model was estimated again, using the same explanatory variables, yet this time the response variable takes the value of zero for management contracts and one for company ownership. Moreover, since the observations of franchised outlets are not included in the second stage, the number of total observations has been reduced to 223. The results of the original specification of the second stage model are presented in the first column of Table 8.10 (Model 1).

At first one could notice that the probability of the LR statistic is very close to zero, indicating that the model with the explanatory variables fits the data better than the model with the intercept only. However, the goodness-of-fit tests calculated by E-Views, namely H-L and Andrews tests again provide contradictory results regarding how well the model fits the data (see Appendix 5). In the first column of table 8.10 (Model 1), one can observe that five of the explanatory variables are found to be statistically significant at least at the 10 percent level. Furthermore, the control variable RMS is also found to significantly influence the choice between the two hierarchical modes, at the 1 percent level.

More specifically, when the original specification of the second stage is examined, the following explanatory variables are found to be statistically significant:
Table 8.11: Regression Analysis for the second stage of the binary model: Original Specification (Model 1), Extended Model (Model 2) and Reduced Model (Model 3)

<table>
<thead>
<tr>
<th>Variables</th>
<th>Model 1 Beta</th>
<th>Model 1 t-value</th>
<th>Model 2 Beta</th>
<th>Model 2 t-value</th>
<th>Model 3 Beta</th>
<th>Model 3 t-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>ICRG2</td>
<td>0.389</td>
<td>0.653</td>
<td>0.832</td>
<td>1.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>ICRG3</td>
<td>-0.226</td>
<td>-0.297</td>
<td>-0.851</td>
<td>-0.79</td>
<td></td>
<td></td>
</tr>
<tr>
<td>LEGRSK</td>
<td>-0.004</td>
<td>0.266</td>
<td>-0.000</td>
<td>-0.04</td>
<td></td>
<td></td>
</tr>
<tr>
<td>GDP</td>
<td>0.000</td>
<td>1.86**</td>
<td>0.000</td>
<td>2.59***</td>
<td>0.000</td>
<td>3.88***</td>
</tr>
<tr>
<td>FSIZE</td>
<td>0.000</td>
<td>1.88**</td>
<td>0.000</td>
<td>2.61***</td>
<td>0.000</td>
<td>3.28***</td>
</tr>
<tr>
<td>FGR2</td>
<td>0.535</td>
<td>0.98</td>
<td>0.327</td>
<td>0.58</td>
<td></td>
<td></td>
</tr>
<tr>
<td>FGR3</td>
<td>0.466</td>
<td>0.80</td>
<td>-0.005</td>
<td>-0.01</td>
<td></td>
<td></td>
</tr>
<tr>
<td>FGR4</td>
<td>1.238</td>
<td>2.01**</td>
<td>1.978</td>
<td>2.77***</td>
<td>1.488</td>
<td>2.80***</td>
</tr>
<tr>
<td>INTEXP</td>
<td>0.034</td>
<td>1.52*</td>
<td>0.019</td>
<td>0.71</td>
<td></td>
<td></td>
</tr>
<tr>
<td>GDSPRS</td>
<td>0.172</td>
<td>0.44</td>
<td>0.552</td>
<td>1.09</td>
<td></td>
<td></td>
</tr>
<tr>
<td>MIDMKT</td>
<td>-1.772</td>
<td>-2.44***</td>
<td>-2.148</td>
<td>-1.00</td>
<td>-2.469</td>
<td>-1.24*</td>
</tr>
<tr>
<td>UPLUX</td>
<td>-0.414</td>
<td>-0.59</td>
<td>2.752</td>
<td>1.98**</td>
<td>2.795</td>
<td>2.31**</td>
</tr>
<tr>
<td>LATEUROP</td>
<td>2.002</td>
<td>3.68***</td>
<td>6.004</td>
<td>3.86***</td>
<td>6.081</td>
<td>4.21***</td>
</tr>
<tr>
<td>RMS</td>
<td>0.000</td>
<td>0.13</td>
<td>-0.000</td>
<td>-0.35</td>
<td></td>
<td></td>
</tr>
<tr>
<td>LOCATION</td>
<td>0.796</td>
<td>1.36*</td>
<td>1.49</td>
<td>2.30**</td>
<td>1.108</td>
<td>2.19**</td>
</tr>
<tr>
<td>MM_LATEU</td>
<td>-0.907</td>
<td>-0.37</td>
<td>-0.545</td>
<td>-0.26</td>
<td></td>
<td></td>
</tr>
<tr>
<td>UP_LATEU</td>
<td>-5.578</td>
<td>-2.98***</td>
<td>-5.232</td>
<td>2.19**</td>
<td></td>
<td></td>
</tr>
<tr>
<td>CRD2_FS</td>
<td>-0.000</td>
<td>-1.13</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>CRD3_FS</td>
<td>0.000</td>
<td>0.54</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FSIZE2</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FSIZE3</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>MIDMKT2</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>UPLUX2</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>LATEUROP2</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>LATEUROP3</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>LR-statistic</td>
<td>49.929</td>
<td>71.140</td>
<td>63.132</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Df</td>
<td>15</td>
<td>19</td>
<td>9</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Probability</td>
<td>0.0000</td>
<td>0.0000</td>
<td>0.0000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>McFadden-R²</td>
<td>0.188</td>
<td>0.268</td>
<td>0.248</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Akaike info criterion</td>
<td>1.110</td>
<td>1.051</td>
<td>0.997</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Schwarz criterion</td>
<td>1.355</td>
<td>1.357</td>
<td>1.150</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hannan-Quinn criter.</td>
<td>1.209</td>
<td>1.174</td>
<td>1.059</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>H-L Statistic</td>
<td>4.158</td>
<td>17.913</td>
<td>15.695</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Probability χ²</td>
<td>0.843</td>
<td><strong>0.022</strong></td>
<td><strong>0.004</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Andrews Statistic</td>
<td>23.415</td>
<td>43.112</td>
<td>36.940</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Probability χ²</td>
<td>0.009</td>
<td><strong>0.000</strong></td>
<td><strong>0.000</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Notes: *=p<.1 in a one-tailed test, **=p<0.05 in a one-tailed test, ***=p<0.01 in a one-tailed test
(a) **Level of Economic Development**: As in the ordered model, the effect of economic development on the modal choice is found to be in the opposite direction to that suggested by the relevant theory. Indeed, the results indicate that the higher the level of economic development, the higher the probability of choosing company ownership and the lower the probability of using a management agreement for a new hotel property. Yet the coefficient, although significant at the 5 percent level is very low (close to zero) suggesting that the level of economic development can only explain a very small part of the choice between management contracts and company ownership.

(b) **Brand Size**: the effect of brand size is also opposite than expected, but again the coefficient is close to zero (as it was the case in the ordered model). Thus, the probability of using company ownership gets slightly higher, the larger the hotel brand that develops the new property.

(c) **Brand Growth**: when the choice between management contracts and company ownership is examined the findings reveal that brand annual growth has an explanatory power only when brands with very high annual growth are compared to brands with very slow growth. More specifically, using the antilogs (see Appendix 5 for E-views output and antilog calculation) it can be argued that hotel brands with annual growth higher than 9.5 percent are 3.5 times more likely to use company ownership as opposed to a management agreement, compared to the reference category, i.e. brands with annual growth less than 1 percent.

(d) **International Experience**: the original specification of the second stage indicates that one more year of international experience increases by 3.5 percent the odds of choosing company ownership over a management agreement for the development of a new hotel outlet.

(e) **Market Segment**: As can be seen in Table 8.10 the effect of market segment on the choice between management contracts and company ownership is significant only for mid-market compared to budget brands. More specifically (using the antilog of the coefficient of MIDMKT), it is revealed that mid-market brands are on average (i.e. for both Anglo-Saxon and Latin-European companies) 0.17 times more likely to choose company ownership or mid-market brands are almost 6 times more likely to choose a management agreement over company ownership compared to budget brands. The
coefficient of UPSCALE is non-significant indicating that, on average, the decision between management contracts and company ownership is not different between upscale and budget brands. A possible explanation is that the coefficients for MIDMKT and UPLUX refer to both Anglo-Saxon and Latin-European brands; if the interaction effects are introduced then the coefficients may indicate that different origins have different effects that counteract when the average effect is calculated.

(f) Country Group (Brand Origin): the effect of brand origin is again found to be positive and highly significant, indicating that Spanish and French brands are 7.5 times more likely to use company ownership over a management agreement, compared to American and British brands.

Overall, the original specification of the second stage of the binary analysis, revealed that the odds of using company ownership over management contracts are higher for bigger hotel brands, brands with more international experience and brands with annual growth higher than 9 percent (compared to brands with growth less than 1 percent.) Furthermore, budget brands and brands that originate from a Latin-European country are more likely to choose company ownership as opposed to management contracts, compared to mid-market and Anglo-Saxon brands respectively. Finally, it should be noticed that the control variable LOCATION also has a positive and significant at the 10 percent level effect on the choice, since the odds of using company ownership over management contracts are 2 times higher if the new hotel is developed in countries other than the country where the hotel brand operates most of its hotels.

8.2.2 The extended model

The explanatory power of the second stage binary model is again improved, when the interaction effects are introduced. More specifically, as can be seen in Table 8.11, the information criteria AIC, SC and H-Q are lower than in the case of the original model and the McFadden R-squared is improved by 8 percent. Even more important is the fact that the goodness-of-fit tests indicate that the extended model provides a good fit to the data since both H-L and Andrews tests have chi-squared probabilities lower than 5 percent (see Table 8.11).
When the interaction effects between (i) country group of origin and market segment, and (ii) brand size and country risk are incorporated into the analysis, international experience becomes non-significant. Moreover, the behaviour of the market segment variable changes. Indeed, it is both the upscale and the mid-market segments that present differences from the budget segment in the effect on the choice: the coefficient of UPLUX is positive and significant at the 5 percent level, suggesting that Anglo-Saxon upscale brands are more likely to use company ownership as opposed to management contracts, compared to A/S budget brands. On the other hand, the coefficient of MIDMKT is non-significant, namely there is no difference on the choice of being a mid-market Anglo-Saxon brand as opposed to a budget A/S brand.

