While today the Marriott brand stands for consistent high quality in numerous lodging concepts worldwide, did you know Marriott started out in the foodservice business?

In 1927, John Willard “J.W.” Marriott, purchased an A&W root beer franchise for $1,000 and opened a nine-stool A&W root beer stand in Washington, D.C. His total capital outlay was $6,000: $1,500 of his own savings, $3,000 from his partner, Hugh Colton, and $1,500 of debt from a bank. After just three weeks of operation, J.W. returned to his Utah hometown to marry his college sweetheart, Alice Sheets. At the time, the couple had so little money that Alice’s mother gave them four $50 bills to pay their way back to Washington, D.C.

Initially, Alice expected to be a stay-at-home wife. Before they married, she said to J.W., “You don’t expect me to go back to Washington with you and sell root beer, do
you?" But the bride soon found herself taking charge of the money and other aspects of the fledgling business. That year, business from the first stand was so good that the Marriotts opened a second stand. According to J.W., "Alice would count the money generated from the two stands and keep a record of the inflow and outflow of cash. As long as the receipts were more than the expenditures, we knew we were doing all right." When they suspected their waitresses were pocketing money, Mrs. Marriott would spy on them through a hole in the back door.

However, as fall approached, the cool weather caused their root beer sales to drop off. To divest the risk of this lost cash flow, J.W. negotiated a new clause in his franchise to allow his root beer stands to sell food as well. Chili, hot tamales, barbecued beef sandwiches, and hot dogs were added to the menu, and the Hot Shoppe concept was conceived. Soon, thereafter, the Marriotts renamed their root beer stands Hot Shoppes and grew the chain to over sixty-five restaurants.

In 1937, a Hot Shoppe manager at the Hoover Airport location observed that airline passengers would buy snacks and drinks from the restaurant to take with them on their flight. He told Mr. Marriott about this, and immediately the entrepreneur cleared a storeroom in the basement and converted it into a flight catering assembly room. The next day, he called the people at Eastern Air Transport and obtained his first catering contract, and the company's In-Flite catering division was born. In spite of World War II, this division quickly expanded into the foodservice management business, providing meals for thousands of workers in government and the private sector.

By 1952, the company's gross income had tripled from what it had been just seven years before. At the end of World War II, its gross income was over $19 million. Mr. Marriott was thus faced with a critical decision: Should he be conservative and grow the business slowly by reinvesting its cash flow, or raise a war chest for expansion and take the risk of going public? J.W. chose the latter. In 1953, Hot Shoppes, Inc., offered 229,880 shares of common stock to the public at $10.25 per share and 18,000 shares to its employees at $7.54 per share. The stock sold out in two hours of trading and raised close to $2.5 million. The flush of cash was used to further expand Hot Shoppes, in-flight catering, and the foodservice management businesses. The company then diversified into lodging with the construction and opening of the Marriott Twin Bridges in Arlington, Virginia. Other Marriott hotels soon followed in Washington, D.C., Dallas, and Philadelphia.

Even after officially relinquishing control to their eldest son, J.W. Marriott Jr., Mr. and Mrs. Marriott continued to shape the company's business until they passed away in 1985 and 2000 respectively. The phenomenal growth of their original root beer franchise into a worldwide hospitality conglomerate was no accident. As J.W. Marriott once said, "A man should keep on being constructive and do constructive things." He and his wife are certainly two great examples of this strong work ethic.

SOURCES
Learning Outcomes

1. Understand why a company must demonstrate consistent growth to be successful.
2. Understand the concept of shareholder value and how management strives to increase it.
3. Learn how to calculate earnings per share (EPS) and a company’s stock multiple.
4. Learn what influences a company’s stock multiple and, as a result, shareholder value.
5. Understand the concept of risk and return, and how to measure it.
6. Identify the benefits and advantages that growth offers a company.
7. Understand the growth strategies available to companies and the advantages and disadvantages of each.

Preview of Chapter 5

Growing the Business

1. THE NEED FOR GROWTH
2. SHAREHOLDER VALUE
   a. Private company goals
   b. Risk and reward
   c. Public company goals
3. BENEFITS OF GROWTH
   a. Provide career paths for employees
   b. Attract new qualified employees
   c. Increase market share
   d. Limit new competition
   e. Diversify to reduce risk
4. GROWTH STRATEGIES
   a. Increase sales and productivity of existing properties
   b. Expand physical facilities
   c. Franchise brand rights
   d. Secure additional management contracts
   e. Merge with or acquire competitors
   f. Go public
Regardless of whether you work for a public company, a private company, a large company, or small company, growing the business of your company is essential to its long-term success. Owners of private companies expect profits, cash flow, and ROI to increase each year. Stockholders of public companies expect the price of their stock to rise each year. To be considered a growth company, a company’s earnings must increase by at least 15% each year. This is a major challenge for most companies and becomes even harder the larger the company becomes. The primary goal of management, therefore, is to increase **shareholder value**.

