

Financing in Tourism: Basic Models of Financing the Accommodation Offer

Slavoljub Vujovic^{1*}, Ljiljana Arsic² and Jelena Premovic¹

¹Economic Institute, Belgrade, Serbia, Kralja Milana Street, No. 16, Serbia

²University of Pristina, Kosovska Mitrovica, Serbia

*Corresponding author: Vujovic S, Senior Research Associate, Economic institute, Belgrade, Serbia, Tel: +381 11 36 13 417; E-mail: kelovic1967@yahoo.com

Received date: June 8, 2018; Accepted date: August 21, 2018; Published date: August 28, 2018

Copyright: © 2018 Vujovic S, et al. This is an open-access article distributed under the terms of the Creative Commons Attribution License, which permits unrestricted use, distribution, and reproduction in any medium, provided the original author and source are credited.

Abstract

Based on the previous theoretical research and empirical experiences and knowledge related to the development aspects of the tourism industry, it can be concluded that the basic models of financing all major projects in the tourism economy are shareholder and loan capital. Today, more as a financing technique rather than as a source of funds, especially from the aspect of how to make returns on invested capital, for investments in certain tourist destinations, it is interesting project financing.

Due to the volume of investments and the duration of construction, financing of accommodation facilities and higher investments in the tourism industry, it is particularly interesting that long-term financing, that is, long-term sources of financing. In today's business conditions, in the domestic and international practice of financing large investments in the tourism industry, the model of financing from the accumulation of own capital is very complicated or not profitable.

Right on, according to the above, the aim of the research is to clarify the significance of these forms of financing when it comes to financing accommodation facilities of the tourist offer.

Keywords: Tourism; Financing; Accommodation facilities

Introduction

In the contemporary international business, tourism is considered as a service sector with the greatest potential of growth which is expected in the near future. Tourism participates with 10% in the world's GNP, through the tourism over 6% of the total world export is realized and 30% world trade of the services [1].

From a broader perspective, the accommodation offer in tourism, as well as other infra- and suprastructural systems, can be financed on or off the balancing sheet. Generally, financing is recorded in the balance sheets of the investing company; however, off-balance-sheet financing (OBS) or incognito leverage is more frequent nowadays and it is a way for a company to impact its level of debt and liability by not including a liability on its balance sheet [2].

Project Finance

The modern concept of economic viability means that the company needs to maintain or increase the level of wealth per capita [3].

'Project finance' is an umbrella term for all aspects of financing of the project with direct debt payoff-the debt is paid off from the project profits instead of the overall debtor company profits-or indirect debt pay off with money coming from the debtor company funds. Therefore, the creditor has clear insights into the money flow, while their only way of return on their investment is the success of the project (hotel, building, lot, etc.), which in itself is the guarantee for the loan [4,5].

In addition to intrinsic guarantees stemming from the project, the investor might ask for additional assurances in case of declining profitability. Such guarantees (direct or indirect) might come from the third party that has invested interest in the success of the project, for example, an industrial or governmental institution that obligated itself to use the offered services (e.g. stay at the hotel) for a number of years. The practice of financing big hotel projects indicates that managers work with large sums of loan capital, but also implement projects financed from shareholder or their own resources [6].

Project financing implies return of the invested funds from the project profits. Therefore, the investor or creditor of a particular infra- or suprastructural system relies on debt pay off from future profits of the project, while the assets guarantee it [7].

Apart from the numerous criteria for the division of projects, more relevant authors point out the following: type of business activity, character of the performer, nature of goals and types of financing [8].

On the basis of all the analyzed classification and division, as a basic one, one can distinguish the division of projects into: investment and business projects.

According to its characteristics, the superstructure of the tourist offer of tourism enters into investment projects, since they require large investments in the long term and a large number of participants (construction of capital infrastructure projects, construction of new hotels, factories, introduction of new technologies, etc.), while business projects require smaller means of financing, shorter duration, require simpler technologies, require a smaller number of participants, etc. [9].

