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## Risks to Hospitality Firms in the International Arena

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# Risks to Hospitality Firms in the International Arena

## **Abstract**

Much potential for growth in hospitality firms exists in foreign countries, but expansion abroad typically bears additional risks that could be detrimental to the operations. The authors explore those risks, currency exchange risk, and country risk, and offer practical techniques to access, manage, control, and reduce them. Deriving benefits from global opportunities requires effective management of these areas

# Risks to hospitality firms in the international arena

by Stephen F. Borde and Stanley M. Atkinson

*Much potential for growth in hospitality firms exists in foreign countries, but expansion abroad typically bears additional risks that could be detrimental to the operations. The authors explore those risks, currency exchange risk, and country risk, and offer practical techniques to access, manage, control, and reduce them. Deriving benefits from global opportunities requires effective management of these areas.*

Hoffman and Schniederjans<sup>1</sup> suggest that one of the most critical strategic decisions facing executives in the hospitality industry concerns the global expansion of operations. When compared to other industries, relatively little attention in the literature has been directed toward international financial management within the hospitality industry. Nevertheless, effective financial management is critical to the survival of hospitality firms operating in an increasingly global environment that is characterized by spiraling competitive pressures.

A significant portion of the potential for growth in this industry exists through expansion into foreign countries, and firms recognize that opportunities abound in the international arena. This seems especially true for firms within the gaming sector, as gaming is currently experiencing explosive international growth.

However, one fundamental axiom is that higher expected returns are typically accompanied by higher risk. This implies that by expanding abroad in pursuit of higher returns, firms are subjecting themselves to a variety of unique and additional risks which may not be immediately obvious. Roh and Andrew<sup>2</sup> suggest that investors who establish appropriate risk management tools will find enticing opportunities and potential rewards in still virtually untapped emerging markets abroad. Hong, Jones, and Song<sup>3</sup> are in the process of investigating political risk assessment in multi-

national hotel development. For their empirical study they use an existing framework that they have modified to identify 58 political factors. These factors will be ranked by decision makers and experts in the international hotel business according to the perceived importance of their impact on the investment decision.

International risk factors can be divided into two groups:

- currency exchange risk
- country risk

Each group has its own risk evaluation and risk minimization techniques, which are explored for each group in this study.

#### **Risks involved in exchanges**

Currency exchange risk is perhaps the most obvious form of additional risk that a purely domestic firm would face when expanding into the international arena. When earnings generated by a foreign subsidiary are converted from foreign currency to home currency, the amount received in home currency units is determined by the rate at which the conversion takes place. If the rate of conversion is fixed, then the amount to be received in home currency units is known with certainty, which implies that little currency exchange risk is present. Alternatively, if the currency exchange rate can change over time, then the amount to be received in home currency units is not known in advance with certainty, which means that the

amount actually received could be more or less than originally anticipated.

In March 1973 the Bretton Woods era of fixed exchange rates ended. The central Banks of the G7 countries decided they no longer could resist free-market forces and allowed exchange rates to float, or find their own equilibrium rates resulting from supply and demand for the respective currencies. This introduced exchange rate risk as an important consideration for firms with international operations. Furthermore, as shall be explained, exchange rate fluctuations can even affect purely national firms with no foreign operations. The degree to which the value of future cash transactions can be affected by exchange rate fluctuations is often referred to as "transaction exposure," as opposed to "economic exposure," which discounts the impact of future transaction exposure based on present value calculations.

For example, the U.S. automobile market is extremely important to the Japanese firms. The decline in the U.S. dollar relative to the yen makes Japanese cars more expensive to American consumers. Japanese companies then lose market share in the U.S. market. To solve this problem most Japanese auto makers have built plants in the U.S. By diversifying production into locations with customers, they will reduce their economic exposure to fluctuations in the dollar/yen exchange rate.

Madura<sup>4</sup> suggests that some critics argue that exposure to exchange rate risk is not relevant, and firms should not be concerned about it. Typically, their arguments are rooted in Purchasing Power Parity (PPP) theory, which suggests that exchange rate movements should be matched by equal and opposite movements in price level differentials between countries. If this argument is valid, the effects of changes in currency value should be exactly offset by the effects of changes in relative price levels so that revenues or earnings derived from foreign operations should remain relatively stable when measured in home currency units. For example, if the exchange rate between U.S. and Canadian dollars is US\$.80/Can\$1 and a product sells for \$24 in the U.S. and \$30 in Canada, PPP would exit in this case and  $US$.80 \times Can\$30 = US\$24$ . Thus, the product is the same price in both markets, and neither country's residents would have any reason to cross the border to purchase the product in the other country.