The coefficient of the interaction term UP_LATEU is negative and highly significant, indicating that the behaviour of Latin-European upscale brands is different compared to Anglo-Saxon ones. On the other hand, the coefficient of the interaction term MM_LATEU is non-significant, suggesting that there is no significant difference between mid-market Anglo-Saxon and Latin-European brands, regarding their choice between management contracts and company ownership. More specifically, UPLUX2 and MIDMKT2 (the coefficients of upscale and mid-market Latin-European brands respectively) are negative and significant and their antilogs reveal that the odds of using management contracts over company ownership are 17 times higher for upscale and 21 times higher for mid-market, compared to budget (Spanish and French) brands.

As far as the effect of country group of origin is concerned, the extended model reveals that both budget and mid-market Latin-European brands are more likely to use company ownership as opposed to management contracts for new hotel developments, compared to their Anglo-Saxon counterparts (both LATEUROP and LATEUROP2 are positive and highly significant). LATEUROP3 (the coefficient that indicates the effect of being an upscale Latin-European compared to an upscale Anglo-Saxon brand), although positive, is not found to be significant, namely in the upscale segment both American/British and French/Spanish brands behave in the same way when they choose between company ownership and management contracts.
8.2.3 The reduced model

Before the predicted probabilities of choosing company ownership (Y=1) versus a management contract (Y=0) for the significant explanatory variables are calculated, the reduced model (Model 3) needs to be estimated. It can be seen from the third column of Table 8.11, that when the non-significant explanatory variables are dropped from the model, the results are similar to the extended one (Model 2). More specifically, the information criteria are improved, and the goodness-of-fit tests have probabilities lower than 1 percent indicating that the model fits the data better than the extended one (though the McFadden $R^2$ is slightly lower).

As for the effect of the explanatory variables on the choice, it can be seen that level of economic development, brand size and growth, and international experience have the same effect as in the previous model. Regarding the market segment variable the results reveal that:

- Both Anglo-Saxon and Latin-European mid-market brands are more likely to choose a management agreement over company ownership, compared to budget brands.

- In the upscale segment, the negative and significant interaction term UP_LATEU suggests there is a difference in the effect on the choice of being a Latin-European relative to an Anglo-Saxon brand. More specifically, upscale Latin-European brands are more likely to choose management agreements over company ownership, compared to their budget counterparts, while the opposite is true for Anglo-Saxon brands.

Finally, the effect of brand origin is in the expected direction, although only as far as budget and mid-market brands are concerned: budget and mid-market Latin-European brands are more likely to use company ownership over management contracts for their new hotel developments, compared to the Anglo-Saxon brands.

The calculation of the respective predicted probabilities would give the following results:
Table 8.12: The effect of Level of Economic Development on the predicted probabilities of choosing company ownership over management contracts

<table>
<thead>
<tr>
<th>GDP per capita</th>
<th>Pr(Y=0)</th>
<th>Pr(Y=1)</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP = 2072</td>
<td>7.75%</td>
<td>92.25%</td>
</tr>
<tr>
<td>GDP = 7259</td>
<td>6.64%</td>
<td>93.36%</td>
</tr>
<tr>
<td>GDP = 22488</td>
<td>4.18%</td>
<td>95.82%</td>
</tr>
<tr>
<td>GDP = 30316</td>
<td>3.28%</td>
<td>96.72%</td>
</tr>
<tr>
<td>GDP = 36569</td>
<td>2.70%</td>
<td>97.30%</td>
</tr>
</tbody>
</table>

Y=1 represents C/O, while Y=0 represents a MC

As indicated by the relevant coefficient, the probability to use company ownership is an increasing function of the target country’s level of economic development. However, company ownership seems to be the prevalent choice regardless of the level of development (other things equal), since the probability of using a management contract for a new development is lower than 10 percent at any level of economic development.

Table 8.13: The effect of Brand Size on the predicted probabilities of choosing company ownership over management contracts

<table>
<thead>
<tr>
<th>Brand Size in rooms</th>
<th>Pr(Y=0)</th>
<th>Pr(Y=1)</th>
</tr>
</thead>
<tbody>
<tr>
<td>FSIZE = 24,186</td>
<td>7.76%</td>
<td>92.24%</td>
</tr>
<tr>
<td>FSIZE = 47,809</td>
<td>6.35%</td>
<td>93.65%</td>
</tr>
<tr>
<td>FSIZE = 55,967</td>
<td>5.92%</td>
<td>94.08%</td>
</tr>
<tr>
<td>FSIZE = 109,200</td>
<td>3.72%</td>
<td>96.28%</td>
</tr>
<tr>
<td>FSIZE = 284,350</td>
<td>0.77%</td>
<td>99.23%</td>
</tr>
</tbody>
</table>

Y=1 represents C/O, while Y=0 represents a MC
Table 8.14: The effect of Brand Growth on the predicted probabilities of choosing company ownership over management contracts

<table>
<thead>
<tr>
<th></th>
<th>Pr(Y=0)</th>
<th>Pr(Y=1)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Growth less than 1% (base</td>
<td>6.04%</td>
<td>93.96%</td>
</tr>
<tr>
<td>category)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Growth higher than 9%</td>
<td>3.15%</td>
<td>96.85%</td>
</tr>
</tbody>
</table>

Y=1 represents C/O, while Y=0 represents a MC

The same is true as far as the effect of brand size and brand growth is concerned. Both very small as well as very large hotel brands are more likely to choose company ownership, when they reach the second stage of the development decision. Moreover, hotel brands that experience high annual growth rates are keener in using company ownership compared to the reference group (brands with less than 1 percent growth), yet in both cases the probability of using management agreements is very low.

Table 8.15: The effect of Market Segment and Country Group of Origin on the predicted probabilities of choosing company ownership over management contracts

<table>
<thead>
<tr>
<th></th>
<th>Pr(Y=0)</th>
<th>Pr(Y=1)</th>
</tr>
</thead>
<tbody>
<tr>
<td>A/S Upscale brands</td>
<td>4.15%</td>
<td>95.85%</td>
</tr>
<tr>
<td>A/S Mid-market brands</td>
<td>32.43%</td>
<td>67.57%</td>
</tr>
<tr>
<td>A/S Budget brands</td>
<td>28.07%</td>
<td>71.93%</td>
</tr>
<tr>
<td>L/E Upscale brands</td>
<td>17.98%</td>
<td>82.02%</td>
</tr>
<tr>
<td>L/E Mid-market brands</td>
<td>22.21%</td>
<td>77.79%</td>
</tr>
<tr>
<td>L/E Budget brands</td>
<td>3.04%</td>
<td>96.96%</td>
</tr>
</tbody>
</table>

Y=1 represents C/O, while Y=0 represents a MC

When it comes to the choice of using a higher control mode of development, i.e. company ownership or management contracts, the following observations can be made regarding the effect of market segment and country group of origin:

- The market segment hypothesis (H7) is only partly supported, since upscale Anglo-Saxon (A/S) companies are 16 times more likely to use company ownership over
a management agreement for the development of a new hotel property, compared to budget ones. However the hypothesis is not confirmed when mid-market A/S brands are compared to budget brands.

- Furthermore, the hypothesis does not hold when the development decision of Latin-European companies is examined: both mid-market and upscale Latin-European brands are more likely to use management contracts compared to budget brands.

- The comparison between origins reveals that Latin-European companies, especially in the budget and mid-market segments, present a higher probability of using company ownership compared to their Anglo-Saxon counterparts. (One should not compare the respective probabilities for the upscale segment, since the coefficient of LATEUROP3, i.e. the coefficient that indicates the difference in the effect of being an upscale Latin-European brand compared to an upscale Anglo-Saxon brand, was not found to be statistically significant.) Hence, the hypothesis for the effect of country group of origin ($H_9$) is also supported in the second stage of the binary model.
8.3 Discussion of the results of the two-stage model

Since the results of the reduced models in both stages are better than the results of the original specifications (where the interaction effects have not been introduced in the analysis), the results of the reduced models will be directly presented. It can be concluded from the presentations of the results in the previous sections, that the reduced specification provides better fit for the data than the original or the extended ones, and thus the discussion hereafter as well as the conclusions in the next chapter will be based on the results of the reduced specification.

(a) Country-specific variables

At the first stage, where the choice between franchising and “non-franchising” is assessed, only one out of the three country specific variables was found to influence the expansion decision, and the same is true for the second stage. More specifically, country political and economic risk is found to be a highly significant factor, since the use of hierarchical modes (as opposed to franchising) is 5 times higher in countries with very low risk compared to countries with high/moderate risk. Yet, if a hotel company chooses to use a high-control mode for its development, then country risk does not influence the choice at the second stage, i.e. country risk does not affect the choice between company ownership and management agreements. Thus the relevant hypothesis (HI) is supported since country risk is an influential factor when the choice between “market” and “hierarchy” is made.

The level of economic development is the country specific factor that influences the choice at the second stage of the decision. Indeed, although the level of economic development is not found to be significant when the choice between franchising and non-franchising is under examination, it seems to have an effect when a company that has chosen to use a hierarchical mode of development considers the use of management contracts over company ownership. Contrary to that predicted by the relevant theory, the results revealed that the higher the level of economic development the more likely it is that company ownership will be the preferred mode of development (as opposed to a management contract).
(b) Firm-Specific Variables

As far as the firm-specific variables are concerned, the results indicate that all the variables have an influence on the choice in at least one of the two stages, although not always in the hypothesised direction.