**Shareholder Value**

Shareholder value is the **market value** of the company. Shareholder value for a public company is the current market price of its common stock multiplied by the number of shares of common stock outstanding. Shareholder value for a private company is the price the company could be sold for on the open market.

**Public Company Goals**

The goals of a public company are to increase:

1. **Earnings per share**
2. **The company's stock multiple**
3. **The market price of its common stock**

Shareholder value for a public company is strongly influenced by analysts’ estimates of the company’s future **earnings per share** (EPS). Earnings per share is calculated by dividing the company’s annual **EBITDA** (earnings before interest, income taxes, depreciation, and amortization) by the number of shares of its common stock outstanding. The relationship between earnings per share and the current market price of a company’s common stock is referred to as its **multiple**.

The multiple is calculated by dividing the current market price of a company’s common stock by its earnings per share. The higher the projected future earnings per share, the higher the multiple. If you were the chief financial officer of your company, would you want a high multiple or a low multiple? You would want a high multiple because for every dollar that earnings per share actually increases, the market value of its common stock should increase by a multiple
of EPS. For example, if earnings per share increases by $1.00 and the company’s stock multiple is 15, the current price of its stock should increase by $15.00.

Successful hospitality companies strive to increase shareholder value by increasing revenues and controlling or reducing expenses, which increases earnings per share. They also strive to increase shareholder value by managing investor expectations of future earnings per share and thus increasing the company’s stock multiple.

The challenge they face, however, is the company’s need for large quantities of capital to grow. The more capital a company requires for growth, the slower the growth rate, as raising capital takes time. The slower the company’s growth, the slower its shareholder value increases.

Because shareholder value is a function of projected future earnings per share and the risks associated with achieving it, the higher the projected future earnings per share and the higher the probability of achieving them, the more investors will pay for the stock today and the higher the company’s stock multiple. An important key to increasing shareholder value is to create the perception that earnings per share will grow steadily at a minimum of 15% per year. A high growth rate encourages investors to buy the company’s stock, anticipating that the stock will be worth more in the future. Another key to increasing shareholder value is to make the perception reality by delivering the anticipated earnings. This makes for happy investors who will invest more capital in the company in the future. The more demand there is for a particular stock, the higher its market price. This is true because, in the short term, the number of shares of stock available for the public to purchase is fixed.

**Risk and Reward**

Because the element of risk is factored into a company’s stock multiple, it is helpful to understand the basic concept of risk and reward. Investors are risk adverse to varying degrees. As a result, the greater the risk that future earnings may not be achieved, the higher the return on investment investors demand. The higher the return on investment demanded, the lower the stock multiple. It is therefore important for management to minimize the perceived risk associated with its future growth.

The degree of risk associated with an investment can be measured. If you have taken a class in statistics, you may remember that the probability of a return on investment can be shown by the normal bell-shaped curve where the variance and standard deviation (square root of variance) apply. The average or mean is the middle of the bell-shaped curve. A +1 to −1 standard deviation covers 68.3% of the bell-shaped curve. A +2 to −2 standard deviation covers 95.4%, and a +3 to −3 standard deviation covers 99.7% of the curve. The risk of an investment, therefore, can be measured by its standard deviation. The higher the standard deviation, the more the return varies from the mean—and the higher the risk.

Industry publications, such as Value Line, measure a company’s market-related risk in terms of **beta**. The value of a company’s beta is measured relative to the market. It is assumed that the market as a whole has a beta of 1.0. If a restaurant company’s stock, for example, has a
beta of exactly 1.0, it carries the same market risk as the market index and should offer the same return. In other words, it is likely that its stock price will closely track that of the market. If the market goes up by two points on a certain day, the price of the restaurant’s company stock will likely go up by two points as well. Conversely, if the market as a whole goes down by three points, so will the restaurant company’s stock.

If a resort company has a beta of 1.5 and the market goes down ten points, the price of the resort company’s stock will likely decrease by 1.5 times ten or fifteen points. Conversely, if a hotel management company’s stock has a beta of 0.5, the price of its stock will only react half as much to the market. The higher a stock’s beta, the riskier investors perceive it to be and the more volatile the stock is in both an economic upturn and downturn.

**Private Company Goals**

The goals of a private company are similar to those of a public company, but they are less driven by the earnings estimates and risk measurements of others. A private company’s primary goal is to increase cash flow and generate a favorable return on investment for its owners. Because private companies are not driven by shares held by the public, their metrics are normally not per share but rather the total value of the company. As cash flow increases, return on investment increases, as does the market value of the company.

**Feature Story**

**Lodging Becomes the Face of Marriott**

J.W. Marriott Sr. handed over the corporate reins to his son J.W. Marriott Jr. in 1972. Under the leadership of Bill Jr., Marriott’s lodging division became the company’s public face. Bill focused the company’s attention on the growth of hotels and originated the concept of brands within a brand, now known as market segmentation. The acquisition of Residence Inn, the creation of the Courtyard product, and the franchising of these brands and others led to explosive growth for the company. The Marriott conglomerate split into two companies on October 8, 1993: Host Marriott, which owned most of the real estate, and Marriott International, which owned the franchise rights to all the Marriott brands, the management contracts, and the franchise agreements. Marriott also spun off its food and concession services business in 1998.

