

A Structural Model for Launching a Business Venture in the Hospitality Industry

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Abstract

This paper is concerned with the important elements to consider when conducting feasibility studies for small and medium sized businesses in today's rapidly changing world. The stages involved in these studies are grouped under two major headings, namely, market feasibility and financial feasibility. Analysis of market feasibility includes defining the market area characteristics, project site & area evaluation, competition and demand analysis, and finally, recommending facilities and services. Financial feasibility covers the estimation of operating results and project valuation.

Keywords: *Business Planning, Feasibility Studies, Capital Budgeting*

JEL Codes: *M10*

1. Introduction

The term feasibility refers to how practical a project or an idea is. When considering a potential hospitality project – whether that project is developing a new hotel or a restaurant, purchasing an existing property, changing the focus or direction of an existing property or bidding on a management contract – a feasibility study must be completed prior to making the “go - no go” decision regarding the project (Mc Cool, 1993:15). On the other hand, the term hospitality industry implies lodging and foodservice businesses that provide short-term or transitional lodging and/or food.

The feasibility study is an integral part in developing an entrepreneurial business activity, where a project flow-chart is similar. For the purposes of a

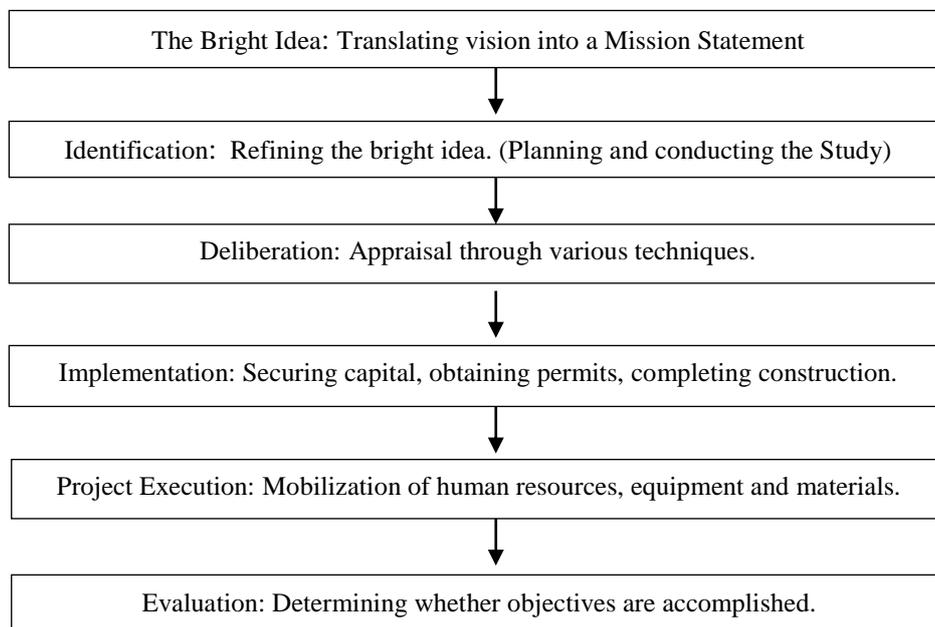
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hospitality project development, the components in the flow-chart can be monitored in six basic steps as shown in Figure 1.

Feasibility studies are generally prepared by organizations such as management consulting firms or accounting firms who might be commissioned by investors. They can also be conducted by the investors themselves or by operators or franchisers. If outside financing is involved, an independent consultant usually conducts the study

Those people who conduct feasibility studies for hospitality projects must be familiar with marketing, operations, and finance. They should be able to study dynamic and changing markets, to trace and understand trends, and to recognize market opportunities for the proposed project (Angelo, 1985:5). Investing in a new property can be a high-risk undertaking and change is a risk that every investor needs to accept (Rushmore, 1996:14).

Figure-1: Principal activities engaged in the Project Flow-Chart



The figure presented above summarizes activities that occur in each phase of the flow-chart. Differing amounts of time may be required for each step in the project flow-chart, depending on the particulars of the project. Typically, it takes two years or even more for a hospitality project to move from identification to project execution. For example, the site selection process, which is one of the most important decisions in the entire feasibility study, usually requires between 60 and 90 days and the permitting process can take up to 120 days, depending on local ordinances (Rose, 1992:14).