Investment in tourism industry very often relies on structural financing techniques with large projects to minimize transfer risk and

secure money flow. With this approach, the money flow is monitored with emphasis on operation, while the insurance of assets emphasizes the financial aspect such as loans and payments. The main reason for such procedures lies in the fact that investor companies need new sources of capital [10]. This practice was common for international investor companies in ex-communist countries in the process of privatization of state companies. Also, the aforementioned technique is usually related to big and complicated projects. However, it is applicable to all projects no matter the size, whether it is the construction of a hotel, a ship, a factory or a solar power plant [11].

In 2002, Enron, a U.S. energy-trading and utilities company, confirmed that there are major oversights and drawbacks of the structural financing techniques. Namely, Enron utilized project financing in economically unsubstantiated way, especially unfair to its shareholders and creditors. Its manipulation of the shareholders and creditors, as well as the perversion of information, cast a shadow of doubt on this kind of financing. Further investigation of Enron activities confirmed the boomerang effect of such malpractice which lead the company to bankruptcy [12].

Main players in project financing are sponsors and financiers [13].

Project sponsor finances the project and is concerned with its successful implementation. It can be a government of the host country, a private company or a business consortium as a future consumer of the goods and services.

Project financiers can come from various backgrounds—companies, investment funds, international development and investment banks, insurance companies, equipment manufacturers, pension funds, future consumers, etc.

Other important players are project company and contractor consortium.

A project can have multiple sponsors. The motivation for participating in a project companies find in the prospects for product manufacture and placement long after the project period with the aim of filling their production capacities. For example, a furniture manufacturer might invest in a construction of a hotel. Secondly, the motivation might stem from profit opportunities. We have seen that the aim of the project is to be profitable from its own resources, without any influence on the passive funds and the credit rating. One way to achieve this is to have a third party guarantee. Projects which are not insured by a third party, which will directly benefit from it, are rare [14].

There are many reasons for disagreements between debtors and creditors. Debtors often wish to have their projects financed off the balance sheets, with only partial reveal of sources of investment. On the other hand, the creditors are not in the venture capital business, meaning they wish to have their pay off guaranteed by the project itself, the sponsors or third party. Herewith lies the challenge of project finance [15].

Successful project financing means structuring it in a way that provides partial or complete pay off from the project profits while ensuring enough capital through sponsorship or third party guarantees. These assurances keep the creditors satisfied with the risk assessment [16].

Financing through Shareholder Capital and Credit Loans

Based on theoretical and empirical research of development in tourism industry, it can be concluded that two main resources for financing big projects are shareholder capital and credit loans. However, the practice has shown that the combination of the two models gives best results. The analysis of the financing models, their benefits and drawbacks, resulted in their classification according to their origin:

1. External and
2. Internal
3. Another basis for classification proves to be significant, the ownership aspect:
 - Personal (company's own capital),
 - Other (loan), and
 - Hybrid (combined) [6].

Very often, the sheer volume of the investment, as well as the duration of the construction of accommodation or any other investment in the tourism industry, requires a long-term investment plan, that is, a sustainable source of capital. The model of self-financing big projects in the tourism industry today proved to be both complicated and unprofitable. It is imperative to distinguish between short-term and long-term investments because of the capital expenditures, duration of the project, and volume of the required capital [17].

The business practice has shown that long-term financing often comes from personal (company's own) funds and long-term loans; on the other hand, short-term financing comes from bank loans, Lombard loans, short-term securities, trader loans, and factoring. The tourism industry also finds leasing (of goods, equipment, and capital) as an acceptable source of financing. Furthermore, there have been examples of other sources such as forfaiting, permanent financing, reimbursement credit, vinculating insurance, mortgage, etc. [18].

When financing accommodation in tourism industry from one's own capital, a company might use: operational funds, shareholder capital, permanent financing, reserves, and long-term reservation of funds. On the other hand, financing from other sources might come from loans, term investments, bonds, etc. [7].