The split was conceived to revive the original Marriott Corporation when it became mired in debt resulting from a hotel building frenzy followed by a period of economic recession. Suddenly, Bill Jr. was faced with crumbling stock prices, a takeover scare, and approximately $1 billion of unsold lodging property sitting on his company’s balance sheet. Under the new structure, Host Marriott, the real estate arm, took over about two-thirds of the original corporation’s $2.9 billion of debt, leaving its sister operating company, Marriott International, with a lighter balance sheet, strong earnings, and the flexibility to go after more management contracts. Without a real estate component, Marriott International was also better protected from the cyclical fluctuations of the economy. In addition to solving its immediate financial problems, the split also enabled
Marriott to return to what it did best: management and service. As Bill Jr. put it, “Marriott was (and is) not about debt, real estate ownership, and deals; we’re about management and service.”

Once again focused on management, Marriott International aggressively broadened its product offering by acquiring the Ritz-Carlton Hotel Company and the Renaissance Hotel Group. It also developed new franchisable lodging concepts such as Fairfield Inn and Spring Hill Suites. As a mega-chain, the company was able to leverage its operational expertise to provide a product for each market segment, which made it easier to cross-sell and provide referrals under one management system.

Marriott also diversified into related products such as vacation ownership and corporate housing by acquiring ExecuStay and expanding its vacation ownership portfolio. In both cases, the Marriott brand enhanced its product image and price points.

Bill Jr. also reembraced franchising to spur his company’s growth. Marriott’s previous attempt at franchising during the late 1960s failed due to the failure of top management to embrace the concept and the lack of suitable franchisable products. However, as Bill Jr. pushed for more product tiers, some of the concepts, such as Courtyard, Fairfield Inn, and Spring Hill Suites, that were relatively inexpensive to develop and easy to operate, proved to be ideal for franchising.

Even though the split was controversial at the time, Bill Jr.’s decision to go ahead in spite of the risk of lawsuits from unhappy bondholders proved, in hindsight, the right move. Since the split, the share price for Host Marriott has increased from $5.67 to $18.89, while the share price for Marriott International has skyrocketed from $11.77 to $67.02.

Today, Marriott International is a $14 billion company with over 2,600 lodging properties in sixty-six countries. It operates and franchises hotels under the Marriott, JW Marriott, Ritz-Carlton, Renaissance, Residence Inn, Courtyard, Towne Place Suites, Fairfield Inn, Spring Hill Suites, Ramada International, and Bulgari brand names; develops and operates vacation ownership resorts under the Marriott Vacation Club International, Horizons, Ritz-Carlton Club, and Marriott Grand Residence Club brands; and operates Marriott Executive Apartments. The company also provides furnished corporate housing and operates conference centers.

**Sources**


**Other Benefits of Growth**

In addition to the financial growth benefits that accrue to the owners of a business, sustained and steady growth provides other tangible benefits for the company as well.

**Provide Career Paths for Employees**

Steady, sustained growth in the number of properties a company owns or manages provides clear career paths for its employees. As employees see their colleagues rewarded with promotions to more challenging and higher-paying positions, they are motivated to try harder to succeed. When
employees can clearly see a promising career path ahead of them, they are also less likely to seek employment elsewhere. Because employee turnover is expensive for the company, it is important to maintain employee longevity.

**Attract New Qualified Employees**

An expansion in the number of company properties can help attract qualified employees and managers currently employed by other companies who view your company as one that could provide them with a more lucrative career.

**Increase Market Share**

Growth, if managed properly, can increase a company’s market share. Market share is the percentage of demand that a company captures within a defined market area. For example, a restaurant company may elect to grow by adding more stores in suburban areas of a large metropolitan region rather than expanding to new cities. By focusing its growth in one city, its market share in that city grows.

**Limit New Competition**

Focused growth of business units in a particular market can limit new competition by making it more difficult for competitors to enter the market. As demand in a market grows, new supply is attracted to that market. If the new supply is provided by the existing brand, additional competition is not as threatening and the subject brand’s market share grows.

An example of this occurred many years ago in the San Antonio airport area. La Quinta Hotels was enjoying a high occupancy at a favorable average rate at its airport property. The company’s competitors viewed the market as desirable and wanted to expand into it. To prevent this, La Quinta decided to build a second La Quinta hotel right next door to the existing property. This strategic move limited new competition for several years and enabled La Quinta to continue as the market leader.