Generally, a feasibility report is expected to accomplish these purposes:

- Assists in obtaining financing
- Assists in obtaining and negotiating contracts for a franchise, lease or management.
- Guides the planners and architects of the projected facilities.
- Assists in formulating operating and marketing plans.
- Serves as a guide in preparing the initial capital and operating budget.

In order to accomplish these objectives, the report usually consists of the following stages.

2. Main Stages Involved in a Feasibility Study

2.1. Executive Summary

Although it appears as an opening section at the beginning, an executive summary is prepared after the feasibility study is concluded. This section provides an overview of the project. However, anyone acting on the basis of a feasibility study should read the feasibility report in its entirety (Angelo, 1985:12). An executive summary in essence includes:

- An introduction stating the scope, aim and approach of the study. (Declaration of vision/mission)
- A statement of feasibility that mentions a possible level of business activity and the year it is expected to be attained.
- A description of the demand for the proposed facility.
- A synopsis of each section of the report as well as a summary of the conclusions including; the economic environment's relation to the proposed facility, suitability of the selected site, major competition, most probable market penetration and approaches to capturing that

market, description of the proposed facility, significant operating aspects, the probable financial performance and cash flow summary for five years.

2.2. Market Area Characteristics

In this section of the report, relevant demographic, economic, and other characteristics of the area or region surrounding the site for the proposed property is presented and analyzed. Generally a hospitality facility draws its patrons from a particular geographic area, which, in certain cases, can be called the market area (trading area) for that operation. The size of such an area varies according to its scope. This may range from one to three km radius for a fast-food facility, up to thousands of km distance for certain lodging facilities attracting international guests.

Typically, the indicators that can be included in this section are: population, income, employment, education, retail sales, industrial and commercial activity, tourism, and transportation routes in the area. Only statistical data that relate to the success or failure of the proposed project should be presented. In addition to that, indicators for either positive or negative trends, which may affect demand for the property, ought to be analyzed. For example; area population trends, such as age, gender, profession and income are indicators of potential business (or lack of business) for the proposed property, provided that they reflect the most current information.

Today's market environment is highly competitive, prone to global economic crises and therefore changing continuously. Changes can occur in one or more of several environments surrounding the prospective operation. These environments include the technological, political/legal, economic and social/cultural environments (Boone and Kurtz, 1999: 430-431). As in the case of restructuring business systems, many challenges confront individuals who undertake the responsibility concerning preparation of feasibility studies.

The economic stability of the area's commercial and industrial enterprises has a direct influence on the future success of the project. As the old adage confirms, "A Rising Tide Sails All the Boats". In the same manner, if the area surrounding the site is confronted with an economic decline, its possible physical deterioration can cause the project site to appear as an undesirable location for patrons (Angelo, 1985:13). A conclusion statement, regarding the economic strength or weakness of the market area, ends this section.

2.3. Project Site and Area Evaluation

The feasibility report should show the location of the site on a map and provide a correct description of the site's physical boundaries and topographical features. Site topography implies the surface features and positioning of the building, particularly if the site is sloped. Any required physical changes, such as grading, retaining walls or landfills have to be identified. Consideration should be given to the vegetation and the landscaping, as well.

A professional engineer or architect must evaluate the technical aspects of the conditions present on the site, as early as possible. So the role of an engineering firm in providing information for the feasibility study is extremely important. Confronting these complexities early in the process can save considerable amount of time and money in the long run, by avoiding unnecessary pitfalls that are expensive to correct (Rose: 1992:14).

The site should be examined in terms of how adaptable it is to the proposed facility. The impact of any environmental items on the site, such as the potential types of pollution, needs to be considered. In addition, the geographic region or area surrounding the site should be studied in relation to the type of facility proposed. Both positive and negative aspects of the site and the area should be presented.