- Brand size is again found to be significant in both stages, although in the opposite direction than expected; the larger the brand, the higher the probability that a hierarchical mode will be chosen for the development of a new hotel property, other things equal. Furthermore, company ownership is the preferred mode when the second stage of the decision is reached. Yet, it should be noted that the effect of brand size on the modal choice is very weak, since the relevant coefficients were almost zero in both stages.

- The results are similar as far as the effect of brand growth is concerned. Hotel brands with annual growth higher than 2.5 percent are 4 times more likely to choose a high-control mode for their development, as opposed to a franchise agreement, compared to brands with slow annual growth (less than 1 percent), opposite than expected. Moreover, at the second stage, it is suggested that high-growth brands (higher than 9.5 percent) may behave differently than the slow-growth ones, since they have a higher probability of choosing company ownership over a management agreement. Combining the results of both stages, it can be argued that high-growth firms are more likely choose a hierarchical mode of expansion compared to a slow-growth firm. Hence H5 is not supported.

- The hypothesis that examines the effect of international experience (H6) is supported by the findings of the 1st stage model: the higher the international experience of a hotel company the more likely that franchising will be chosen as opposed to a high-control mode. Thus, the results are in line with the argument that firms with presence in more countries may find it easier to attract franchisees and also easier to assess their effort and their performance than companies with presence in less countries.

However, it should be noted that the effect of brand size, growth and international experience on the second stage of the development decision could be explained by different arguments from those used to justify their effect on the choice between "market" and "hierarchical" modes. More specifically, if at the first stage of the decision
a hotel company has decided to use a hierarchical mode rather than franchising for a new hotel property, it could be that at the second stage, there are other issues to be taken into consideration, such as financial constraints. It could be that larger hotel companies with more international experience are more willing to invest financial resources for their new hotel developments. On the other hand, smaller hotel companies may not have the financial strength to participate with significant amounts of equity in their new developments.

- Another hypothesis that is supported by the findings of the binary model is that hotel brands in higher market segments are more likely to expand using a hierarchical mode than a franchise agreement, while the opposite is true for hotel brands in lower market segments (H7). In particular, it was found that the odds of choosing a hierarchical mode of development over franchising for an Anglo-Saxon hotel brand in the upscale segment would be 46 times higher compared to a budget brand, while at the same time for an upscale Latin-European brand they would be 11 times higher. (Although no difference was found between the effect of being a mid-market as opposed to a budget brand, the results still support the hypothesis, as long as there is a significant difference between the effect of being an upscale as opposed to a budget brand, on the choice between “market” and “hierarchy”.)

In the second stage of the decision, the results reveal that when Anglo-Saxon brands decide to use a hierarchical mode of expansion, upscale brands will be more likely to choose company ownership, compared to budget ones, while mid-market brands will be more likely to choose management contracts. As far as Latin-European brands are concerned, both mid-market and upscale brands are keener on using management contracts as opposed to company ownership, compared to their budget counterparts. Thus the market segment hypothesis is supported only as far as the first stage of the development decision is concerned. That is, market segment of operations is a significant factor for the expansion decision only as far as the choice between “market” and “hierarchy” is concerned. Overall, since market segment is found to be significant at the first stage, it can be argued that H7 is supported, since the main theoretical argument of TCE and AT refers to the different features between “market” and “hierarchy”.

- As for the country group of origin, the findings support the hypotheses that Anglo-Saxon brands are less likely to use a hierarchical mode and more likely to use
franchising, than their Latin-European counterparts, other things equal. More specifically, the odds of choosing a hierarchical mode of development over franchising are 38 times higher for a budget Spanish or French brand than it is for an American or English brand and even higher when mid-market brands are considered.

- Finally, geographical concentration is found to be significant at the first stage of the modal choice; that is, when hotel companies decide whether franchising or "non-franchising" will be used for the development of a new hotel property, geographical concentration seems to favour the use of the former, contrary to what is suggested by the theoretical framework of this study. As it was argued in the previous chapter, where the results of the ordered model were presented, it could be the findings are biased by the fact that most franchised outlets in this sample are located in the U.S. where hotel properties are concentrated (many hotel properties per capita).

Overall, the two-stage binary model (especially as far as the first stage of the decision is concerned) provides similar results to those of the ordered model. In both cases the only country-specific hypothesis that is supported is the one that refers to the effect of country political and economic risk on the expansion decision. Regarding the firm-specific hypotheses, both models provide support for the effect of international experience and more importantly the effect of market segment and country group of origin.

The most important additional information provided by the two-stage binary model is related to the fact that more hypotheses are confirmed at the first stage, compared to the second one, suggesting that transaction cost economics and agency theory provide a better explanation for the first stage of the corporate development decision (i.e. when the choice between "market" and hierarchy is made), than of the second stage (choice between "hierarchical" modes). This is actually a conclusion one would expect, since the contribution of transaction cost economics in the economic theory is based on the presentation and analysis of the features that distinguish "market" from "hierarchy" and their implications for the organisation.

Table 8.16 presents the results of the two-stage model regarding the nine hypotheses of this study. The table is actually based on the findings of the first stage of the model, since, as already explained earlier in this section, this is actually the stage where the validity of TCE and AT is assessed.
Table 8.16: Summary of the results of the two-stage binary model

<table>
<thead>
<tr>
<th>Hypotheses</th>
<th>Supported</th>
<th>Rejected</th>
</tr>
</thead>
<tbody>
<tr>
<td>Negative correlation between political and economic risk and use of high control modes</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Positive correlation between legal risk and use of high control modes</td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>Negative correlation between the level of economic development of the target market and the propensity to use a high-control mode</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Negative correlation between hotel brand size and the proclivity to use a high control mode</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Negative correlation between hotel brand growth and the proclivity to use a high control mode</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Negative correlation between brand’s int’l experience and the proclivity to use a high control mode</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Positive correlation between the market segment in which a hotel brand operates and the use of a high control mode</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Positive correlation between geographic concentration of hotel properties and the use of a high control mode</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Latin-European companies are more likely to use company ownership, while Anglo-Saxon are more likely to use a lower-control mode</td>
<td>✓</td>
<td></td>
</tr>
</tbody>
</table>
CHAPTER 9: SUMMARY AND CONCLUSIONS

9.1 Introduction

The current study examines the decision of international hotel companies to expand using "market" versus hierarchical modes of development. So far, there is only limited empirical evidence with respect to the entry mode or corporate development decision of service firms (Alon and McKee, 1999; Erramilli, 1990 and 1991; Erramilli and Rao, 1990 and 1993; Fladmo-Lindquist and Jacque 1995), while the studies that focus specifically on the hotel industry are even fewer (Contractor and Kundu, 1998a and 1998b; Dunning and McQueen, 1982; Erramilli, Agarwal and Chev, 2002; Kehoe, 1996).

The development of a robust theoretical framework, combining both Transaction Cost Economics and Agency Theory, with respect to the expansion strategy of international hotel firms, was a primary objective of this study. As an extensive analysis in the literature review showed, TCE suggests that the international hotel company must trade-off the costs of proprietary knowledge leakage and free riding, as well as problems associated with tacit knowledge and information impactedness, against the benefits achieved by the use of the high-powered incentives of franchising. Agency Theory suggests that company ownership and management contracts are more likely to create moral hazard than franchising, and therefore incur high costs of monitoring agents' behaviour. However, while franchising will attenuate the moral hazard problem, it may create incentives for free riding by the franchisee. Which organisational mode the hotel company should choose for its expansion depends on the costs associated with each form.

Management contracts and franchising agreements, although both contractual modes, are characterised by certain features that differentiate them and imply the need to treat each mode in a different way. Management contracts have certain characteristics that classify them towards the "hierarchical" mode of organisation, since the hotel operator maintains ownership of the intangibles, including transaction-specific assets, such as pre-opening costs as well as non-specific codified assets (e.g. computer reservation systems). Under
franchising the right to use these intangibles is acquired by the franchisee as part of the franchise "package". In that case the company retains control over the brand, while the franchisee is in charge of the daily operations, the human and codified assets and in most cases also the physical assets. Thus, franchising takes a form similar to subcontracting, which is an organisational form very close to the "market" one.

In the following section, a summary of the study will be presented, including the main methodological issues, as well as the main findings. Subsequently, the validity of Transaction Cost Economics and Agency Theory regarding the corporate development decision will be discussed, followed by the contribution of this study to the previous knowledge as far as the entry mode and the expansion decision of international hotel firms are concerned. Finally, the limitations that were encountered during this study, along with the identification of areas of further research, will be presented in the last two sections of this chapter.
9.2 Summary of the study

This study applied both TCE and AT in order to identify the factors that influence the expansion strategy of international hotel firms. In this section an overview of the present research study will be provided, with respect to the theories applied, the methodological issues of the study, as well as the findings that were revealed through the data analysis.

9.2.1 Theoretical framework and methodological approach

So far several theories have been applied by previous researchers, when examining the entry mode choice of international firms. Although both Organisational Capabilities Theory and Internalisation Theory are among the most commonly used, it was argued in the respective chapter (Chapter 3), that the former presents many similarities to Transaction Cost Economics and thus would not provide any additional explanation regarding the expansion decision, while the latter, although it provides a comprehensive explanation for the existence of the firm, its application in this study would require the treatment of management contracts as a non-equity, collaborative agreement, namely a “market” mode, rather than a “hierarchical” one.

Drawing from both TCE and AT, several factors that may influence the expansion strategy of international hotel firms were identified and the respective hypotheses were formulated. Three of the hypotheses, the ones that refer to the influence of brand growth, proprietary knowledge (operationalised using the market segment where the brand operates) and country group of origin of the brand, have not been examined by previous studies in the hotel industry.