**Diversification to Reduce Risk**

Rather than focus on expansion in a single city, some companies elect to expand to new markets. The benefit of this type of growth is that it spreads the risk of expansion over several markets. If one market experiences economic problems, growth in earnings in the other markets may balance the overall profitability of the company. Some companies elect to reduce risk by diversifying into new products. The more diversified a company’s product line, the less risk it is likely to incur if a particular product fails to achieve its profit goal. An example of a diversified company is Choice Hotels. Choice franchises numerous brands all across the world, as shown in Illustration 5-1.
Brands
Comfort Inn
Comfort Suites
Quality
Sleep Inn
Clariion
Clariion Collection
Main Stay Suites
Econo Lodge
Rodeway Inn

Geographic Areas
Asia and Pacific (over 400)
Canada (over 200)
Central and South America (over 50)
Europe and Middle East (over 500)
United States and Caribbean (over 3,000)

ILLUSTRATION 5-1
Brands and Geographic Areas of Choice Hotels International

THE REAL DEAL
Many have dined at a Wendy’s and love the Wendy’s choice of fries, baked potato, chili, garden salad, or Caesar salad with a combination meal. However, few may know that Wendy’s also owns or partly owns Tim Hortons, Baja Fresh Mexican Grill, Café Express, and Pasta Pomodoro. Wendy’s has successfully grown its business by merging with or purchasing other restaurants that complement its core mission. With over 6,600 Wendy’s units, 2,700 Tim Hortons, 295 units of Baja Fresh, 19 units of Café Express, and 45 Pasta Pomodoros, Wendy’s offers a lot of dining choices besides burgers. Visit Wendy’s website at http://www.wendy-invest.com for more up-to-date information.

GROWTH STRATEGIES
Hospitality companies can elect to pursue a variety of strategies to achieve and sustain steady growth in earnings.

Increase Sales and Productivity of Existing Properties
A popular growth strategy is to attempt to generate more sales volume with the same number of stores (assets) while maintaining the business’s current profit margin. As sales increase, earnings should grow as well. Higher sales volume can be achieved by either raising the price of products or by selling more products.
McDonald’s Restaurants implemented a creative growth strategy many years ago when it began serving breakfast at all of its restaurants. With the addition of a new meal period, sales volume increased dramatically, as did profits. Today, breakfast is McDonald’s highest-volume meal. A key benefit of this growth strategy is that it does not require new capital to achieve growth in earnings—and as you now know, capital, especially equity capital, can be expensive to secure.

McDonald’s was able to utilize its existing stores and kitchen equipment to prepare and sell the new breakfast items. The only added expense was the cost of the new breakfast items, the labor to prepare and sell them, a little marketing expense to let customers know that McDonald’s now served breakfast, and a few additional dollars for utilities. Another popular fast food growth strategy is to operate restaurants twenty-four hours a day, seven days a week. Once again, as long as the additional sales volume exceeds the additional variable cost, growth in earnings will be achieved.

**Reduce Expenses**

When sales volume stops growing or stabilizes, companies look to cut costs to sustain earnings growth. The goal is to find ways to reduce expenses while maintaining the current level of sales. If this is accomplished, earnings grow even though sales remain static. An additional benefit of cost control is that for every dollar of cost reduction, 100% falls to the bottom line, while in the case of sales growth, expenses required to generate the new sales must be deducted from the increase in gross sales. A good example of how cost control may benefit the lodging industry is the occupancy versus average room rate debate. Which is more favorable, a 10% increase in occupancy or a 10% increase in the average daily rate (ADR) of the hotel? Although mathematically they achieve the same results in terms of revenue, if there is an increase in ADR, you are not selling any extra rooms and thus will not incur costs to clean and maintain those rooms. Therefore, by increasing revenues without increasing expenses, more profits go to the hotel’s net income.

**Labor Cost**

In the hospitality industry, when costs must be cut, the first expense that gets management’s attention is labor cost. Increasing labor productivity becomes management’s short-term goal. Greater productivity can be achieved by improving employee scheduling, reducing expensive overtime, encouraging additional voluntary time off, reducing employee hours, eliminating employee positions, and using more advanced technology. Restaurants also focus on food cost and beverage cost to improve their bottom line. The cost control systems discussed in chapter 2 and chapter 4 can help reduce expenses and increase profits.
MARKETING EXPENSE

Unfortunately, another expense that is usually cut when costs must be reduced is sales and marketing. While the benefits of advertising and public relations are difficult to measure and a reduction in the amount of money spent in this area will increase profits, long-term harm to the property’s profitability and long-term competitive position may result. Customers lured to a competitor are difficult to get back. Saving a few marketing dollars today can lose you hundreds or even thousands of dollars in the long run. We recommend that you carefully analyze the situation before you elect to reduce sales and marketing expense. There are usually better ways to prop up earnings.

CAPITAL IMPROVEMENTS

Another area to be cautious about when making arbitrary cost cuts is capital improvements. While it is sometimes tempting to get one more year out of old carpet, defer the replacement of television sets, or try to repair air conditioning units rather than buying new ones, once a property begins to deteriorate, it can go downhill fast. It is important to keep your hotel or restaurant looking clean and fresh. If guests perceive that your property is not being properly maintained, they will not hesitate to give your competition a chance to satisfy their needs. It does not take long for deferred maintenance to result in lower occupancy, lower average daily rate, and lower earnings.

ENERGY COST AND CREDIT CARD COMMISSIONS

Two areas that are often overlooked when expenses must be reduced are energy conservation and credit card commissions. An effective energy conservation program and the renegotiation of credit card rates can result in significant savings and an increase in profits.