Accessibility in relation to demand generators and modes of transportation bears importance in this context. Site visibility can be vital for a roadside operation. Good visibility often provides a competitive advantage. Therefore, the selection of a good location is critical. It will not guarantee success, but the selection of a poor location will almost guarantee failure. Besides, availability of adequate utilities has to be determined at that point.

In the case of a new development or a proposal for a major renovation of an existing property, the site must be large enough to accommodate the building required to support the anticipated capacity plus provide space for possible future expansion plans.

2.4. Competition Analysis

This section presents an inventory of all lodging and food service businesses in the proposed project's market area. A thorough analysis of direct, indirect and potential competition has to be conceded by locating them on a map, wherever as possible.

The direct competition – those properties that will compete directly with the proposed facility for the same markets – is typically defined by considering the following factors:

- Location (proximity of competitors to the proposed project site)
- Physical condition of facilities (level of maintenance, age of the operation)
- Chain affiliation (if any)
- Perception among guests and within the community (qualitative analysis)
- Operating factors (capacity, quoted prices, types of services)

In the real world, the relative feasibility of a new hospitality project can be strongly impacted by the type of financing in place on competing operations. Yet, feasibility studies rarely investigate and report the amount, terms or interest of such debt (Turkel, 1995: Executive Forum).

Potential competition refers to other prospective hospitality projects in the area that may be either announced or already under construction. However, not all projects that are announced are actually built. Generally, projects under construction can be expected to compete in the market area.

The presence of direct, indirect and potential competition should not be perceived as a threat for the proposed project. In fact, a competitor's success may be an excellent indicator of the market potential of a site and/or area. What is important is consideration of the total volume of the market available in the area. The market must be large enough to continue to support the existing competition as well as the new proposed operation (Mc Cool, 1993:23).

2.5. Demand Analysis

Demand analysis section can be regarded as a keystone of a feasibility report. The previous sections of the feasibility study may be thought of as an introduction to the Demand Analysis. The Market Area Characteristics section defines the market areas within which the proposed property will function. It also indicates the strength or weakness of the economic environment where the patrons of hospitality business will emerge. In project Site and Area Evaluation, relationship of the site to the area's demand generators and the transportation routes are evaluated. Competition Analysis provides information as to the volume and characteristics of the demand, and how well the demand is being satisfied by the existing supply of properties (Angelo, 1985:23). The

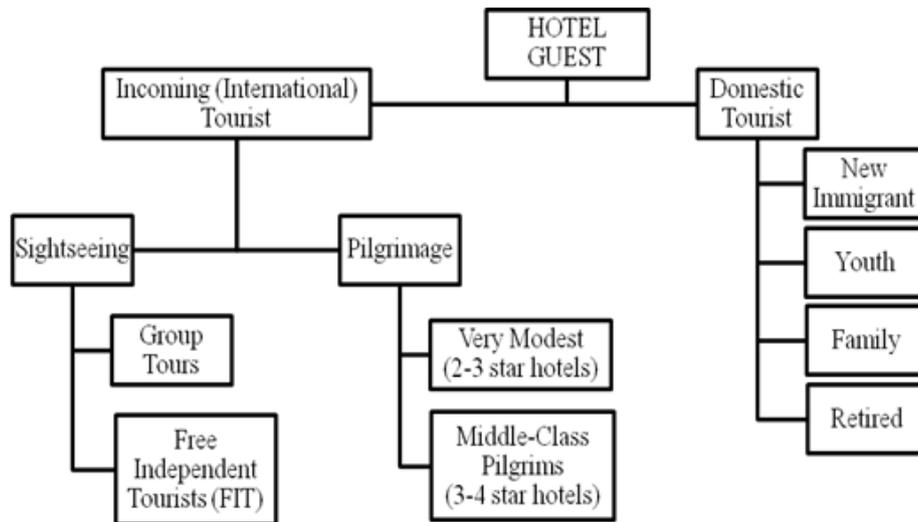
conclusions of the Demand Analysis section is expected to provide guidance regarding recommended facilities/services of the proposed project and establish a base for the reports estimates of operating results.