A central issue regarding the hypotheses formulation is that franchising is considered as the “default” choice, i.e. the normally preferred option, since it represents the “market” mode. According to TCE, one needs to consider using a “hierarchy” mode only when the “market” mode of organisation becomes more costly to use (Williamson, 1985).

As far as data analysis is concerned, two different approaches were followed and two different models were tested respectively. First, an ordered logit model was tested and subsequently a two-stage binary model was examined. In the first case it was assumed that international hotel companies develop their expansion strategy at a single stage,
where the choice is made among all the available alternatives (in the case of this study, company ownership, management contracts and franchise agreements). The ordered logit model was used instead of the multinomial logit one, since the latter would fail to account for the information conveyed by the ordinal nature of the data, and thus could not test for the hypothesis that the three development modes (franchising, management contracts and company ownership) constitute a set of increasing control modes.

For the two-stage model to be applied, it was assumed that the expansion strategy is formulated in two consecutive stages: at the first stage, the hotel executives choose between high- and low-control modes, i.e. between franchising and “non-franchising” and at the second stage a choice is made between the two high-control modes, i.e. management contracts and company ownership, in cases where the low-control mode has been rejected at the first stage.

An interesting point regarding both models is the introduction of interaction effects between certain independent variables. The first interaction effect examined whether there was a relationship between the politico-economic risk of a country and the brand size, while the second assessed whether the effect of market segment of operations is influenced by the country group of origin of the brand.

9.2.2 Main findings of the study

When the one-stage ordered model was employed, five out of the nine hypotheses were supported. More specifically, the results revealed that there is indeed a positive relationship between country politico-economic risk and the use of lower control modes, that is, franchising will be the preferred option in high-risk countries. Hence, support is provided for the hypothesis that in markets characterised by a high degree of political and economic instability, hotel firms would be more likely to opt for a lower resource commitment organisational mode of development, which would allow for lower switching costs and less volatile rents in the presence of undesirable situations. The findings are consistent with what previous studies in the hotel industry proposed (Contractor and Kundu, 1998a and 1998b; Fladmoe-Lindquist and Jacque, 1995).

The rest of the location (country) - specific hypotheses were not supported by the results of the one-stage analysis. Legal risk was not found to be a significant factor in
determining the expansion strategy, although the reason for the finding might have been the use of a proxy that cannot actually capture the effect of legal risk. (It has to be noted at this stage, that in the context of this study, legal risk refers to both local regulations and policies regarding trademark and intellectual property rights protection, as well as to court enforcement and thus the number of patents filed in each country were used to measure the legal protection of intellectual property. It could be argued that the fact that numerous patents are filed in a country indicates confidence regarding patent protection and thus confidence regarding intellectual knowledge protection in general.)

The level of economic development on the other hand, was found to influence the modal choice but in the opposite than expected direction. Yet, the effect of this variable was found to be very weak and could have occurred due to the fact the majority of the observations in this study refer to developed countries.

The results of the study indicate that the firm-specific variables are more important determinants of the corporate development decision than country specific variables, since four out of the six firm-specific hypotheses were confirmed. More specifically, the results support the hypothesis according to which hotel brands with more international experience tend to favour the use of franchising, rather than the use of higher-control modes, contrary to the results of previous studies in the manufacturing, as well as the hotel industry. Indeed, a hotel company with limited international experience may find it more difficult to attract and select qualified agents (i.e. franchisees), as well as to assess their performance, than to employ staff and monitor their effort, and therefore may prefer to opt for a more hierarchical (high-control) mode.

Brand size was found to have an opposite than hypothesised but again very weak effect on the modal choice, while brand growth was found to have mixed effects on the choice. Hotel brands with medium annual growth rate (i.e. growth rate between 1 and 2.5 percent) were found to expand using more franchising compared to hotel brands with growth rate less than 1 percent, while the opposite is true for hotel brands with very high growth rates (i.e. annual rate higher than 9 percent). Thus, the results of the study could not lead to a solid conclusion with respect to the effect of brand growth on the corporate development decision. It could be that both FSIZE and FGR have a curvilinear effect on the choice, in line with the suggestion of Shane (1998).
The most valuable findings revealed in this study refer to the importance of proprietary knowledge (market segment of operation) on the expansion strategy of international hotel firms. The findings provided support that in higher market segments of operation (upscale and luxury segments), it is more likely that a high-control mode of development will be preferred (as opposed to franchising). Hence, the results are in line with the main transaction cost argument, that upscale hotel brands would expand using a hierarchical mode. The services provided by upscale and luxury brands require specialised knowledge and managerial expertise both of which are associated with high levels of human asset specificity and information impactedness, a situation that favours the use of high-control modes.

As for the effect of geographic concentration on the choice of organisational mode of a new hotel property, it was not supported by the results of the ordered model. Although most of the previous studies confirm the agency theoretic arguments regarding the effect of monitoring costs on the choice between franchising and company ownership, in the current study the results indicated that the more dispersed the hotel properties in a particular country, the more likely it is that a hierarchical mode will be chosen over franchising. As already explained, this unexpected finding may have been the result of the use of a proxy that could not capture the effect of geographical dispersion on the modal choice. An alternative explanation would be related to the sample structure, namely the fact that most franchised outlets in the sample are located in the U.S., a country where the number of hotels per capita (GDSPRS index) is high. That is, in the country where the majority of the franchised hotels of this sample are located, there are high levels of both geographic concentration and the use of franchising. This “US effect” may have biased the results of the study.

Finally, with respect to the country group of origin, the findings indicate that Anglo-Saxon brands are less likely to use company ownership and more likely to use franchising, than their Latin-European counterparts, but only in the budget segment. Hence, the results are in line with the hypothesis that American and British hotel companies, which are more familiar with the use of low-control modes, are less willing to invest equity capital for their expansion, while for French and Spanish companies high control is still associated with equity participation, rather than with management contracts.
It could be that Anglo-Saxon firms are more aware of the value of their intangible assets, since they have stronger brand recognition, compared to the brand name of the Latin-European companies, and thus they employ an aggressive, rather than a defensive use of their properties by splitting the real-estate from the management business. Marriott and Hyatt are two sound examples of U.S.-originated companies that have realised the potential benefits of separating ownership from control.

One could argue that Accor brands, such as Sofitel, Novotel and Ibis have also gained strong brand names during the last couple of decades in the international arena. Yet, it appears that the Accor management follow the same strategy for both its upscale and its budget brands, trying to develop as many hotel operations possible through owning the properties. It seems they feel they need to defend the economic rents from their intangible assets by owning the properties. The desire of Latin-European companies to own and manage the hotel properties is an area that needs further examination, as it will be pinpointed later on, in the relevant section of this chapter.

The application of the two-stage model provided similar results to those of the ordered model. It has to be noted here, that the comparison of the findings between the two models, actually refers to the ordered model and the first stage of the two-stage binary model. Indeed, as already explained in the previous chapter (Ch. 8), it is at the first, rather than the second stage, where the validity of the theoretical framework of this study is evaluated, since at the first stage the choice between “market” modes and hierarchical modes is examined (franchising vs. “non-franchising”).

As far as the results of the two stage model are concerned, the only country-specific hypothesis supported by the data analysis was the one that tested the effect of politico-economic risk on the choice between franchising and “non-franchising”. Regarding the firm-specific ones, the findings provided support for the influence of international experience, market segment of operation and country group of origin, while the effect of brand growth was partly confirmed.

The most interesting result of the two-stage model is related to the importance of the 1st stage of the decision, namely the stage where the hotel company decides between the use of a low- versus a high-control mode of expansion (i.e. franchising versus “non-franchising”). While the 2nd stage binary model provides satisfactory goodness-of-fit,
Expansion Strategies of International Hotel Firms

only 25% of the variation in the choice between company ownership and management contracts is explained by the explanatory variables, and thus it can be concluded that the influence of the examined factors on the choice between those two organisational modes is of only limited importance in this decision by international hotel companies.
9.3 Validity of the theoretical framework

The power of Transaction Cost Economics and Agency Theory to predict the expansion strategy of international hotel firms is supported by the empirical results of this study. More specifically, this study provides clear empirical evidence that the degree of proprietary content and idiosyncratic knowledge embedded in the service provided by the hotel company is one of the most important factors to define international hotel expansion strategy. The higher the market segment of operation, the higher the specialised skills and managerial expertise required in order for the developed hotel to operate according to standards, the more likely it is that a hierarchical mode will be applied for the development of the property.

In addition, it is suggested that hotel brands originating from Latin-European countries, (in the present study Spain and France), are on average more inclined to use higher-control modes of development than brands originating from Anglo-Saxon countries (in this study North America or England). However, when the effect of market segment is combined with the effect of country group of origin it is revealed that this is the case only as far as budget brands are concerned.

This is actually an issue that requires further examination: why would a budget hotel brand choose to expand using company ownership, since the service provided by budget brands is easy to document and to transfer from the franchisor to the potential franchisee through operating manuals and staff training at a low marginal cost? As already explained in previous chapters, the only Latin-European budget brand in the sample is Ibis (an Accor brand), and thus the corporate development decision of budget Latin-European brands in the sample is totally influenced by the expansion strategy of Accor. Nevertheless, one would be interested in finding out why this international hotel company would choose to expand its most popular budget brand, i.e. Ibis Hotels, using company-owned outlets.

In theory there are two possible reasons why a company would prefer to acquire properties instead of signing a management or franchise contract. The first comes from the area of financial management and refers to the expectation that the property market will go up and thus the hotel company will gain value. Hence, it could be that the Accor
management expects that the property market in France and in certain other countries where they own the hotels will be go up and the company’s assets will benefit from that development in the future.