HIGHER LODGING PROFITS

When sales plummeted following the 9/11 disaster, the lodging industry did an excellent job of increasing labor productivity, reducing expenses, and maintaining profit margins. Now that business volume is rebounding, profit margins are increasing dramatically, resulting in record profits for most hotel companies.

Expansion of Physical Facilities

Another popular growth strategy is to increase sales and profits by expanding existing properties, constructing new properties, and acquiring existing properties. As noted earlier, focus can either be on markets currently served by the company or on new markets. While this strategy can
succeed in increasing earnings, it requires large quantities of new capital to finance the growth. In addition, management must make sure that the earnings generated by the additional assets are greater than the company’s cost of capital. If the earnings from the new assets fail to cover a public company’s cost of capital, earnings per share are diluted, which usually results in a decline in the company’s stock price, which consequently reduces shareholder value.

Franchise Brand Rights

Once a company establishes the value of its brand in the marketplace and proves that its brand can travel, franchising the brand becomes another potential growth strategy. Numerous hotel and restaurant companies have learned that franchising can be very profitable. Franchising involves selling the rights to a company’s brand in a specific location or market for a stated number of years. Franchise fees range from a few thousand dollars to $100,000 or more for a premium franchise. In addition, an ongoing franchise royalty is paid by the franchisee to the franchisor each month. The franchise royalty is calculated as a percentage of sales volume. The franchisor also charges the franchisee for ancillary services such as marketing, training, frequent guest programs, hotel reservations, and purchasing fees. Total franchise royalties and other fees charged by lodging brands range from 8% to 10% of rooms revenue. Total franchise royalties and other fees charged by restaurant brands range from 4% to 5% of total sales. For instance, McDonald’s currently charges a 4% service fee, which is a monthly fee based on sales, and a monthly base rent or percentage rent that is a percentage of monthly sales. The fees paid to a hotel franchise company may include the following: franchise royalty (5% of rooms revenue), reservation fees ($5 to $10 per reservation, or around 2% of rooms revenue), national sales fee (2% of rooms revenue), and the frequent traveler program (1% to 2% of rooms revenue).

THE REAL DEAL

Franchising is an exciting opportunity, but it is not an easy process. Many hotel companies are user friendly, giving prospective franchisees valuable online information and providing an email address for further questions. Choice Hotels International has an elaborate website for its prospective franchisees, and Hilton Hotels and Cendant Hotels also offer useful information:

http://www.choicehotelsfranchise.com
http://www.hiltonfranchise.com
http://hotelfranchise.cendant.com

In addition to the financial rewards that franchising offers the owner of a particular brand, franchising also provides the following benefits to branded companies seeking growth:

1. Greater distribution system for both franchise and company stores (units owned and operated by the franchisor)
2. Rapid growth without the need for large amounts of capital
3. Higher profit margins, as the real estate is owned by the franchisee rather than the franchisor and no interest or depreciation expense is charged on the franchisor's income statement

The primary disadvantage of franchising, from the brand's perspective, is the risk of not being able to maintain brand standards or control the quality and consistency of the product and services. To minimize these problems, franchise companies inspect each franchise unit periodically and have the authority to de-franchise a unit if it does not meet brand standards or fails to achieve a passing score on customer satisfaction surveys.

Secure Additional Management Contracts

Another growth strategy, available primarily to lodging companies, is the expansion of management contracts to operate hotels for owners that do not have in-house management capabilities. In addition to the major hotel brands, over 100 independent hotel management companies offer hotel management services. Fees paid to the management company range from 3% to 5% of total sales plus an incentive fee based on a percentage of gross or net operating profit.

As in the case of franchising, securing contracts to manage hotels for other owners can be lucrative. A typical annual management fee for a 300-room full-service hotel ranges from $300,000 to $400,000 with no capital investment on the part of the management company. In addition, all costs associated with the management of the hotel, including employee wages and management salaries, are handled by the hotel owner, not the management company.

The primary disadvantage of growing a lodging company via management contracts is the risk of the contract being terminated. Many management contracts have a termination-on-sale provision that allows the owner to cancel the management contract if the property is sold.

THE REAL DEAL

While some businesses diversify in order to grow, McDonald’s stays true to its original mission of providing high-quality food and thus guaranteeing customer satisfaction anywhere in the world. A McDonald’s burger is of the same high quality whether someone purchases it in the United States, China, or Russia. Will McDonald’s ever explore other ventures? This may be a question for the future. For now, McDonald’s is using international connections such as basketball star Yao Ming of the Houston Rockets to do commercials that appeal to its Asian market, specifically China, Vietnam, and Korea. As the ad reads, “Trying to steal the ball from me is tough. Trying to steal my Chicken Selects is even tougher!”

Management contracts with the major hotel branded companies like Marriott, Hilton, and Starwood also include the franchise rights to their brand in addition to the management of the
Mergers and Acquisitions of Competitors

Once a public company reaches a certain size and has access to substantial amounts of capital, the merger and acquisition growth strategy becomes another option for the company to pursue. In the case of an acquisition, the purchasing company has the option of financing the purchase with debt, existing equity, selling new shares of stock to raise new capital, or using its stock as barter to acquire the company that is for sale.