The ability to obtain both equity and borrowed capital depends on the project's profit potential. Profit level is based on a demonstrated demand projection for the proposed property. In Demand Analysis, accurate and reliable data must be available and then conclusions have to be drawn based on certain assumptions. A feasibility study needs to rely on a set of assumptions. The closer they are to reality, the more valuable the study. If assumptions are overly optimistic or simplistic, investors may not value the results properly (Matson, 2000:10).

- Main sources of data used in figuring out the demand can be obtained from:
- Local Chamber of Commerce statistics
- Sales figures of existing properties (where available)
- Interviews with authorities from Ministry of Tourism, banks, major retailers, hotels & restaurants.
- Tourism and Information bureaus.
- Publications of demand generators
- Ministry of Tourism information bank

A feasibility report is also expected to establish a detailed market segment profile. As shown in Figure 2 below, market segmentation implies dividing the total market for hospitality businesses into several relatively homogenous groups (Boone and Kurtz, 2002:477). In this example, those homogenous groups are composed of Incoming (International) Tourists and Domestic Tourists. These groups can then be divided into subsegments based on the primary purpose of using services / facilities of the proposed operation, i.e., sightseeing and pilgrimage. Those subsegments could be further divided into specific types of business activities, such as Group Tours and Free Independent Tours. Although such an analysis is time-consuming, it may result in a thorough perception of all relevant markets and may provide a more solid base upon which to make critical marketing decisions.

Figure 2: A Market Segmentation Approach for a Sample Resort Hotel



Source: Reichel et al., 1998:164-166)

The sub segments depicted in Figure 2, have to be defined in terms of their share of total market, their seasonality, characteristics, needs and wants. Besides, an anticipated growth rate of each market sub segment has to be computed with overall market trends. Based on all these, demand for facilities and services of the proposed property can be estimated. Generally, estimates are made anywhere from between two to five years.

2.6. Recommended Facilities/Services

A feasibility report, which is a business plan in essence, should contain recommendations for facilities and services that will satisfy the market needs researched in the Demand Analysis section.

This section will deal with the product/service mix to suit the needs and wants of the particular demand segments. If remodeling of an existing property is under discussion, then a critique of the present design features and/or architectural plans can be considered. An experienced consultant is expected to review the plans for type, size and location of facilities/services as well as relate the overall facilities to traffic flow, control, and operations. Based on that critique, changes can be recommended to better satisfy the requirements of the

market and as a result, the property can be placed in the best competitive position.

It is time to determine the concept or “ambiance” precisely, if it has not been clearly defined at the beginning of the study, with the exact capacity to fulfill market demand and develop points of difference to beat the competition. This concept may be suggested by the structure and décor of direct competitor properties, or by the interviews brought forward in the previous section of the report, namely, Demand Analysis.

Meanwhile, the probable effects - which can be either positive or negative - of that concept on local community and on potential markets have to be taken into consideration. Price structure, themes, or specialties, entertainment policies and other operational items should also be included in the recommendations. However, they should be related to facility planning and to capital budgeting principles as well. In other words, opportunity costs have to be kept in mind, as always.

2.7. Estimates of Operating Results

Estimates of revenues and expenses are made based on the recommended facilities/services of the proposed property. A feasibility study should vary the possible results with changes in key elements of the project. This controlled variation, called scenario analysis, permits planners to view project elements that are the most susceptible to positive and negative changes. Both “worst-case” possibilities and optimistic scenarios should be compared (Matson, 2000:10). Besides, annual estimates of revenue and expenses at a stabilized operational level, that the property most likely to achieve after a breaking-in period, are also found in the operating results section. So, in order to indicate the sensitivity of operating results to changes in operational levels, estimates need to be shown for three different levels of operation, namely, worst case, stabilized (realistic) and optimistic.

Since the feasibility study should enable investors to make informed decisions on whether to proceed with, revise or abandon the project, the report should also include possible project risks for potential investors. The longer the number of years is covered by estimates, the greater will be the degree of uncertainty. Projected financial statements, i.e. income statements and balance sheets, for the investment for a standard year of operation are converted into five-year projections using “business-development” assumptions. These

financial statements can be presented both in nominal terms and as percentages (Özer, 1996:23). A discounted cash flow statement that will show the present value of future cash flows can also be prepared. This is done by discounting the annual cash flow at a required return on the investment. The purpose is to determine if the cash flows will return the amount of the investment, and a required return on the investment (Angelo, 1985:33).