The second reason why a company like Accor would choose company ownership for the expansion of its budget brands comes from the marketing area. More specifically, owning a brand allows a company to better exploit the monopoly rents of the property, rather than when renting it to others through a management contract or when signing a franchise agreement, because a budget brand that is not well-known cannot attract franchisees. French budget brands, like Ibis, do not have such a strong brand name and recognition outside France, as the North American and British brands (e.g. Holiday Inn Express, Days Inn and Howard Johnson), and thus French hotel firms may find it difficult to attract franchisees that would agree with the required revenue structure. Expansion by purchase may also have the effect of increasing the property portfolio even if the ultimate aim is to sell the outlets to franchisees.

The issue of brand strength and its importance for the choice among alternatives modes of expansion is something that cannot be tested using secondary data. Thus in the context of this study it was not possible to test whether the brand strength of Anglo-Saxon as opposed to Latin-European brands have influenced their expansion decisions. The appropriate method to test an issue like that would have been the collection of primary data and the application of a case study method, which would reveal more in-depth information regarding the effect of brand strength and could lead to valuable conclusions in that area.

A comparison between the one-stage and the two-stage model reveals that, contrary to what was found by Gatignon and Anderson (1988) in their study in the manufacturing industry, the expansion strategy in the hotel industry does not clearly appear to be a two-stage, rather than a one-stage, process. The theoretical model based on Transaction Cost Economics (TCE) and Agency Theory (AT) did not provide a better explanation for the corporate development decision, when that decision was modelled in two stages.

Hence, one could conclude that from a TCE and AT perspective, company ownership and management contracts are more like two alternatives modes of development; that is, there may be no obvious TCE or AT factors that would favour the use of management
contracts over company ownership. A possible explanation for the inability of the second stage analysis to provide a solid explanation for the choice between management contracts and company ownership may be the choice of independent variables that have been included in the model. The assessment of the strategic choice between the two hierarchical modes of expansion may require different explanatory variables from those used to explain the choice between market and hierarchical modes.

Hence, no evidence was found to support that when a hotel company decides to develop a new hotel property, the choice of organisational mode to be applied is made in two consecutive steps. In other words, it appears that the company may well consider all the alternative modes (company ownership, management contracts and franchising) and decide which one to apply for the development of the new outlet according the specific circumstances in the target country and the characteristics of the hotel brand.

However, although there is no evidence to support the prevalence of the two-stage model over the one-stage, it has to be noted that the first stage of the two-stage model was found to provide more support on the theoretical framework of this study that the one-stage ordered model. Thus, it could be that the most important decision the hotel executives make regarding the expansion of their hotel brands refers to the choice between “market” and hierarchical modes.

The results of the previous chapters (Ch. 7 and 8) reveal that TCE and AT explain nearly 70% of the choice between franchising and “non-franchising” (first stage of the two-stage model), whereas at the one-stage ordered model they explain only 50% of the choice among the three expansion modes. Yet, the second stage of the two-stage model is considerable less helpful in explaining the choice between the two hierarchical modes, i.e. management contracts and company ownership, since it explains only 20% of the variation. There is obviously a reason why this is the case: TCE and AT may not be capable to distinguish between the hierarchical modes, namely the theoretical foundation of transaction costs and agency theory cannot provide sufficient reasoning why a hierarchical mode would be superior to another hierarchical mode.
9.4 Main contribution of the study

This study makes an important contribution in the existing literature both conceptually and methodologically. In fact, this is the first study to argue that management contracts, although a non-equity$^{40}$ mode of organisation, should be viewed as a more hierarchical form of organisation and to provide empirical support for that statement. Previous research considered franchising and management contracts as two alternative forms of contractual agreements that both lie towards the “market” mode of organisation, whereas an application of transaction cost theory supports the view that management contracts is a “hybrid” mode that should be placed further towards the “hierarchy” end.

Both the theoretical framework and the empirical evidence support the main argument of this study with respect to the differences that exist between franchising and management contracts. Indeed, the results of the ordered model and the first stage binary model suggest that franchising is chosen in different situations than management contracts. Hence, although there are similarities between franchising and management contracts, the distinguishing features are strong enough to justify a different evaluation and treatment.

Furthermore, what is being examined in this study is the expansion strategy of international hotel firms, rather than the decision to enter new markets. Consequently, no distinction is made between home and foreign countries. It is argued in the context of this study, that truly multinational companies do not have a “home” country. This is especially true when the hotel industry is under examination. Most of the international hotel brands change ownership fairly easily and in short periods of time and develop their hotel portfolios under different company profiles and corporate cultures.

A final conceptual contribution of this study refers to the use of explanatory variables that have not been tested before in the hotel industry (not even in the service sector in general). Brand growth was one of these variables. Although the effect of firm growth has been tested in the manufacturing industry, this is not the case as far as the hotel industry is concerned. Unfortunately, the results of the data analysis could not provide

$^{40}$ Management contracts nowadays may require an equity investment on behalf of the international company, yet the proportion in the total equity is quite small and refers usually to pre-opening expenses.
clear evidence to support the effect of brand growth on the expansion strategy of international hotel companies.

Country group of origin of the brand is another variable that was introduced by this study. Previous studies were focused on the effect of cultural distance between the home country and the country where a new outlet was going to be developed, however most of them could not provide empirical evidence to support their hypotheses. None of the studies so far, has included any proposition or evidence regarding how the country of origin of an international hotel company influences its entry mode or expansion decision. Is it possible that a hotel brand that has originated from the U.S., the pioneer country in the application of franchising, would be more inclined to use this mode compared to hotel brands that have originated from other countries, such as the Latin-European ones? The results of this study provide empirical support for the importance of this variable in the corporate development of international hotel firms.

Most importantly, this study is the first to test the effect of market segment of operations on the expansion strategy (or entry mode choice). This is a vital contribution of the present study, considering that market segment represents the level of proprietary content (tacit knowledge) and asset specificity, dimensions that are crucial in every study that applies the transaction cost theory. The results of the data analysis support the suggestion that the degree of proprietary content and idiosyncratic or tacit knowledge embedded in the service provided by the hotel company is one of the most important factors to define international hotel expansion strategy both in the one-stage and the two-stage approach. Indeed, the higher the market segment of operation, the higher the specialised skills and managerial expertise required in order for the developed hotel to operate according to standards, therefore the more likely that a hierarchical mode will be applied for the development of the property.

In addition, this study makes the following two methodological contributions in the area of entry mode and corporate development analysis. First, it introduces interaction effects between certain explanatory variables. Erramilli and Rao (1993) were the first to recognise that possible interactions between explanatory variables may influence the initial effect individual variables have on the modal choice. This study is the first study in the hotel industry that examines interactions between the effect of (i) brand size and country politico-economic risk and (ii) market segment and country group of origin, on
the expansion decision. In both cases it was found that when the interaction terms are introduced in the model, there is a different effect of the explanatory variables on the development decision.

Last but not least, this study is the first to apply a two-stage analysis in the examination of corporate strategy in the hotel industry. There is no study so far in the service sector to propose a two-stage model for the entry mode or expansion strategy of service firms. Although the results of the data analysis do not support the application of a two-stage process in the strategic choice of hotel companies, it provides some evidence suggesting the treatment of management contracts as a "hierarchical" mode of development. That is, it is recognised that the vital decision for the hotel companies is whether to employ a "market" as opposed to a hierarchical mode of development. If the hierarchical mode has been chosen, then the choice between a management agreement and company ownership is of less importance from a TCE/AT perspective.
9.5 Limitations

Transaction Cost Economics and Agency Theory provide an appropriate framework for understanding the way in which an international hotel company makes decisions regarding its mode of corporate development. However, expansion in a new market depends not only on the international hotel firm's preferences, but also on the strategic choices of the second party in the transaction, i.e. the potential franchisee or property owner. Yet, in the context of this study it has not been possible to incorporate in the analysis the preferences of the second party, and thus their influence on the mode of expansion had to be disregarded.

The examination of the effect the second party would have in the expansion strategies of international hotel firms would require a different research design altogether, maybe in the form of a case study approach. Yet, the distance between the researcher's residence and the international companies' headquarters rendered this type of research impossible, due to high financial and time constraints. Moreover, hotel companies consider such data as highly confidential and would it have been extremely difficult to get access to their database.

In addition, the simultaneous analysis of both contracting parties in the transaction (i.e. the hotel company and the property owner/potential franchisee) would probably require a different theoretical approach as well. Thus, for example, a game theoretic approach would be more appropriate, which requires different theoretical background and qualifications with respect to the researcher, suggesting that this could have been a research topic for other researchers in more economics-oriented disciplines.

Another limitation of this analysis refers to the implicit assumption that the decision to develop a new property in a particular market has already been made. Thus, no possible interactions between the decision to expand and modes of development have been considered. Moreover, it is assumed that the hotel company, having decided to undertake new operations in a given market, has a certain range of choices. This ignores possible government restrictions or governmental policies that make certain modes more desirable.
Perhaps the most troubling limitation is caused by the composition of the sample. Although most of the data were obtained from secondary sources, the information regarding the mode of operation of the examined outlets had to be provided by the hotel companies. Non-random sampling became a necessity since the research was restricted to hotel brands that agreed to provide the relevant information. For example, Ibis is the only budget Latin-European brand in the sample, and American brands represent 90 percent of the franchised hotels. Thus, the results may not be as representative as they would have been if more companies had been included in the study.

One final limitation refers to the use of proxies to measure some of the explanatory variables. Although similar proxies have been used in the past by recognised researchers, they do not necessarily constitute valid measures. Among those, the proxy that has been used to assess the effect of geographical dispersion is the most worrying. An effort was made for the development of a more appropriate measure, compared to the ones used in previous studies; however, this measure was far from ideal in terms of reflecting the effect that monitoring costs may have on the development choice.