Both the lodging industry and the foodservice industry have witnessed major mergers and acquisitions over the last several years. Illustration 5-2 highlights some of these transactions.

Going Public

The ultimate growth strategy, and the dream of most small business owners, is to go public someday and take part in an initial public offering (IPO) of its stock. As a company grows, becomes profitable, and requires more and more capital for growth, there comes a time when ownership must decide whether to take the company public or sell it to the highest private bidder. The decision of whether to take the company to the next level by going public, or simply cashing out, is not an easy one to make.
VALUING THE COMPANY

Before making this major decision, owners should first estimate how much they think they could sell the company for today and then compare that price with the company’s potential value in a few years, assuming it goes public and accelerates its growth curve. If the difference is significant and the owners believe they are up to the challenge, an IPO should be seriously considered.

One of the biggest misconceptions people have about going public is that you do so to cash out. All investment bankers will tell you just the opposite. If you are fortunate enough to be in this position someday and are looking to cash out, simply sell your company privately. The purpose of taking a company public is to raise a large amount of new capital to accelerate future growth. If you want to cash out, you should not attempt to go public.

If a company is private, it can command a sales price that is normally based on a multiple of its annual cash flow. The multiple varies based on the type of business but usually ranges from nine to twelve. For example, if a company’s annual cash flow is $1 million, it would sell for between $9 and $12 million. On the other hand, if the owners are patient, management dedicates itself to growth, and an experienced investment banker is hired to orchestrate the public offering, the value of the company could, in a few years, be worth several times more than it is today.

THE IPO PROCESS

While going public sounds exciting and can be lucrative to everyone involved, owning and managing a public company is much different than owning and managing a private company. A public company is just what the term implies—public. Everything from management salaries to the company’s profitability to lawsuits filed against the company is available for public viewing.

Here is how the process of going public works:

1. The company hires an investment banking firm. The firm manages the process of going public and charges approximately 5% of the amount of capital raised as their fee.

2. Next, a law firm is hired to help write the prospectus. The prospectus tells the company’s story. It clearly describes the corporate business plan and growth strategy, and it explains why an investor should buy its stock versus the other stocks available. This is what’s referred to as an out-of-pocket expense. The company is obligated to pay the law firm’s fee before the new capital is raised.

3. Next, the company hires an accounting firm to prepare certified audits for the company’s prior three years of operation. This too is an out-of-pocket expense. Nobody said that going public was inexpensive. In fact, a company normally ends up spending up to 10% of the capital raised in out-of-pocket expenses.
4. Once the prospectus is drafted, it’s time to plan the road show. A road show is a coast-to-coast whirlwind journey with the investment banker, chief executive officer, and chief financial officer to meet prospective institutional investors and retail stockbrokers to sell them on the merits of the public offering. In many cases, the CEO and CFO have only ten minutes to tell the company’s story and get the prospective buyer excited about buying the stock.

5. After the road show, it’s time to price the offering and finalize how much of the company the existing owners are willing to sell to the public. The investment banker helps make this important decision based on feedback from the institutional investors during the road show.

6. Once the stock is priced, the owners meet with the management of the stock exchange selected to make a market for the stock.

7. When the bell rings, signifying that the stock exchange is open for business, the company has officially gone public.

**Working with an Investment Banker**

The role of an investment banker in the IPO process is twofold. First, the banker helps value the company, establishes a price for the stock, and manages the selling process. The selling process includes preparing the prospectus, making sure it is in compliance with all the security regulations and laws; marketing the prospectus to potential buyers; and arranging for a syndication of investment bankers to expand the marketing effort, if required. The second duty of the investment banker, and probably the most important one, is to maintain a market for the company’s stock once it is offered for sale so the stock not only gets off to a good start but enjoys a steady rise in price over time. The investment banker accomplishes this by promoting the company’s stock to its clients and by purchasing stock for his or her own account when trading activity is low. Generally, the higher the daily trading volume of a stock, the more likely it is the stock will increase in price.

**Being a Public Company**

Once a company is public, everything management does or does not do is open to public scrutiny, praise, and criticism. As a public company, management is required to file extensive quarterly and annual reports with the SEC. Management is also required to deal regularly, sometimes several times a day, with Wall Street research analysts who follow the company’s stock and attempt to predict how many cents per share of EBITDA the company’s next quarter will yield to public shareholders. Management is also now required to report to a board of directors at least four times a year and hold an annual stockholder’s meeting to answer any questions shareholders may have, even if they own only one share of the company’s stock.
Managing a public company is significantly different than managing a small start-up company. As the chief executive officer of a public company, you have one goal and one goal only: to increase shareholder value. If management is successful in achieving this goal and can meet or exceed Wall Street analysts’ projections of the company’s EBITDA each quarter, the rewards will be significant.