Now suppose inflation in Canada increases prices by 20 percent. The product now costs Can\$36. PPP no longer exits. At the exchange rate of US\$.80/Can\$1, Canadians could cross the border, exchange Can\$30 for US\$24, buy the product and save \$6. By purchasing the product in the U.S., Canadians increase the supply of Canadian dollars in the foreign-exchange market, thus lowering

the exchange rate. This will continue until the exchange rate falls to US\$.67/Can\$1. At this exchange rate, PPP is restored since  $US$.67 \times Can\$30 = US\$24$ .

However, results of empirical tests of the PPP theory show that it does not hold in the short or long run, which suggests that foreign currency exchange rate risk is relevant [see Abuaf and Jorion<sup>5</sup>, Mishkin<sup>6</sup>, Adler and Dumas<sup>7</sup>].

### **Fluctuations may impact firms**

To a lesser extent, purely domestic firms are indirectly affected by exchange risk by being in competition with firms that are directly affected by exchange rate risk, such as multinational firms. Multinational firms may change their domestic rates and prices as a result of changes in revenues that are derived from foreign operations. For example, if a multinational firm's foreign earnings are abnormally high because of a weak foreign currency or a strong home currency, it may lower its domestic prices in an attempt to gain domestic market share. By changing the dynamics of the supply side, this could affect the revenues and market share of purely domestic competing firms. In this case, the revenues or market share of the purely domestic firm could be indirectly affected by currency exchange rates.

Arbell and Geller<sup>8</sup> find that hotel revenues are considerably affected by fluctuations in foreign exchange rates, not only in loca-

tions with a large volume of foreign tourism, but also in locations with a comparatively low number of foreign travelers due to the substitution effect. That is, when the home currency is relatively strong, travelers may go abroad instead of spending their travel budgets domestically. Anastasopoulos<sup>9</sup> provides empirical evidence, which indicates that international travelers' patterns of behavior are sensitive to currency value fluctuations. Thus, international currency exchange risk can introduce an element of risk into the operation of purely domestic firms with no international involvement.

#### **Variability determines risk**

Because currency exchange rate risk is relatively low when exchange rates are fixed, and relatively high when exchange rates are highly uncertain, the degree of variability in the exchange rate between two currencies can be used as a measure of exchange rate risk.

The degree of variability can be quantified by assessing the standard deviation (or variance) of the exchange rate between two countries over a period of time. For example, the exchange rate between two currencies could be recorded on a weekly basis over a two-year period and the standard deviation computed to arrive at a relative measure of exchange rate volatility.

The degree of variability of an exchange rate is subject to change

over time, and a single measurement should not be used blindly without considering other factors, such as political or economic changes that may have occurred within the countries concerned. Thus, proper assessment of currency exchange rate risk should entail the use of a combination of quantitative measurements and assessment of qualitative factors.

#### **Risk can be controlled**

There are more than seven methods of controlling exchange rate risk:

- multinational diversification
- futures contract hedges
- forward contract hedges
- money market hedges
- currency option hedges
- cross-hedging
- currency swaps and parallel loans
- set rates in U.S. dollars

The first is diversification across countries, which is one method of reducing risk. Instead of establishing one large hotel, restaurant, or casino in a single country, establishment of several smaller operations in different countries with different foreign currencies would tend to reduce the degree of variability of revenues or earnings derived from a portfolio of property investments. Lower correlations among foreign currency exchange rates that com-

prise the portfolio of foreign currency sources offer greater opportunities for risk reduction, and higher correlations offer less.

Buckley and Geyikdagi<sup>10</sup> show that a country could stabilize its foreign currency income and be better off by combining tourism and exports rather than relying on one of them alone, which is simply another form of diversification.

### **Hedging reduces uncertainty**

A second method of reducing currency exchange risk is hedging, the four most common forms of which are the futures contract hedge, the forward contract hedge, the money market hedge, and the currency option hedge.