Thus, possible financial results should be a prominent part of a feasibility study. Variations in these elements have to be included in the scenario analysis. In other words, sensitivity analyses should be undertaken to enable owners to understand the range of alternatives under various assumptions of reasonableness and uncertainty (Turkel, 1997:16). Operating expenses and net revenues are factors that indicate if the project is financially viable. Consequently, the study will contain pro-forma operating statements, discounted cash flows and an analysis of return on investment.

Obviously, many investors will tend to work with banks with which they have an established business relationship. This may facilitate the process of obtaining financing. Nevertheless, the financial institution must know and understand the unique aspects of the hospitality industry, such as the high risks involved and the requirements of substantial amounts of capital investment.

A cardinal rule in banking is to borrow from a lender who is familiar with a specific business, or, conversely, never to lend money on a business project that is not understood (Matson, 2000:10). Therefore, a feasibility study is often conducted with an aim to explain the project to potential financiers. The terminology and format used in the Estimates of Operating Results section of a feasibility report should be in accordance with the Uniform System of Accounts, naturally.

3. The Role of Feasibility Studies in Reaching Investment Decisions

Developing any new hospitality business venture is difficult and costly. Taking a project from the initial idea through the operational stage is a complex and time-consuming effort. Besides, in many countries, land acquisition, construction, furniture, fixture, and equipment costs increase each year as well as financing costs. Often hospitality business operations involve risks with which the investors might be unfamiliar. The study allows them to preview project outcomes and to decide if they should continue. Although the costs of conducting a study may seem high at the beginning, they are relatively minor when compared with the total project cost. The small initial expenditure on a

feasibility study can help to protect larger capital investments that may end up disastrous later on. When securing financing from investors and lenders who need reassurance that the project is viable, this service fee can be considered as a form of insurance (Rushmore, 1996:14).

The allocation of capital in small firms is as important as it is in large ones. In fact, given their lack of access to the capital markets, it is often more important in the small firm because the funds may not be available to correct mistakes. Also, large firms allocate capital to numerous projects, so an error on one project can be offset by success with others (Weston and Brigham, 1993: 520).

Consequently, all new hospitality projects, whether they involve small, medium sized or large operations, must be undertaken with care. It is inconvenient to convert lodging and/or a foodservice facility to another use. If circumstances necessitate, alternative uses for a hotel can be thought as a student dormitory, a hospital or a commercial building.

4. Conclusion

Undertaking a new hospitality business project is considered a high-risk investment, since economic environments are volatile in many countries due to global economic crises. Stiff competition compels firms to operate at low profit margins, although the development costs are on a steady increase. The estimates of revenues and expenses should reflect the market conditions and the concept as recommended in the study. Otherwise, judgments based on insufficient or inaccurate information can be catastrophic for investors, operators and financiers. Therefore a feasibility study is an indispensable analysis that can satisfy the diverse interests of all stakeholders in a new hospitality business project.

While financiers are potential users for the study, it should not be conducted merely to prove to them that a project is viable. Actually, a feasibility report can be used as a guiding tool in all stages of project development by investors and/or operators. Especially, the break-even chart relating to operations and fund shortage or surplus that may arise during the forecasted periods can be very valuable for these individuals. No prudent investor will commit his/her scarce resources without having a strong indication of a satisfactory profit.

A feasibility study presents an independent review of the project and is often conducted long before development takes place. Within the dynamics of the economic environment, even six-month-old studies can become obsolete. So, consideration should be given to updating figures regarding characteristics of the market area and estimates of the operating results.

The proposed model in this study, for launching a business venture in the hospitality industry, can be extremely useful tool for private sector entrepreneurs at times of economic crises and changes as well as for government agencies while assessing the feasibility potential of future projects with regards to allocating precious state incentives and/or granting other scarce public sector resources.

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