A more appropriate measure would have been, for example, the average distance among all the hotel properties in a country or in certain regions around the world (e.g. North-America, Europe, Southeast Asia). Yet, the application of such a measure would require the availability of specific data on every hotel property in each company’s system, not only data on the hotels that started their operation within the examination period (1998-2000). Unfortunately, this level of information would not have been possible to obtain.
9.6 The way forward

As already explained in the previous section, this study examines the expansion strategy of international hotel firms, taking into consideration only the strategic choice of the hotel company that seeks to develop new operations and ignoring the preferences and the availability of potential hotel owners and investors. An interesting area of analysis would be the identification of variables that affect the choice of impendent hotel owners and franchisees to co-operate with an international hotel company. For this research to be undertaken, a completely different research methodology would be required. A possible approach would be the application of case study analysis, where each company would be one case study, where the researcher would identify how the hotel companies approach or are being contacted by potential franchisees/hotel owners and what difficulties they face when they attempt to employ the preferred strategy. One could also conduct a survey of current franchisees and property owners that have entered a management contract with an international hotel company, in order to examine the factors that influence their choice to co-operate with a particular hotel company under a certain organisational mode.

Furthermore, one could try to improve the sample of the study, in order to get findings that would be more representative of the hotel population. Additional observations could include either more hotel brands (and outlets) for the same time period, i.e. improved cross-sectional data, or data on new hotel developments that took place within a longer time frame (i.e. longitudinal data).

In addition, more interaction effects, between country-specific and firm-specific variables could be incorporated in the sample. The results of this study indicated that the higher the country risk, the more likely it is that franchising will be the preferred mode of development. On the other hand, it was found that upscale and luxury brands favour the use of hierarchical modes, such as company ownership and management contracts. What would be the effect on the modal choice if an upscale brand would like to develop new operations in a high-risk country? The introduction of interaction terms between two individual explanatory variables would provide unique results regarding the simultaneous effect of those variables on the expansion strategy of international hotel firms.
The results of the last hypothesis that examines the effect of the country group of origin on the modal choice revealed that there is some kind of cultural effect that needs to be examined in a more systematic way. More specifically, during the data inspection it became apparent that Spanish and French companies were more inclined in using company ownership for their budget brands, compared to American and British companies, who favoured the use of franchising. It would be quite interesting for future researchers to set up a study that would examine this issue in more detail, maybe in a form of a more qualitative analysis, for example application of a case study that would compare the strategy of an established U.S.-originated budget brand, like Holiday Inn Express, and a French-originated budget brand, like Ibis. A study like that could reveal areas of concern for the hotel companies that have not yet been incorporated in any theoretical analysis.

Finally, one could apply a theoretical framework, similar to the one developed in the context of this study, for the examination of the expansion strategies that are followed in different service sectors. One could then identify areas where hotel companies present similarities to companies from other service sectors and areas that suggest there are significant differences between hotel firms and other service companies.
REFERENCES


• UNISCO Statistical Yearbook, 1999.


• www.accor.com


September 9, 2004

Ms.
Director International Hotel Development Planning
Marriott Hotels & Resorts
Bowater House West,
114 Knightsbridge
London SW1X 7XH

Subject: Research on International Hotel Corporate Development

Dear Ms.

I got your name and contact details from Mr. Nihal Sirisena, with whom I am currently working on a case study regarding hotel development. He advised me to contact you regarding a request for information on your brand. I am a researcher at the University of Surrey, School of Management Studies for the Service Sector, and we are working on a project regarding corporate development of international hotel companies. We are particularly interested in the factors that influence the choice of hotel firms between management contracts and franchise agreements for new hotel development. So far there has been only a very limited research on this subject, and thus we believe that our study will shed some important light on expansion decision-making.

The empirical part of this study will be conducted using published data for the most part. However, some of the information required for our study is not available from published sources. It would be invaluable for this research if you or a colleague were able to find the time to provide us with the information presented on the next page. If you are able to do this, please return the attached sheets duly completed to the address above. Alternatively, if you have the same information in any other form (hard copy or electronic), would you kindly just mail or e-mail it to us?

Your help would be very much appreciated. If you are able to do assist us, we will be happy to send you a summary of our findings.

We would like to assure you that all the data you provide will be treated as strictly confidential, and the name of the company or brand will not be mentioned in any of our published material.

If you have any queries, please do not hesitate to contact me.

With many thanks for your help, in anticipation,

Sincerely,

Irini Dimou
PhD Researcher
Email: I.Dimou@surrey.ac.uk
1. Are there any companies that operate as Marriott’s franchisees in certain areas? If yes, please state where those companies are based and for which areas they are responsible.

2. When did Marriott first operate outside USA?

3. The following list presents the new hotel developments for Marriott Hotels & Resorts in the period between mid-1998 and March 2001, as derived from the comparison of two editions of International Hotel Directory (Travel and Tourism Intelligence, 1998 and 2001). (New developments include existing properties that have become part of your system during that period.) Could you please indicate for each new hotel property the organisational mode under which it operates? Please give F for the outlets that operate under a franchise agreement (where Marriott is the franchisor), MC for outlets under management contract (i.e. Marriott is the operating company) and CO for company ownership (including leased properties), where Marriott is both owner (or lessee) and manager. For countries with more than one new development please indicate how many hotels operate under each mode, e.g., China: 2 CO, 1 MC. For the new developments in Canada please indicate how many operate under each mode, in each province, e.g., Ontario: 1 MC, 2 CO.

(If the information exists in a hard copy or electronic form, we will be happy to complete the tables below ourselves if you kindly send us the information.)

<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>ORGANISATIONAL MODE</th>
</tr>
</thead>
<tbody>
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<td>Japan</td>
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<td>Mexico</td>
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<tr>
<td>UK</td>
<td>11</td>
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<tr>
<td>Vietnam</td>
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REQUIRED INFORMATION REGARDING RENAISSANCE HOTELS

1. Are there any companies that operate as Renaissance's master franchisees in certain areas? If yes, please state where those companies are based and for which areas they are responsible.

2. When did Renaissance first operate outside the USA?

3. The following list presents the new hotel developments for Renaissance in the period between mid-1998 and March 2001, as derived from the comparison of two editions of International Hotel Directory (Travel and Tourism Intelligence, 1998 and 2001). (New developments include existing properties that have become part of your system during that period.) Could you please indicate for each new hotel property the organisational mode under which it operates? Please give F for the outlets that operate under a franchise agreement (where Renaissance is the franchisor), MC for outlets under management contract (i.e. Renaissance is the operating company) and CO for company ownership (including leased properties), where Renaissance is both owner (or lessee) and manager. For countries with more than one new development please indicate how many hotels operate under each mode, e.g., UK: 2 CO, 2 MC. For the new developments in the US please indicate how many operate under each mode, in each state (or region), e.g., California: 1 MC, 2 CO.

(If the information exists in a hard copy or electronic form, we will be happy to complete the tables below ourselves if you kindly send us the information.)

<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>ORGANISATIONAL MODE</th>
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<td>Turkey (2)</td>
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<td>UK (4)</td>
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</tr>
<tr>
<td>USA (11)</td>
<td></td>
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</tbody>
</table>

248
REQUIRED INFORMATION REGARDING RAMADA INTERNATIONAL

1. Could you also give us the following information regarding Ramada's master franchisees: where are those companies based and for which areas they are responsible?

2. The following list presents the new hotel developments for Ramada International in the period between mid-1998 and March 2001, as derived from the comparison of the two editions of *International Hotel Directory* (Travel and Tourism Intelligence, 1998 and 2001) and from the company's website. (New developments include existing properties that have become part of your system during that period.) Could you please indicate for each new hotel property the organisational mode under which it operates? Please give F for the outlets that operate under a franchise agreement (where Ramada is the franchisor), MC for outlets under management contract (i.e. Ramada is the operating company) and CO for company ownership (including leased properties), where Ramada is both owner (or lessee) and manager. For countries with more than one new development please indicate how many hotels operate under each mode, e.g., China: 2 CO, 2 MC.

(If the information exists in a hard copy or electronic form, we will be happy to complete the tables below ourselves if you kindly send us the information.)

<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>ORGANISATIONAL MODE</th>
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</thead>
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<td>Qatar (1)</td>
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<tr>
<td>Switzerland (2)</td>
<td></td>
</tr>
</tbody>
</table>
REQUIRED INFORMATION REGARDING RITZ-CARLTON HOTELS

1. When did Ritz-Carlton first operate outside USA?

2. The following list presents the new hotel developments for Ritz-Carlton in the period between mid-1998 and March 2001, as derived from the comparison of the two editions of *International Hotel Directory* (Travel and Tourism Intelligence, 1998 and 2001) and from the company's website. (New developments include existing properties that have become part of your system during that period.) Could you please indicate for each new hotel property the organisational mode under which it operates? Please MC for outlets under management contract (i.e. Ritz-Carlton is the operating company) and CO for company ownership (including leased properties), where Ritz-Carlton is both owner (or lessee) and manager. (For countries with more than one new development please indicate how many hotels operate under each mode, e.g., Germany: 1 CO, 1 MC.)

<table>
<thead>
<tr>
<th>COUNTRY</th>
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</thead>
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<tr>
<td>Japan (1)</td>
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<tr>
<td>USA (1)</td>
<td></td>
</tr>
</tbody>
</table>
REQUIRED INFORMATION REGARDING COURTYARD HOTELS

1. Are there any companies that operate as Courtyard’s master franchisees in certain areas? If yes, please state where those companies are based and for which areas they are responsible.