When choosing an appropriate financing plan in tourism industry, a company must consider the ratio of personal and borrowed capital, type and volume of the projected activities, characteristics of the investment, the risk assessment, and its creditworthiness [19]. Nowadays, the most common way to finance the accommodation in the tourism industry is the combination of loans and shareholder capital with additional subventions and grants to reduce the amount of the borrowed money [20].

Financing from loans by its nature is characterized by the interest rate which is either fixed from the beginning of the loan or it varies in accordance with the financial market. Loans are tightly controlled in terms of the payment plan and the collateral used as a borrower's pledge of specific property to secure the repayment. It is increasingly common to use the facility under construction as collateral. The overall value of the facility might not cover the loan in full but the creditor has a right of the first offer in the process of selling the asset. However, the creditor might ask from the project manager to guarantee the deadline of the completion of the construction and provide the letter of credit in

case of exceeding the budget. This is also known as unsecured loans, without pledging the collateral.

Financing from shareholder capital is a means of funding hotels and other touristic facilities whereby the investors obtain ownership interest in the company and as such they have a right of the first refusal when cashing in on their shares. Namely, financing from share capital implies in-paid capital with equal allocations of risk where the stake in the company corresponds to the ownership percentage.

Consequently, shareholders count on the company performing well in the market (since there is no repayment as with loans). The shareholders participate in the redistribution of the profits in accordance with their stake in the company. "Equity capital can come from the direct money flow, or through bond traders. Many countries support financing from equity capital in hotel and tourism projects through subventions, monetary policy, tax benefits, preferential interest rates, etc."

Banks and other investment companies have vested interest in the success of the project paying special attention to the analysis of the prerequisites crucial to the implementation of the project. Feasibility studies and money flow projections are especially important in the evolution of a project proposal. Creditors insist on a "powerful" project manager, an experienced co-contractor as an assurance in high-risk projects. Therefore, it is important to have a business plan verified by an independent expert team. In addition, the investors value forecasting of financial, developmental, marketing, and human resource strategy of the company accompanied by a competent and effective management of the project.

Moreover, influential management companies can aid the process by asking for fixed rates in the early stages of the project, thus cutting the costs and the risk for both creditors and investors. To that end, creditors approve of projects capable of repayment from its future profits with special care paid to the interest coverage ratio.

All in all, before deciding on financing a certain project, a bank will primarily insist on insurance and security of its assets. Very often, a bank will hire independent experts to evaluate the hotel based on its profitability and project value, which is an important step in risk assessment [20].

Differences between Financing from Equity Capital and Loans

When financing the accommodation offer, it is important to compare and contrast equity capital and loans as two primary sources of financing. Various authors have analyzed them and stated major differences as follows [21]:

- Equity capital (share capital) entitles the holder to ownership interest and as such, the holder has a right to a vote. Loan capital, on the other hand, means crediting partnership; therefore, the investor (creditor) only has a right to payment.
- Financing from loans is limited in time by the payment due date, upon which the principal amount is repaid and the loan is liquidated. Contrary to that, equity capital is timeless, or as durable as the shareholder is in possession of the stocks, until the holder decides to sell them in the secondary market or the company is liquidated.
- Unlike, creditor status within the company, the shareholder has a right to a vote (controlling interest) because they are partial owners of the company with allocated risk.
- In case of bankruptcy, the creditors have a right of the first offer, meaning they are repaid first. The shareholders get repaid if there are any funds left.
- Another difference is reflected in the repayment obligation. Companies are obligated to repay principal and interest to their investors and creditors as stipulated in the financing agreement, regardless of the company profits. On the other hand, paying dividends to the shareholders depends on the profits of the company.
- There is also a considerable difference in the risk profit ratio. Shares of the company carry greater risk, hence they bring greater profits. Dividend income and capital gains from shares depend on their price on the secondary market.
- Finally, the tax obligations are different. Tax on issued shares is considered as expenditure for the company. The amount is deducted from the net profits. On the other hands, payments to investors and creditors are done from the net profit which is already taxed. Therefore, financing from loans is cheaper than from equity capital.

