

Analyze the Hotel Industry in Porter Five Competitive Forces

Dr. David S. Y. Cheng, Faculty (Business) Upper Iowa University – Hong Kong Campus

ABSTRACT

This article is going to discuss the strengths and weaknesses of the Hotel Industry on a global basis and to study the viability of a hotel project, taking into account the five competitive forces of Michael Porter's Model. The main competitive forces and factors within those forces will determine the feasibility and potential profitability in a hotel project. The two crucial factors that enable hotels to differentiate themselves are good location for relative target market and quality of service.

INTRODUCTION

Industry can be broadly defined as a group of companies producing products and services that satisfy a need, function and use. It can be narrowly defined as a group of companies producing products and services which are close substitutes for each other. Business strategy can be defined as an integrated set of acts aimed at securing a sustainable competitive advantage over competitors. The Five Competitive Forces of Industry will influence prices, costs and investment (Porter, 1980). The feasibility and potential profitability of a hotel can be determined by answering the following questions.

STRENGTHS AND WEAKNESSES OF THE HOTEL INDUSTRY IN THE FIVE COMPETITIVE FORCES

Threat of New Entrants – Barrier to Entry

According to Michael Porter (1980), threat of new entrants are determined by barriers to entry which include economies of scale which include size and scope of operations required to achieve viable cost structure; product differentiation, switching costs and customer loyalty created by quality, reliability and brand image; capital requirements which involve size of cash and financial resources required to establish and run a business; cost disadvantages independent of scale as opposed to advantages held by existing competitors such as location, patents and experience; access to distribution channels which include means to reach customers; government policy such as licensing, subsidies or tax incentives; and expected retaliation from existing competitors which are determined by current rivalry, history of vigorous retaliation and strengths of incumbents.

The Hotel Industry on a global basis is characterized by high capital costs and a high proportion of fixed costs to total costs. There are considerable economies of scale in the local Hotel Industry. The high capital costs require that from the outset the hotel project must be managed to achieve the most cost-effective use of resources applied to construction, furnishing and equipment, pre-operational expenses and finance. The optimum size for a hotel in metropolitan cities is around 500 rooms. It may also be a marketing advantage to belong to a “chain of hotels” to benefit from brand image or loyalty.

Hotels must also aim to fill their rooms as profitably as possible, both through room occupancy levels and the relative tariffs applied. The two crucial factors that enable hotels to differentiate themselves are good location for the relative target market and quality of service. This latter issue is dependent upon

good management and trained and motivated staff. The Hotel Industry in most metropolitan cities in the world provides considerable opportunity to cross-sell profitable products such as Food and Beverage. Tariffs are determined according to the level of differentiation achieved through location, management, staff and guest ratios and any other miscellaneous factors such as the quality of architecture or decoration.

A hotel operator will need either to sell the hotel project before completion or to acquire hotel management expertise by a management agreement or some form of acquisition. The industry generally exhibits high product differentiation in this respect. Capital requirements for hotel projects are high. Hotels cannot be easily traded, but must be retained on a long-term basis for investment purposes. The industry is subject to considerable cost advantages or disadvantages independent of size. The success of a hotel project is very sensitive to location, management and the quality and experience of staff.

The growth of the Hotel Industry in most metropolitan cities is limited by the availability of suitable locations. Access to distribution channels can be a problem, but this factor can be mitigated by a connection with an international hotel chain. Government policy in most metropolitan cities, in itself, is not hostile to new hotels. Likely reaction from existing competitors is likely to be quite acute, but varies according to the particular market segment and strategic group. The industry exhibits high entry barriers restricting new entrants, particularly because of the combined factors of economies of scale and high capital cost of entry, together with the limited supply of suitable locations.

Threats of Substitute Products

Michael Porter (1980) indicated that substitute products can be existing or potential products and services which are able to perform the same function. Substitute products can reduce costs, and/or provide better quality performance and better value which very often the result of technological innovation.