The Securities and Exchange Commission

All public companies are regulated by the SEC and therefore must comply with its rules and regulations. The SEC was established in 1934 to enforce the Securities Act of 1933 and the Securities Exchange Act of 1934. These laws were designed to restore investor confidence in the capital markets by providing more structure and government oversight after the stock market crash of 1929. The first chairman of the SEC was Joseph P. Kennedy, the father of President John F. Kennedy.

Equity Markets

Equity markets are stock exchanges where the public can buy and sell shares of stock. Although the markets discussed below also deal with public debt securities, the discussion in this section focuses strictly on equity issues. The two main public equity markets in the United States are the New York Stock Exchange (NYSE) and NASDAQ.

The most notable stock exchange in the United States is the NYSE. It is a corporation managed by a board of directors that monitors and oversees the activities of the stock exchange, its members, and the companies whose stock is traded on the exchange. The NYSE was founded in 1792 and originally comprised twenty-four securities brokers. A fixed commission was charged by each broker whenever a stock was bought or sold. In 1850, a seat on the NYSE cost $1,000. Today that same seat costs about $2.2 million. Only those who have a seat on the exchange can do business and trade. The NYSE has created a market for securities trading. This market comprises listed companies, individual investors, institutional investors, and member firms. It is a place where buyers and sellers meet and conduct business in an organized fashion under the rules of the SEC. On average, over 1.4 billion shares of stock are traded daily at a value of over $45 billion.

NASDAQ was founded in 1971 and originally stood for National Association of Securities Dealers Automated Quotation. Today, SDAQ is its official name. Although the business and goals of NASDAQ are basically the same as those of the NYSE, all of NASDAQ’s transactions are transmitted over a telecommunications network. There is no physical address for NASDAQ. Today, NASDAQ is the largest electronic market in the United States, processing about 1.8 million transactions per day.
Finance in Action

Analyzing Goldtown

Mr. Perry Silverton is a financial analyst who specializes in the casino segment of the hospitality industry. Forty-eight states currently allow various types of gaming, such as riverboat casinos, Native American casinos, lottery, bingo, and pari-mutuel gambling. Mr. Silverton is specifically interested in publicly traded land-based and riverboat casino operations. Only a few major players operate in the world because the industry has undergone a period of many mergers and acquisitions.

People depend on Mr. Silverton’s analysis of the casino market on a daily basis to determine whether they should buy or sell stocks in any particular company. One of the unique features of casino operations is that the majority of revenue is generated on the casino floor and not from rooms or food and beverage. This also means that casinos have to operate with a great deal of working capital because the nature of their business is dealing in cash.

Mr. Silverton is currently analyzing one of the smaller casino companies, Goldtown Casinos, Inc., which operates riverboat casinos in four states and has slightly over 10,000 employees. Goldtown Casinos, Inc., has 25.34 million shares of outstanding common stock, a current sales price of $22.55, an annual EBITDA of $204,345,000, and a beta of 9.5.

Questions

1. Calculate Goldtown’s shareholder value, earnings per share, and multiple.

   Shareholder Value = Current Market Price of Common Stock × Number of Outstanding Shares of Common Stock
   OR
   $ 620,830,000 = $22.55 × 25,340,000

   Earnings per Share = EBITDA ÷ Number of Outstanding Shares of Common Stock
   OR
   $ 8.06 = $204,345,000 ÷ 25,340,000

   Multiple = Current Market Price ÷ Earnings per Share
   OR
   2.8 = $22.55 ÷ 8.06

2. If the overall casino industry has an EPS of $1.5, how does Goldtown Casinos’ EPS compare?

   Because Goldtown Casinos has an EPS of $8.06, it is faring better than the overall industry and can produce $8.06 in earnings per share of common stock, while the industry is only able to produce $1.50 per each share of common stock.
3. Analyze Goldtown's beta and what this number means to a potential investor.

Goldtown has a relatively high beta of 9.5, which indicates an overall higher risk than the market. If the market goes down 1 point, Goldtown is likely to go down 9.5 points; however, on the upside, if the market goes up, then Goldtown's stock should increase 9.5 points.

WHERE WE'VE BEEN, WHERE WE'RE GOING

Growing the business is a must for any operation to continue to be successful. Growth provides financial rewards to its shareholders and other benefits and advantages to its management and employees. Growth in the hospitality industry can be achieved through expansion of physical facilities, franchising, management contracts, or a combination of these strategies. The key is to select the strategy or combined strategies best suited to your business. Once you select a growth strategy, your next step is to secure the capital required to finance the growth. Should you invest more of your personal equity, borrow the funds, or raise additional equity from outside investors? We examine these options and the costs associated with each one in the next chapter.

Key Points

➤ A company must demonstrate consistent growth to be successful. It does so by increasing the wealth of its shareholders.

➤ The goals of a public company are to increase current earnings per share, to increase the company's stock multiple, to increase projected earnings per share, and to increase the market price of the common stock. The goals of a private company are similar because they are also profit driven. Private companies look at the total value of the company in terms of increasing profits, increasing cash flow, and increasing its return on investment. All these increases cause the company's market value to increase as well.