If a firm expects to receive funds from a foreign operation denominated in foreign currency at some future point in time but wants to eliminate the currency exchange risk, it can sell a foreign currency futures contract on the Chicago Mercantile Exchange. Futures contracts are standardized contracts that obligate the seller to deliver a specified number of foreign currency units on a specific date at a specific predetermined exchange rate. This reduces currency exchange rate risk by allowing the firm to know in advance, with certainty, the exact exchange rate at which the units of foreign currency would be converted in the future. Currency futures contracts are available to hedge against foreign currency movements in Australian dollars, British pounds, Canadian dollars,

German marks, Japanese yen, and Swiss francs.

The forward contract hedge is another form of hedging currency exchange rate risk and is very similar to the futures contract hedge, except that forward contracts are customized contracts that are tailored to the firm's specific needs with respect to the time period of the contract and the number of foreign currency units that will be exchanged at a future date. Because forward contracts are individualized contracts, they typically are direct agreements between firms and banks and are generally used for larger foreign currency transactions, typically of US\$1m or more. Like futures contracts, forward contracts are binding in that both parties to the contract (the firm and the bank) are obligated to fulfill the terms of the contract, even if the current or spot exchange rate moves in a favorable direction in the interim.

Another form of hedging currency exchange rate risk is to employ a money market hedge. Using this approach, the firm would obtain a bank loan denominated in the foreign currency and immediately convert the proceeds of the loan into the home currency at the current spot exchange rate. This immediately secures a known exchange rate and, therefore, eliminates the uncertainty in the conversion rate. The foreign currency loan is subsequently repaid using the funds received from the foreign operation when they become available at a later

date. Having converted the foreign currency units into home currency units at a known exchange rate, currency exchange rate risk is significantly reduced or virtually eliminated.

Another approach to reducing currency exchange rate risk is to employ a currency option hedge. If a firm wants to have the option, but not the obligation, to convert foreign currency receipts that it expects to receive at a future date, it can purchase a currency option contract on the Philadelphia Exchange. A firm may choose this approach when it believes that favorable changes in the spot exchange rate are more likely to occur than unfavorable ones, but it wants to maintain protection against unfavorable exchange rate movements. If a favorable change in the spot exchange rate occurs, the firm would likely allow the option to expire without exercising it. The firm effectively limits its losses to the price or premium paid for the option contract.

Conversely, if the spot exchange rate moves in an unfavorable direction, the firm could exercise the option to convert the foreign currency receipts at the option contract's predetermined exchange rate. This approach allows the firm to benefit if the foreign currency spot exchange rate moves in a favorable direction and avoid major losses if the spot exchange rate moves in an unfavorable direction. Thus, a significant amount of currency exchange rate risk can be eliminated using

foreign currency option contracts. Currency option contracts are available at the Chicago Mercantile Exchange for Australian dollars, British pounds, Canadian dollars, French francs, German marks, Japanese yen, and Swiss francs.

### **Cross-hedging may be used**

When a firm has operations in a foreign country for which no currency futures, forward, or option contracts are available, the firm may use a cross-hedging technique. To implement this strategy, the firm applies one of the traditional hedging techniques using a contract that is denominated in a major currency that is highly correlated with the currency for which a hedge is sought. A major currency that is highly positively correlated with the currency of a country that is a major trading partner of the country in which the foreign operation is located is the goal. A perfect hedge may not be achievable using this cross-hedging technique.

Rates and prices for currency futures, forward, and options contracts are reported for each trading day in the major financial press. Rates and prices for hedging instruments can be found in the *Wall Street Journal*, the *Financial Times*, and other publications.

### **Currency swaps are difficult**

Other methods of hedging foreign currency exchange rate risk include currency swaps and parallel loans, which are actually long-term hedging techniques whereby



two firms agree to swap foreign currencies or loan payments at a distant future date at a specific predetermined exchange rate. However, identification of another firm with reciprocal foreign currency needs over a similar lengthy time frame may be difficult. Also, the value of such a long-term hedge largely depends on the long-term creditworthiness of the participating firms.

Certain sectors of the hospitality industry may be able to employ some other method of reducing currency exchange rate risk. For example, a U.S.-based hotel with property located in foreign countries may be able to set room rates in U.S. dollars instead of the local currency, which would tend to reduce the adverse impact of a declining local currency. This approach may not be feasible for restaurants, but gaming operations could conceivably establish games that are denominated in a major currency such as U.S. dollars.