Financing from Collaborative Projects

In construction of certain major infra- and suprastructural facilities, there may be more than one interested parties. The collaborators then establish a new company where a power struggle is not uncommon [22]. However, there are benefits to a collaborative project and working with partners with same goals and multiplied resources.

This is the case when:

- A project is outside the scope and financial abilities of a single company—then, the partnership can be complementary;
- Having a big collaborative project is more profitable than a small project managed by a single company;
- The risk allocations are better shared among the partners; and
- One or more partners have tax benefits.

Financing from collaborative projects carries its own set of risks. Therefore, the success of the project, especially with multiple partners, depends on competent risk management. Since different stages of the project implementation are characterized by different risks, the funding and the creditors need to be actively secured. The initial phase is often a prolonged planning and projecting, when the necessary equipment is purchased and various aspects of construction are negotiated, followed by the construction phase. The risk increases with rising spending on materials, equipment, and work force.

The end of the construction phase is by no means the end of the project. Sustainability and profitability of the facilities are still questionable and that is the real test of the feasibility study and project planning. The project implementation is finished only when the facilities have proven to be sustainable and profitable for a prolonged period of time.

Most projects are financed by a single or a group of investors. However, big projects often require various investors for various project stages. This stems from different risks arising from different phases of the project, as well as different characteristics and capabilities of the investors to accept the risks. For example, certain creditors only

loan money short-term, or are specialized for a specific stage of the construction process. Some might ask for third party assurances, while others might offer lower interest rates, etc.

The benefits of financing from collaborative projects lies in its process of accumulating material value from its status of the debtor itself, therefore allowing for favourable ratio between the project asset as a collateral and the loan sum.

Most common benefits of collaborative project financing for the developers and investors are [4]:

1. Insurance of funds – favorable loans;
2. Insurance of minimal engagement of company's own funds;
3. Maximizing the loan with fixed interest rates;
4. Aligning the repayment with the money flow;
5. Aligning the repayment in foreign currency with the profits in the currency;
6. Minimizing investment costs;
7. Achieving the planned profit rate;
8. Engaging more public and private investors;
9. Achieving the necessary level of flexibility in financing.

There two key benefits for all parties in collaborative project financing:

1. Increasing availability of various sources of financing which in turn increases the chances of successful implementation of a project that would otherwise be unprofitable based only on equity capital or direct borrowing.
2. Decreasing the risk because it is allocated to a larger number of participants. In case of risk transfer by various financial instruments, it is common to issue securities or financial derivatives: options, futures, swaps, and forwards.

Presenting the Project for Financing

When preparing the project proposal for presenting to future investors (whether they are creditors or shareholders) several important aspects must be considered (even though the investment companies will perform analysis of their own):

1. It is often insisted on project manager to secure a part of the capital even before the project proposal is submitted for consideration;
2. Financial and business plan must be verified by an independent expert panel through a feasibility study;
3. Creditors often hire independent agencies to evaluate the technical aspects of the proposed construction plan, especially against the proposed budget, and often require the project manager to provide a letter of credit in case of exceeding the agreed framework in terms of time and money;
4. Creditors insist on efficient and competent management of the hotel, even if this means hiring an outside management company;
5. Location of the hotel is also evaluated to determine its suitability to the target clients;
6. Hotel management contract must make sure that the income of the management structures is directly related to or dependent on the hotel profits.

Investing companies, by default, require a submission of independent study on financial, market, and marketing potentials of

the project proposal. Since their main goal is profit, proposal evaluation done by a renowned consulting agency is of utmost importance. A feasibility study is a detailed risk assessment of the potential of the company to service a long-term debt and repay the invested capital. This study is comprised of:

1. A description of the state, region, and location of the proposed facility, including economic and demographic data;
2. A study of current and projected tourist trends in the region;
3. An analysis of the business operations of the competitors;
4. A market analysis, including the existing supply and demand of the hotel capacities in the area;
5. Comments on the proposed location of the hotel, as well as the projection of the average room rate and utilization degree;
6. A report on the projected profit and loss, including all the costs and incomes from the gross operational profit;
7. "A sum of money needed for the project calculated from the preliminary assessment, capital expenditures, and financing models" [6].