➤ The relationship between earnings per share (EPS) and the current market price of a company's common stock is referred to as its multiple. The multiple is calculated by dividing the current market price of a company's common stock by its earnings per share. The higher the earnings per share, the higher the multiple.

➤ The benefits and advantages of growth in a company include providing career paths for employees, increasing market share, limiting new competition, and diversifying in an effort to reduce risk.

➤ The growth strategies available to companies include increased sales and productivity, expanding physical facilities, franchising brand rights, securing additional management contracts, merging or acquiring companies, and going public. Each of these strategies has advantages and disadvantages.
Key Terms

SHAREHOLDER VALUE: For a public company, the current market price of its common stock multiplied by the number of shares of common stock outstanding; for a private company, the price the company could be sold for on the open market.

MARKET VALUE: The number of shares of common stock outstanding multiplied by the current market price of one share of a company's common stock.

EBITDA: Earnings before interest, income taxes, depreciation, and amortization.

EARNINGS PER SHARE: EBITDA divided by the number of shares of common stock outstanding.

MULTIPLE: The current market price of a company's common stock divided by its EPS.

BETA: Indicates the risk of an investment relative to the risk of the market.

DILUTED: Reduced earnings per share.

COMPANY STORES: Units owned and operated by a franchisor.

INITIAL PUBLIC OFFERING (IPO): Where stocks of a company are sold to the public for the first time.

Application Exercises

1. Compare and contrast the goals of a public company with those of a private company.
2. Name two incentives for companies to grow their business rather than maintaining the status quo.
3. Define the term risk and explain why a company needs to balance risk and return.
4. This chapter discusses six strategies for increasing sales and productivity in order for a company to grow. Describe three of the six strategies and comment on the pros and cons of each one.
5. Consider franchising versus mergers and acquisitions. Which is a better strategy for growth? Please explain.
6. What are management contracts, and how would they help a company grow? Is this a risky proposition?
7. List the steps required when a company goes public.
8. How can an investment banker help or obstruct the process of taking a company public?
9. ETHICS ✶ One of the major expenses in the hospitality industry is the cost of energy. At one point in the last few years, a surcharge was added to hotel folios to cover the increase in energy cost. Do you think this is an ethical or sound business practice? What would you do if you were the manager of a 400-room spa resort? Propose three strategies to combat increased energy cost without passing the cost to the guests in the form of surcharges.
10. EXPLORING THE WEB ✶ Based on the websites mentioned in this chapter and on other websites you may find, choose one company you would want to open a franchise with and explain the financial rationale behind your choice.
The Case of Expansion for Brownstone

The Fillis Bistro, operated by Brownstone Restaurants, Inc., is a fine dining restaurant that caters to those with discerning taste. The executive chef was trained in France and only uses the highest-quality organic ingredients. He even grows his own herbs in a garden behind the restaurant so he can serve the freshest food possible.

Restaurant sales for the Fillis Bistro have leveled off over the last couple of years, and Brownstone is trying to determine the best method for expanding the business. Management has discussed several ideas for expansion, including increasing off-premise catering sales, opening a second operation, and scrutinizing costs to cut back expense, but they cannot agree on anything.

Brownstone Restaurants, Inc. owns and operates over 20 restaurants on the east coast of the United States. These restaurants include The Fillis Bistro, 6 Mexican restaurants, 5 Chinese restaurants, and 8 Greek restaurants. All of the restaurants are operating at optimal levels and reaching budgeted financial projections.

Questions

1. Utilizing the information covered in this chapter, list all growth options available to Brownstone Restaurants, Inc.
2. Analyze each expansion option and discuss the positive or negative impacts they could have on the restaurant’s operations.
3. Which expansion option would you recommend to Brownstone Restaurants, Inc. and why?

Private or Public for Tranquil Hotels

Tranquil Hotels Co. specializes in developing resorts and spas for busy people who are always on the go and need to relax. Each location is specially chosen for the beauty of its setting, the ambiance of the city, and the ease of arrival for its guests. Tranquil Hotels are located all over the world in countries like France, Brazil, Greece, Italy, and many other locations. The company’s mission is to “provide our guests with the most relaxing experience that they would find at any place in the world.”

Tranquil Hotels Co. has hired a consultant to analyze its business and determine if the company should remain privately held or go public. The company has experienced an influx of business from U.S. travelers over the last couple of years. U.S. employees tend to work very hard, so when they have time off to relax, they want to get away from everything, and Tranquil
Hotels is the perfect place. Management believes there is a big market for their resorts and the best option for expansion is through an IPO. Last year, the company's cash flow reached nearly $7.5 million. Overall the company has been enjoying annual cash flow increases of 5%.

**Questions**

1. What price range would you currently assign to Tranquil Hotels Co. if you were to sell it as a private operation?
2. Describe the IPO process the owners would need to go through if they decided to take the company public.
3. If you were an owner, would you go public? Why or why not?
4. If the owner is considering getting out of the business, should he or she take the company public? Why or why not?