The Hotel Industry in all major cities is not threatened by substitute products except that in times of recession domestic travel might replace international or overseas travel and certain destinations replace more expensive ones on cost grounds. In theory, substitute products perform same function, reduce costs, and/or provide higher quality performance with better service due to technological advancement (Porter, 1980). In the “lower” strategic groups for tourist traffic, hostels, motels and staying with relatives might replace cheaper hotels. This market is either low-income or cost-conscious, but in any event, it is quite price-sensitive.

A hotel operator in anywhere can compete on a low cost basis in a niche segment. It can also compete on the basis of a modern, comfortable but not luxurious hotel situated in a popular and convenient location appearing to offer good value to the cost-conscious visitors. Whether this strategy is sustainable in the long term is uncertain, given that in an area with good communications and cost-conscious travelers may be prepared to suffer slight inconvenience for cost savings. The importance of location to the target market may be over-rated. The hotel operator may not be able to rely solely on location to retain its market share in a situation of oversupply and consequently intense rivalry.

There is no major threat of substitute products specific to a hotel’s product and service. A hotel will be subject to powerful buyers only if its marketing strategy concentrates on attracting tour groups, provided no oversupply for the hotel’s target market develops. A hotel may not appear to be particularly vulnerable to intense rivalry because of the fragmented nature of the competition in its strategic group and the potential growth rate of its target market. In the “upper” strategic groups, for example, those particularly catering for business traveler, or the upper middle aged and old aged bracket, there is little opportunity for substitute products. Substitute products are not a major present or likely threat to Hotel Industry as a whole.

Bargaining Power of Suppliers

Porter (1980) emphasized that suppliers to an industry may be powerful if they are more concentrated than their customers and their customers do not command a significant share of their business because their customers do not represent a potential long-term or major relationship, for example, one-off or small customers versus regular or bulk buyers. Or their customers face differentiated products and services or high switching costs. A customer may be reluctant to change a supplier if such change would face extra one-time switching expenditure. Also if such change entails a perceived deterioration in the quality, image or quality of the supplier's product which will adversely affect the customer's service. Suppliers have more bargaining power if their product is an important input in the industry success. The supplier's input is crucial to the success of the customer's product and service such as local tourist operators, thereby lowering the customer's price sensitivity.

There is a great demand for enhanced global information and booking capabilities in the hospitality industry (Kotler et al., 1998, pp.761). However, the only supplier which might exercise power over any company would be labor and experienced trained personnel, which is in great demand in the Hotel Industry all over the world. In relation to other industries, hotels are not significantly subject to the bargaining power of their suppliers and suffer low levels of indirect pressure on their competitiveness from this source. For a sustainable business strategy over the long term a hotel will have to maintain a permanent cost advantage over potential competitors in higher strategic groups, say in the four or even five star categories hotels, as well as further differentiating itself within its own strategic group.

Bargaining Power of Buyers

Porter (1980) mentioned that the buyers of goods and services from an industry may be powerful if they are more concentrated than the players in the industry and are able to force down prices as well as reduce the industry's margin. They can purchase from the industry in large volumes, thus forcing down prices, or increase costs through demand for higher quality products and services. If the products and services purchased by buyers lack differentiation or switching costs, they can easily find acceptable alternative sources of supply. Buyers can pose a threat of backward integration as large group of buyers can acquire the supply source. If the industry's input is not crucial to the success of the buyer's product and service, price sensitivity thus increased. Buyers have the incentive to be powerful if purchases from the industry represent a significant proportion of their total costs. Buyers will earn low margins and are price sensitive if they cannot pass on cost increases easily, or absorb them due to low profit margins. This can happen to a lot of in-bound tour operators or travel agencies in most metropolitan cities.

Certain buyer groups exercise bargaining power as a result of their concentration or bulk purchases of hotel rooms. These groups would include tour operators, domestic or international airlines and large customers, such as convention organizers. This factor is more acute in the lower tier strategic groups which cater more to travel groups than the independent leisure or business traveler. Differentiation is a significant factor in respect of the business travelers and for certain categories of independent leisure travelers, but it declines in importance in the strategic groups catering to budget leisure travelers and groups.