2. When did Courtyard first operate outside the US?

3. The following list presents the new hotel developments for Courtyard in the period between mid-1998 and March 2001, as derived from the comparison of two editions of International Hotel Directory (Travel and Tourism Intelligence, 1998 and 2001). (New developments include existing properties that have become part of your system during that period.) Could you please indicate for each new hotel property the organisational mode under which it operates? Please give F for the outlets that operate under a franchise agreement (where Courtyard is the franchisor), MC for outlets under management contract (i.e. Courtyard is the operating company) and CO for company ownership (including leased properties), where Courtyard is both owner (or lessee) and manager. For countries with more than one new development please indicate how many hotels operate under each mode, e.g., Germany: 2 CO, 1 F. For the new developments in the US and Canada please indicate how many operate under each mode, in each state (or region), and for Canada in each province, e.g., California: 1 MC, 2 CO, Ontario: 1F, 1CO

(If the information exists in a hard copy or electronic form, we will be happy to complete the tables below ourselves if you kindly send us the information.)

<table>
<thead>
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<th>COUNTRY</th>
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<td>Germany (3)</td>
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</tr>
<tr>
<td>USA (78)</td>
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</table>
THE COMPOSITE RISK RATING

The method of calculating the Composite Political, Financial, and Economic Risk Rating remains unchanged. The political risk rating contributes 50% of the composite rating, while the financial and economic risk ratings each contribute 25%.

The following formula is used to calculate the aggregate political, financial and economic risk:

\[
CPFER (\text{country } X) = 0.5 \left( PR + FR + ER \right)
\]

where

- \( CPFER \) = Composite political, financial and economic risk ratings
- \( PR \) = Total political risk indicators
- \( FR \) = Total financial risk indicators
- \( ER \) = Total economic risk indicators

The highest overall rating (theoretically 100) indicates the lowest risk, and the lowest rating (theoretically zero) indicates the highest risk.

As a general guide to grouping countries on the basis of comparable risk, the individual risk of individual countries can be estimated using the following fairly broad categories of Composite Risk:

<table>
<thead>
<tr>
<th>Risk Level</th>
<th>Points Range</th>
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<tbody>
<tr>
<td>Very High Risk</td>
<td>00.0 to 49.5 points</td>
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<tr>
<td>High Risk</td>
<td>50.0 to 59.5 points</td>
</tr>
<tr>
<td>Moderate Risk</td>
<td>60.0 to 69.5 points</td>
</tr>
<tr>
<td>Low risk</td>
<td>70.0 to 79.5 points</td>
</tr>
<tr>
<td>Very Low Risk</td>
<td>80.0 to 100 points</td>
</tr>
</tbody>
</table>
APPENDIX 3: E-VIEWS OUTPUT - ORDERED MODEL

ORDERED MODEL - ORIGINAL SPECIFICATION

Dependent Variable: OM  
Method: ML - Ordered Logit  
Sample: 1487  
Included observations: 487  
Number of ordered indicator values: 3  
Convergence achieved after 11 iterations  
Covariance matrix computed using second derivatives

<table>
<thead>
<tr>
<th>Coefficient</th>
<th>Std. Error</th>
<th>z-Statistic</th>
<th>Prob.</th>
<th>Antilog (β)</th>
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<td>0.78008</td>
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<tr>
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<td>0.577111</td>
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<td>FGR3</td>
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<td>FGR4</td>
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Limit Points

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<tr>
<td>LIMIT_2:C(17)</td>
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</table>

Akaike info criterion | 1,127827 | Schwarz criterion | 1,274030 |
Log likelihood | -257,626 | Hannan-Quinn criter. | 1,185261 |
Restr. log likelihood | -468,5888 | Avg. log likelihood | -0,529006 |
LR statistic (15 df) | 421,9256 | LR index (Pseudo-R2) | 0,450209 |
Probability(LR stat) | 0,00000 |
## ORDERED MODEL - ORIGINAL SPECIFICATION
### COEFFICIENT COVARIANCE MATRIX

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<thead>
<tr>
<th></th>
<th>ICRGD2</th>
<th>ICRGD3</th>
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<th>GDP</th>
<th>FSIZE</th>
<th>FGR2</th>
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<td>-0.032835</td>
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<td>Limit 1:C(1')</td>
<td>-0.02115</td>
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<td>-0.001904</td>
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<td>1.48E-07</td>
<td>0.084733</td>
<td>0.119855</td>
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<tr>
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<td>-0.017525</td>
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<td>2.07E-07</td>
<td>0.066277</td>
<td>0.128501</td>
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<td>0.074175</td>
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<td>0.096181</td>
<td>0.10408</td>
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<td>0.234047</td>
</tr>
</tbody>
</table>

254
## ORDERED MODEL - EXTENDED

Omitted Variables: MM_LATEU UP_LATEU CRD2_FS CRD3_FS

Log likelihood ratio: 56,94034  
Probability: 0,00000

Dependent Variable: OM  
Method: ML - Ordered Logit  
Sample: 1 487  
Included observations: 487

Number of ordered indicator values: 3  
Convergence achieved after 12 iterations  
Covariance matrix computed using second derivatives

<table>
<thead>
<tr>
<th>Coefficient</th>
<th>Std. Error</th>
<th>z-Statistic</th>
<th>Prob.</th>
<th>Antilog β</th>
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<td>0,01210</td>
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</table>

Limit Points

| LIMIT_1:C(20) | 5,32183 | 0,99070 | 5,37176 | 0,00000 |
| LIMIT_2:C(21) | 9,16898 | 1,07868 | 8,50020 | 0,00000 |

Akaike info criterion: 1,02733  
Schwarz criterion: 1,20794

Log likelihood: -229,15580  
Hannan-Quinn criterion: 1,09828

Restr. log likelihood: -468,58880  
Avg. log likelihood: -0,47055

LR statistic (19 df): 478,86590  
LR index (Pseudo-R2): 0,51097

Probability(LR stat): 0,00000
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ORDERED MODEL - REDUCED

Redundant Variables: ICRGD3 LEGRSK FGR3

Log likelihood ratio 1,664808 Probability 0,644786

Dependent Variable: OM
Method: ML - Ordered Logit
Sample: 1 487
Included observations: 487
Number of ordered indicator values: 3
Convergence achieved after 12 iterations
Covariance matrix computed using second derivatives

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<tr>
<th>Coefficient</th>
<th>Std. Error</th>
<th>z-Statistic</th>
<th>Prob.</th>
<th>Antilog β</th>
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Limit Points

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Akaike info criterion 1,018432 Schwarz criterion 1,173234
Log likelihood -229,9882 Hannan-Quinn criter. 1,079244
Restr. log likelihood -468,5888 Avg. log likelihood -0,47226
LR statistic (16 df) 477,2011 LR index (Pseudo-R2) 0,50919
Probability(LR stat) 0,00000
<table>
<thead>
<tr>
<th>ICRGD2</th>
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## APPENDIX 4: E-VIEWS OUTPUT - 1ST STAGE BINARY MODEL

### 1ST STAGE BINARY MODEL - ORIGINAL SPECIFICATION

- **Dependent Variable:** OM
- **Method:** ML - Binary Logit
- **Sample:** 1 487
- **Included observations:** 487
- **Convergence achieved after 12 iterations**
- **Covariance matrix computed using second derivatives**

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- **Mean dependent var:** 0.457906
- **S.D. dependent var:** 0.4987
- **S.E. of regression:** 0.260541
- **Akaike info criterion:** 0.506166
- **Sum squared resid:** 31.97222
- **Schwarz criterion:** 0.643768
- **Log likelihood:** -107.2515
- **Hannan-Quinn criter.:** 0.560222
- **Restr. log likelihood:** -335.8348
- **Avg. log likelihood:** -0.22023
- **LR statistic (15 df):** 457.1665
- **McFadden R-squared:** 0.680642
- **Probability(LR stat):** 0.00000

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1ST STAGE BINARY MODEL - EXTENDED

Omitted Variables: MM_LATEU UP_LATEU CRD2_FS CRD3_FS

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Mean dependent var 0.457906  S.D. dependent var 0.498737
S.E. of regression 0.255245  Akaike info criterion 0.501855
Sum squared resid 30.42512  Schwarz criterion 0.673857
Log likelihood -102.2016  Hannan-Quinn criterion 0.569424
Restr. log likelihood -335.8348  Avg. log likelihood -0.20986
LR statistic (19 df) 467.2663  McFadden R-squared 0.695679
Probability(LR stat) 0.000000

Dependent Variable: OM
Method: ML - Binary Logit
Sample: 1 487
Included observations: 487
Convergence achieved after 12 iterations
Covariance matrix computed using second derivatives

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1ST STAGE BINARY MODEL - REDUCED

Redundant Variables: LEGRSK GDP FGR2 MM_LATEU UP_LATEU C_ORIG

F-statistic 0,063938 Probability 0,99897
Log likelihood ratio 2,395132 Probability 0,88002

Dependent Variable: OM
Method: ML - Binary Logit
Date: 05/16/03 Time: 15:07
Sample: 1 487
Included observations: 487
Convergence achieved after 12 iterations
Covariance matrix computed using second derivatives

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<th>Prob.</th>
<th>Antilog β</th>
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S.E. of regression 0,253725 Akaike info criterion 0,48213
Sum squared resid 30,45012 Schwarz criterion 0,60253
Log likelihood -103,3992 Hannan-Quinn criter. 0,52943
Restr. log likelihood -335,8348 Avg. log likelihood -0,21232
LR statistic (13 df) 464,8712 McFadden R-squared 0,69211
Probability(LR stat) 0,000000

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## 1st Stage Binary Model - Reduced