### **Country risk is complicated**

Country risk has several facets, many of which are inextricably intertwined and difficult to isolate and individually assess. Country risk has roots in the economic, financial, political, legal, and social conditions of a foreign country.

Because foreign economies are subject to a different combination of macroeconomic conditions, they are likely to function in a way that is different from the firm's home

economy. Thus, traditional economic relationships may not hold, and unstable economic conditions in the foreign country could lead to unstable financial performance of the foreign subsidiary.<sup>11</sup>

Political stability is difficult to assess and quantify, but its effects are very real and can have a devastating impact on a firm's foreign operations. Political instability can lead to a less severe impact than that experienced by Woods<sup>12</sup> during the Iraqi invasion of Kuwait, but political instability could still create adverse operating conditions in a foreign country. Examples are outright expropriation of assets or forced sales of assets at below fair market values, adverse changes in local tax laws, restrictions on repatriation of profits, restrictions on currency convertibility, and restrictions on the accessibility of work permits for foreign labor or management personnel. Outright expropriations of assets are always a possibility but are less common than various forms of host government restrictions. Kobrin<sup>13</sup> provides an in-depth discussion of political risk.

There are more than five methods of estimating country risk:

- the checklist approach
- the Delphi technique
- quantitative analysis
- inspection visits
- published country ratings
- other approaches

Each of these approaches has its advantages and disadvantages.

- **Checklist approach:** The checklist approach requires subjective assignment of numerical scores, based on individual judgment, to all political and financial factors that could potentially affect the foreign operation. Having captured all available factors, relative weights are subjectively assigned to each factor. Those factors thought to have a greater impact on overall country risk should be assigned heavier weights. An overall country risk score can then be computed as a weighted average of the component factors. Use of this method of assessing country risk is most common among bankers.<sup>14</sup>
- **Delphi technique:** The Delphi technique averages country risk scores developed independently by individual risk assessors, without group discussion. This approach to country risk assessment is another method of subjectively quantifying country risk, but incorporates opinions of several different individuals and therefore may be less subject to bias.
- **Regression analysis:** Regression analysis is a quantitative technique that can be used to estimate the direction and degree of influence various financial and political factors have on country risk. Using a sample of coun-

tries of known risk, parameter estimates from the regression analysis can then be applied to similar variables from other countries to estimate those other countries' risk levels. Other quantitative techniques have been developed and applied with varying degrees of success [see Cosset, Siskos, and Zopounidis<sup>15</sup>; Saini and Bates<sup>16</sup>; Davis<sup>17</sup>; and Wilson<sup>18</sup>].

- **Inspection visits:** Inspection visits require travel to the foreign country to get a first-hand impression of the prevailing conditions. Meetings with local officials, executives, bankers, and other local constituents can provide valuable input to the process of developing a country risk rating. As mentioned earlier, some elements of country risk can only be assessed subjectively.
- **Published risk ratings:** Country credit risk ratings have traditionally been published by *Euromoney* and *Institutional Investor*. The *Euromoney* credit ratings are a weighted average of three indicators: market, credit, and analytical indicators. *Institutional Investor* ratings are a weighted average, based on an unpublished formula, of ratings compiled from surveys of 75 to 100 international bankers. These ratings are reported twice per year and span a

scale from 0 to 100, where higher ratings indicate higher degrees of creditworthiness. Since these ratings may not be perfect proxies for the types of country risk that are relevant to a particular hospitality firm, other sources of country risk information may be helpful. Nevertheless, these ratings may be useful guides which could represent one component in a broader assessment of country risk. Baer<sup>19</sup> discusses other sources of information that may also be useful in country risk analysis.

#### **Other methods exist**

Results of recent empirical research by Mauro<sup>20</sup> on assessing country risk indicate that all categories of country risk are positively and significantly associated with each other and with per capita income levels. Similar results are reported by Cosset and Roy<sup>21</sup>, which could imply that per capita income levels may be useful as a proxy for assessing country risk. Burton and Inoue<sup>22</sup> find that the most powerful variables that influence country risk are Foreign Direct Investment (FDI) per capita, foreign aid per capita, political instability (notable assassinations, government crises, and *coups d'etat*), budgetary deficits, growth in Gross Domestic Product (GDP), inflation, and Gross National Product (GNP) per capita.