Money Flow

Gross operational profit is a constant source of income in project financing. Estimated money flow indicates the potential of the project to service a long-term debt and repay the invested capital. Money flow is the amount left after the tax and investment gain are deducted from the gross profit.

"Gross operational profit includes operational costs and profit, while some of the non-operational costs are paid separately. A typical money flow report will include the following:

- Lot rent – fee paid for the location of the hotel;
- Building insurance – considered as a construction cost;
- Refurnishing and equipping the facility – calculated as a percentage of the initial cost of furniture and equipment, or as percentage of construction cost, or percentage of income;
- Management agency fee – if the hotel is run by a management agency, its fee is tied to the gross operational, though it is possible to cover the fee after the repayment of debt for the fiscal year;
- Debt repayment – it can be organized in equal installments over an agreed period of time, or in proportionally smaller or larger installments in the beginning and in the end of the loan period (yearly debt consists of equal and regular installments, which lessens the money outflow in the beginning of the project when the income is usually smaller);
- Interest rate – the feasibility study considers a fixed interest rate in calculating its value (however, this rate often fluctuates)" [6].

Deductions from the gross operational profit leave an annual excess before the tax reductions. After all that, the tax on investment gain is deducted, plus insurance against currency fluctuations. Because of these fluctuations, creditors often grant a loan in the same currency as the expected profit. However, the most difficult obstacle is how to reduce the risk of inability to transfer money and property. Tourism industry circumvents the issue by paying outside the destination itself, that is, by paying clients, tourist agencies, guides, etc. The money goes through creditors who keep a percentage for repayment, while transforming the rest of the money locally [23].

Before investing, creditors evaluate the appeal of the project proposal in various ways. One of the important aspects for an investor

is the capital turnover. It represents average annual income from the investment. Moreover, they place importance on the loan period – number of years needed for the investment to pay off. However, neither approach is perfect.

Focusing on the capital turnover ignores the temporal dimension of money, while the second approach ignores the effective devaluation of base capital due to inflation. Therefore, the investors consider discounted cash flow to evaluate the present value of all future cash estimated and discounted by using cost of capital to give their present values. The sum of all future cash flows, both incoming and outgoing, is the net present value, which is taken as the value of the cash flows in question. This way, the invested money is repaid from interest rates.

Therefore, the project whose net present value is higher for the same amount of invested money is more appealing. Hence, the discount value represents the value of the project expressed in:

- Sales revenue in its last year of the projected money flow;
- Value of future money flow after its last year of implementation.

“The projected sales revenue of a hotel is calculated from multiplied gross operational profit at the time of the sale. The discount value, together with the annual discount money flow, is used to calculate net present worth.”

Furthermore, when evaluating investment projects, tax fares need to be considered. However, tax deductions and exemptions in the early stages of the project can maximize its efficiency. Finally, the internal rate of gain, which should be higher than the interest rate on the principal, is highly important for investors [24]. “The internal rate of gain represents net present value of zero thus equating the current net value of the money flow to current value of base capital (money outflow)”.

Conclusion

When it comes to financing tourist accommodation facilities, based on previous theoretical research and empirical experience, it can be concluded that the basic models of financing all major projects in the tourism economy are shareholder and loan capital. However, examples in practice, the financing of the construction of accommodation facilities of the tourist offer, the combination of action and loan capital, stand out as the best model.

Due to the volume of investments and the duration of construction, financing of accommodation facilities and higher investments in the tourism industry, it is particularly interesting that long-term financing, that is, long-term sources of financing. In today's business conditions, in the domestic and international practice of financing large investments in the tourism industry, the models of financing from the accumulation of own capital is very complicated or not profitable.

In practice, long-term financing is made from equity and long-term debt, and short-term financing is done through bank loans, Lombard loans, short-term securities issue, commercial loans and factoring. In the tourism industry as a special source of financing (equipment, goods and capital), leasing appears as an acceptable model of financing.