Users of hotels are not likely to buy them, with the possible exception of airlines, because of the high level of investment required. Even many international hotel chain companies themselves function as operators or managers instead of owners. There is, therefore, only a minor threat of backward integration. With regard to business travel, buyers will tend not to be price-sensitive if the purchase of a hotel room represents only an insignificant item relative to the underlying business transaction. Otherwise, large-

scale buyers of hotel rooms for business purposes will tend to “shop around” for special rates. Buyers of hotel rooms are often, as a group, rather fragmented on a worldwide basis.

Where buyer groups become more concentrated, for example, tour groups, the prevalence of low profit margins will tend to raise the buyer group’s price-sensitivity. In this context a hotel’s choice of buyer group becomes crucial and hotels which target tour groups or other categories of concentrated buyers will be more subject to the bargaining power of buyers. Within that class its strategic group is further defined by its target market, namely, medium-pocket in the upper age bracket. Purchases of hotel rooms are important to certain categories of leisure traveler, and to most categories of business traveler. The bargaining power of buyers varies significantly within the industry, depending upon a hotel’s target buyer group, but this factor becomes acute in a situation of oversupply or where buyers of hotel rooms are concentrated.

Jockeying for position among current competitors

Porter (1980) reiterated that intensity of rivalry is dependent on number and size of direct competitors as numerous and/or equally balanced competitors may lead to intense competition. This is because business growth sought is greater than rate of growth of the industry. The rivalry for market share becomes intense when product differentiation and switching costs are low. Rivalry becomes more intense in fixed costs particularly in high preservation/carrying cost industries such as the Hotel Industry in most metropolitan cities. There are strong pressures to sell capacity by price-cutting except weekends and holiday seasons. Capacity augmentation exists as large additions to capacity can disrupt the demand and supply balance and leads to intense rivalry. Exit barriers happen due to economic, strategic and economic factors which retain competitors in an industry. Despite low or negative profitability and diversity, companies and industries may have different origins, goals and strategies and an overlap in target customers.

WHAT ARE THE KEYS TO PROFITABILITY IN THE INDUSTRY?

What are the main competitive forces and factors within those forces which determine potential profitability in the industry? The Hotel Industry in most metropolitan cities in the world is characterized by high capital costs and a high proportion of fixed costs to total costs. The high capital costs require that from the outset the project must be managed to achieve the most cost-effective use of resources applied to construction, furnishing and equipment, pre-operational expenses and finance. Hotels also been built to an optimum size, approximately 500 rooms, in order to benefit from the economies of scale. Hotels must also aim to fill their rooms as profitably as possible, both through room occupancy levels and the relative tariffs applied.

WHAT IS A HOTEL’S COMPETITIVE ADVANTAGE AND COMPETITIVE POSITION?

Competition in the Hotel Industry anywhere in the world is intense within strategic groups subject to the level of industry growth. Industry growth in major cities, capitals or financial centers is high at present partly due to the travelers from tourist groups, business and independent leisure travelers, resulting in low levels of jockeying. Competitive position involves Cost and Differentiation. There are no switching costs, which could increase potential jockeying. Product differentiation can be high ranging from budget hotels to deluxe hotels. Hotel operators wish to exploit to establish customer loyalty, image

and differentiation. Fixed costs are high in the industry and consequently high room occupancy rates are critical. Competition would, therefore, be very fierce in a situation of oversupply of hotel rooms. Capacity is augmented in large increments in recent years due to some major international events such as Olympia Games, Expo or World Cup.

Competitors' reaction is expected to be fragmented, haphazard and insignificant, especially as the common market is forecast to be one of the more buoyant segments among total arrivals in the coming future. The key issue remains that whether there are any further sites in the immediate vicinity of any big cities which may be purchased by other business groups commanding similar capital resources to any hotel operator which will pose significant potential future competition.