Other factors should also be considered in the process of

assessing country risk. Rusth and Lefever<sup>23</sup> and Clark and Arbel<sup>24</sup> identify potentially challenging conditions such as communication difficulties due to inadequate telephone, fax, or computer facilities. Problems, which could also translate into risk, may develop because of differences in labor patterns, costs, supplies, religions, customs, work ethics, and languages. Firms should also analyze the impact that a new operation is likely to have on the community in which it is to be located, in addition to the community's likely response to the new establishment.<sup>25</sup>

#### **Country risk can be managed**

Because country risk can manifest itself in so many different forms, managing country risk requires as many different approaches. There are at least five methods of dealing with country risk:

- multinational diversification
- borrowing locally
- hiring local labor
- specialized inputs
- insurance

#### **Diversification can be solution**

One strategy for dealing with country risk is to diversify foreign operations across different foreign countries. Beyond the concept of diversification, firms can utilize other corporate tactics that could help to reduce the level of country risk associated with a specific for-

eign operation. Such tactics might include borrowing funds in the foreign host country, hiring local labor in the foreign host country, using specialized inputs, and purchasing insurance.

Arbel and Grier<sup>26</sup> find empirical evidence to support the notion that substantial risk reduction can be achieved through diversification of hotel holdings across categories and regions. Singh and Gu<sup>27</sup> provide evidence that diversification improves financial performance and stability of food service firms. Substantial risk reduction could be achieved by applying this technique in an international context as risk is reduced through two different mechanisms, diversification of exchange rates and diversification of country risk. That is, when one foreign currency is weak, another may be strong.

The degree of risk reduction that is achieved through diversification depends on the extent to which country-specific conditions are independent of each other. The greater the degree of independence, the greater the degree of possible risk reduction. Thus, when economic conditions of one country are gloomy, those of another may be buoyant. If one country is experiencing political turmoil, another may be stable. In this way, weak earnings from one source will, hopefully, be offset by strong earnings from another.

### **Local sources are good**

Borrowing funds from local sources would tend to reduce the probability of host government expropriation, and discourage the adoption of other government policies that could threaten the viability of the foreign operation. If a host government takeover or policy change increases the probability of a loan default, the local lender would likely exercise political pressure to avert the policy change. Clearly, the effectiveness of this tactic would depend upon the balance of political power within the host country.

Hiring local labor may also have a similar effect because of political pressures. If jobs in the host country are indirectly threatened by any type of host government action, political pressure would likely come to bear upon the host government to maintain the status quo, in order to avert losses in employment.

Use of specialized inputs can also discourage adverse host government action. For example, subsidiary disconnection from the parent company, as would occur with expropriation, could trigger loss of local employment, as the foreign operation may fail due to loss of access to vital inputs. Any host government action that directly or indirectly threatens local employment is likely to be met with resistance from local constituents. This approach to controlling one aspect of country risk seems particularly well suited to the gam-

ing industry. For example, as computerized machines pervade the gaming sector, a technological barrier is implicitly created which would tend to ultimately reduce the probability of a foreign host government takeover and consequently reduce country risk for a foreign casino operation.

### Insurance reduces risk

Finally, insurance against various forms of country risk can be purchased through the Overseas Private Investment Corporation (OPIC), which is an agency of the United States Government. Several other countries have investment guarantee programs that are designed to insure, to some degree, the risks of expropriation, war, and currency blockage for firms operating in the international arena.

As Hoffman and Schniederjans stated, compared to other industries, the hospitality industry seems to have directed little attention to the management of risk faced by operating in the international arena, although the industry has been expanding internationally for some time. Because of the escalating competition in an increasingly global environment, hospitality firms are being compelled to bear the additional risks that operating abroad entails lest they lose out to this competition.

Exposure to foreign currency exchange risk can be measured and controlled through the use of global diversification, various

hedging techniques, and other techniques such as setting rates in U.S. dollars. Country risk can also be assessed and managed using global diversification, borrowing in foreign currencies, hiring local labor, using specialized inputs, and purchasing insurance.

The opportunities available to hospitality firms in the international arena are virtually boundless, but actualizing these benefits requires effective measurements and management of the additional risks incurred when operating abroad.

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