### Coefficient Covariance Matrix

|       | C       | ICGRD2  | ICGRD3  | FSIZE  | FGR3    | FGR4    | INTEXPY | DHOTELS | MIDMKT  | UPLUX   | LATEURO | CRD2_FS | CRD3_FS | RMS     |
|-------|---------|---------|---------|--------|---------|---------|---------|---------|---------|---------|---------|---------|---------|---------|---------|
| C     | 1.145284| -0.332666| -3.50E-01| -2.43E-06| -0.302897| -0.557188| -0.010258| -0.020678| -0.00041| -0.096866| -1.52E-01| 1.31E-06| 2.55E-06| -0.000909|
| ICGRD2| -0.332666| 0.554825| 3.04E-01| 9.67E-07| 0.004217| 0.015615| 0.000117| -0.083628| 0.100679| 0.076468| 1.26E-03| -2.54E-06| -1.03E-06| 7.63E-05|
| ICGRD3| -3.50E-01| 3.04E-01| 8.72E-01| 1.15E-06| 2.09E-02| 7.42E-03| -3.13E-04| -2.82E-02| 4.28E-02| 4.26E-02| 1.66E-02| -1.22E-06| -6.55E-06| 0.000261|
| FSIZE | -2.43E-06| 9.67E-07| 1.15E-06| 1.85E-11| 8.63E-07| 1.06E-06| -2.52E-08| -2.89E-07| -1.28E-06| 1.04E-06| 1.17E-06| -6.51E-12| -9.88E-12| 4.33E-10|
| FGR3  | -0.302897| 0.004217| 2.09E-02| 8.63E-07| 0.318291| 0.223689| 0.000893| 0.012402| 0.020655| 0.036818| -1.83E-02| -2.31E-08| -6.17E-07| 6.19E-05|
| FGR4  | -0.557188| 0.015615| 7.42E-03| 1.06E-06| 0.223689| 0.497196| 0.006783| 0.021875| -0.006643| 0.074784| 4.46E-02| -8.15E-08| -6.53E-07| 0.000173|
| INTEXPY| -0.010258| 0.000117| -3.13E-04| -2.52E-08| 0.000893| 0.006783| 0.005621| 0.001783| -0.002427| -0.007542| -8.67E-04| 1.22E-09| 1.07E-09| 8.59E-07|
| DHOTELS| -0.020678| -0.083628| -2.82E-02| -2.89E-07| 0.012402| 0.021875| 0.001783| 0.133702| -0.001066| -0.077113| -8.31E-02| 2.58E-07| -3.29E-07| 0.000148|
| MIDMKT | -0.00041 | 0.100679| 4.28E-02| -1.28E-06| 0.020655| -0.006643| -0.002427| -0.001066| 0.497336| 0.188486| -1.47E-01| -3.39E-07| 2.80E-07| -0.000268|
| UPLUX | -0.096866| 0.076468| 4.26E-02| 1.04E-06| 0.036818| 0.074784| -0.007542| -0.077113| 0.188486| 0.490594| 8.15E-02| -3.63E-07| 1.32E-07| -0.00069|
| LATEURO | -1.52E-01| 1.26E-03| 1.66E-02| 1.17E-06| -1.83E-02| 4.46E-02| -8.67E-04| -8.31E-02| -1.47E-01| 8.15E-02| 4.47E-01| 5.44E-08| 5.60E-08| 6.21E-05|
| CRD2_FS| 1.31E-06| -2.54E-06| -1.22E-06| -6.51E-12| -2.31E-08| -8.15E-08| 1.22E-09| 2.58E-07| -3.39E-07| -3.63E-07| 5.44E-08| 1.83E-11| 6.42E-12| 4.56E-11|
| CRD3_FS| 2.55E-06| -1.03E-06| -6.55E-06| -9.88E-12| -6.17E-07| -6.53E-07| 1.07E-09| -3.29E-07| 2.80E-07| 1.32E-07| 5.60E-08| 6.42E-12| 8.24E-11| -4.91E-09|
| RMS   | -0.000909| 7.63E-05| 0.000261| 4.33E-10| 6.19E-05| 0.000173| 8.59E-07| 0.000148| -0.000268| -0.00069| 6.21E-05| 4.56E-11| -4.91E-09| 6.03E-06|

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## APPENDIX 5: E-VIEWS OUTPUT - 2ND STAGE BINARY MODEL

### 2ND STAGE BINARY MODEL - ORIGINAL SPECIFICATION

**Dependent Variable:** OM  
**Method:** ML - Binary Logit  
**Sample:** 1 223  
**Included observations:** 223  
Convergence achieved after 11 iterations  
Covariance matrix computed using second derivatives

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<th>Probability</th>
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Mean dependent var: 0.282511  
S.D. dependent var: 0.4512  
S.E. of regression: 0.413585  
Akaike info criterion: 1.110218  
Sum squared resid: 35.40788  
Schwarz criterion: 1.354678  
Log likelihood: -107.7893  
Hannan-Quinn criter.: 1.208905  
Restr. log likelihood: -132.754  
Avg. log likelihood: -0.48336  
LR statistic (15 df): 49.92946  
McFadden R-squared: 0.188053  
Probability(LR stat): 0.0000  

Obs with Dep=0: 160  
Total obs: 223  
Obs with Dep=1: 63

265
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### 2ND STAGE BINARY MODEL - ORIGINAL SPECIFICATION

#### GOODNESS OF FIT TEST

- **Dependent Variable**: OM
- **Method**: ML - Binary Logit
- **Sample**: 1 223
- **Included observations**: 223

#### Andrews and Hosmer-Lemeshow Goodness-of-Fit Tests

Grouping based upon predicted risk (randomize ties)

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**Prob. Chi-Sq(8):** 0.8426  
**Andrews Statistic:** 23,4151  
**Prob. Chi-Sq(10):** 0.0093
2ND STAGE BINARY MODEL - EXTENDED

Omitted Variables: MM_LATEU UP_LATEU CRD2_FS CRD3_FS

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Sum squared resid 32,47337 Schwar criterion 1.356554
Log likelihood -97,18404 Hannan-Quinn criter. 1.174337
Restr. log likelihood -132,754 Avg. log likelihood -0.435803
LR statistic (19 df) 71,13994 McFadden R-squared 0.267939
Probability(LR stat) 0.000000

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Obs with Dep=1 63
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**2ND STAGE BINARY MODEL - EXTENDED COEFFICIENT COVARIANCE MATRIX**
### 2nd Stage Binary Model - Extended

**Goodness of Fit Test**

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<th>Dependent Variable: OM</th>
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**Method:** ML - Binary Logit

**Sample:** 1 223

**Included observations:** 223

**Andrews and Hosmer-Lemeshow Goodness-of-Fit Tests**

Grouping based upon predicted risk (randomize ties)

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<th>Quantile of Risk</th>
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**H-L Statistic:** 17.913  Prob. Chi-Sq(8 0.0219

**Andrews Statistic:** 43.112  Prob. Chi-Sq(1 0.0000
### 2ND STAGE BINARY MODEL - REDUCED

| Redundant Variables: ICRGD2 ICRGD3 LEGRSK FGRD2 FGRD3 INTEXPY DHOTELS CRD2_FS CRD3_FS RMS |
|---|---|
| F-statistic | 0.613778 | Probability: 0.801207 |
| Log likelihood ratio | 8.007595 | Probability: 0.628095 |

Sample: 1 223
Included observations: 223
Convergence achieved after 12 iterations
Covariance matrix computed using second derivatives

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<td>2.185949</td>
<td>0.0288</td>
<td>3.03</td>
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</tbody>
</table>

Mean dependent var: 0.282511 S.D. dependent var: 0.451234
S.E. of regression: 0.396316 Akaike info criterion: 0.9972
Sum squared resid: 33.45522 Schwarz criterion: 1.149988
Log likelihood: -101.1878 Hannan-Quinn criterion: 1.05888
Restr. log likelihood: -132.754 Avg. log likelihood: -0.45376
LR statistic (9 df): 63.13235 McFadden R-square: 0.247779
Probability(LR stat): 0.00000

Obs with Dep=0: 160 Total obs: 223
Obs with Dep=1: 63
## 2nd Stage Binary Model - Extended

### Coefficient Covariance Matrix

<table>
<thead>
<tr>
<th></th>
<th>C</th>
<th>GDP</th>
<th>FSIZE</th>
<th>FGRD4</th>
<th>MIDMKT</th>
<th>UPLUX</th>
<th>LATEURO</th>
<th>MM_LAT</th>
<th>UP_LATE</th>
<th>C_ORIG</th>
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</thead>
<tbody>
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<td>-4.12E-06</td>
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<td>-0.782948</td>
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<td>-1.747028</td>
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<tr>
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<td>7.74E-07</td>
<td>1.71E-06</td>
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<td>-7.89E-07</td>
<td>3.57E-07</td>
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<td>0.062542</td>
<td>0.232939</td>
<td>0.240477</td>
<td>-0.186367</td>
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</tbody>
</table>
Dependent Variable: OM
Method: ML - Binary Logit
Sample: 1 223
Included observations: 223

Andrews and Hosmer-Lemeshow Goodness-of-Fit Tests
Grouping based upon predicted risk (randomize ties)

<table>
<thead>
<tr>
<th>Quantile of Risk</th>
<th>Dep=0</th>
<th>Dep=1</th>
<th>Total</th>
<th>H-L Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low</td>
<td>High</td>
<td>Actual</td>
<td>Expect</td>
<td>Actual</td>
</tr>
<tr>
<td>1</td>
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</tr>
<tr>
<td>3</td>
<td>0.0893</td>
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<td>19.7025</td>
</tr>
<tr>
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<td>0.1625</td>
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<td>19.5924</td>
</tr>
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<td>5</td>
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<td>Total</td>
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<td></td>
<td>160</td>
<td>160</td>
</tr>
</tbody>
</table>

H-L Statistic: 15.6953
Andrews Statistic: 36.9401

Prob. Chi-Sq(8) 0.0470
Prob. Chi-Sq(10) 0.0001