In addition to the aforementioned, in the financing practice of the tourism industry, other sources of financing also appear: forfeiting, permanent deposits, ranbus loans, vinculative loans, mortgage loans, etc.

When choosing the financing of accommodation facilities by own funds, the following can be used as sources: business fund, share capital, long-term deposits, reserves and long-term provisions, while in the decision for the use of other assets, sources such as loans, time deposits, bonds, etc.

Pursuant to the previously presented work, it can be concluded that investors in the tourism industry in the financing of large projects, in order to control the flow of money used in the project, implement a structural financial technique. This financial technique includes an overview of the flow of money by giving priority to operations, while in securing the asset the flow of money focuses on a financial aspect such as loans and payments. The reason for such activities is that companies investors need to have new sources of capital. This type of financing of large projects was used by international corporations in the former communist countries in the affairs of privatization of state-owned enterprises. This technique of project financing is characteristic of large and complicated projects. However, this technique is applicable to all types of projects regardless of size, whether it is the construction of a hotel, ship, factory or solar power plant.

However, in addition to the positive features of the previous project financing technique, that there are flaws and negative features in practice, it was previously explained on the example of Enron.

References

1. Premovic J, Boljevic A, Vujovic S, Arsic LJ (2013) Global Ecological Problems and Sustainable Tourism Development, *Ecologica* . 70: 305-310.
2. Matić V (2018) Structural funding.
3. Premovic J, Boljevic A, Arsic LJ (2011) Small and Medium Enterprises as Generators of Sustainable Regional Development, *Economics of Agriculture* 58: 137-144.
4. Vujović S, Kvrđić G (2008) Business Finance Management, High Business School of Vocational Studies, Čačak.
5. Arsić LJ (2004) Models and directions of company transformation-monograph. Faculty of Economics.
6. Ristic Z, Komazec S (2011) Global Financial Management. EthnoStil, Belgrade.
7. Vujović S (2000) Financing accommodation in tourism FRJ, Master's thesis, Faculty of Economics, Belgrade.
8. Vukadinović P, Jović Z (2012) Investment, University singidunum, Belgrade
9. Đedović B (2010) Project Management and Evaluation, FMMSF, Belgrade
10. Miladinovski S (2012) Development of debt securities market-experience and perspectives- International conference of the Belgrade Stock Exchange Upgrade in Belgrade.
11. Ognjanovic J, Pešterac A (2016) Investment activities for building a hotel facility, HiT Management br. 2/2016, Faculty of Hospitality and Tourism, Vrnjaska Banja.
12. Thomas WC (2002) The Rise and Fall of Enron, *Journal of Accountancy*.
13. Drljača S (2014) Application of bot financing models for the construction of transport infrastructure.
14. Leković M, Pantić N (2014) State Financial Support and Capital Investments as Factors for the Development of Serbian Tourism, HiT Management No.1/2014, Faculty of Hospitality and Tourism, Vrnjaska Banja.
15. Bruner KF, Langohr H (1992) Project financing: An economic overview, Harvard Business School.
16. Suzie Harris, Kathy Krueger (1999). An Overview of the project finance market, Harvard Business School.
17. Ristic Z (1994) Financial Management, NIGP "ABC GLAS", Belgrade.

-
18. Ristic Z (1990) Money Market and Capital Market, Author Edition, Belgrade.
 19. Stancic P (2018) Sources of financing of the company, Faculty of Economics, Kragujevac.
 20. Vujovic S (2008) Material basis of tourism, Institute of Agricultural Economics, Belgrade.
 21. Vučurević S (2013) Distribution of undistributed profits of joint stock companies. Institute of Economics and Finance, Belgrade.
 22. Kapor P (2006) Sources of funds for international financing of infrastructure investment projects.
 23. <https://finansijskoposlovanje.wordpress.com/>
 24. Jovanovic P (1995) Project Management, FON, Belgrade.