WHAT ARE OTHER MAJOR INCOME STREAMS FOR HOTEL OPERATORS?

Income from any hotel project can be safeguarded by six major income streams apart from room sales:

- (1) *Food and Beverage* is one of the important income sources. A large restaurant serving Western or local food or a coffee shop serving buffet must be planned for any hotel project. These will attract considerable non-hotel resident business including banquet facilities. By world standards F&B income is a very large component of the total hotel income in the Hotel Industry as a whole.
- (2) *Exhibitions and Conventions* can provide steady rental and service income for any hotel.
- (3) *Entertainment* such as Cinemas, Concerts and Business Function Room Facilities are likely to receive heavy patronage.
- (4) *Commercial and Shopping Complex* must be planned. The shopping space with retail shops selling luxury merchandises, watches and jewelry can provide recurrent rental income.
- (5) *Neon-Signage* can be planned which will further diversity income.
- (6) *Car-parking Service* can be another major income source.

WHAT IS THE HOTEL'S BUSINESS STRATEGY?

Porter (1980) indicated that intensity of rivalry is dependent on number and size of direct competitors, rate of growth of the industry, product differentiation and switching costs, fixed and running costs, capacity augmentation, exit barriers and diversity. If jockeying for position in a higher strategic group became more intense in a position of oversupply, hotels might be diverted to another segment of the market, forcing hotels to cut margins unless it has established sufficient differentiation to maintain its own position within its strategic group.

The Hotel Industry in any major cities in the world contains very high exit barriers. Once in, it is very difficult to get out. There is considerable diversity in the strategy and aims of companies owning hotels. For example, an airline entering the hotel industry may see its hotel operations as ancillary to its core business of selling air travel. Similarly, a property developer engaged primarily in property development and investment, may have a different objective and strategy from a company whose core business is hotel ownership/management.

The corporate structure of the company holding the hotel can be designed from the tax planning angle with a view to being able to sell this development at much reduced rates of stamp duty and legal expenses. The company can keep the options open either to sell before completion or to keep the hotel project as a long term investment.

CONCLUSION

The two crucial factors that enable hotels to differentiate themselves are good location for relative target market and quality of service. This latter issue is dependent upon good management and well trained staff. The Hotel Industry can provide considerable opportunity to cross-sell profitable products such as Food and Beverage, Entertainment or Exhibitions and Conventions services. Tariffs are then determined according to the level of differentiation achieved through location, management, staff and guest ratios and any other miscellaneous factors such as quality of architecture, decoration, furniture and fittings, layout or interior design.

In the event of a downturn in the world's economic cycle the hotel's target market should be more durable than the tourist market because of the different forces and motives driving tourism. That is not, however, to say that a hotel itself is immune to such a downturn. If jockeying for position in a higher strategic group became more intense in a position of oversupply, a hotel's price advantage might be eroded and business might be diverted to another segment, forcing the hotel to reduce its profit margins further unless it has established sufficient differentiation to maintain its status quo within its respective market segment.

REFERENCES

- Kotler, P., Armstrong, G., Brown, L. and Adam, S. (1998). Marketing fourth edition, Prentice Hall, Sydney.
- Kotler, P. and Armstrong, G. (2010). Principles of Marketing 13th Edition, Pearson Education Inc.
- Kotler, P. and Keller, K. L. (2006). Marketing Management 12th edition, Pearson, Prentice Hall.
- Porter, M. E. (1979). How Competitive Forces Shape Strategy, Harvard Business Review, Volume 57, Number 2.
- Porter, M. E. (1980). Competitive Strategy: Techniques for Analyzing Industries and Competitors, New York: The Free Press.
- Porter, M. E. (1998). Competitive Advantage: Creating and Sustaining Superior Performance, New York: The Free Press, NY 10020.
- Porter, M. E. (2003). Strategy and the Internet, Harvard Business Review on Advances in Strategy, Harvard Business School Publishing Corporation.