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# Barriers to hotel chain development in China

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## Keywords

Hotels, Development, Hotel and catering industry, Market economy, China

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## Abstract

This paper is based on findings from a two-year MPhil research project that aimed to examine the development of hotel chains in China since 1978 and to recommend policy and operational guidelines for their further expansion. The study confirmed the unique nature of the hotel industry in China, existing as it does in a country moving from a centrally planned economic system that is strongly influenced by communist dogma towards a Western-style market economy. This paper identifies and discusses four main categories of barriers to chain development, namely: economic and political systems; hotel ownership; hotel management capability and resources; and competition between local and foreign firms. Massive growth in China's hotel industry is forecast, and this presents a great attraction for hotel companies. However, the need to understand and appreciate these barriers is recommended to any company, local or foreign, contemplating doing business in this unusual but potentially very large market place.

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## 1. Introduction

By the year 2020 China will become the world's number one tourist destination, with annual arrivals of 130 million (WTO, 1999). This is quite an incredible statistic when one remembers that China's international tourism industry only started in 1979 as a result of the Open Door Policy.

In 2001 China had 33 million tourist arrivals spending US\$17.8 billion (CNTA, 2002). The stock of hotels in 2000 stood at 10,481, with a total of 948,185 rooms (CNTA, 2001). China's stock of hotels will need to expand and upgrade very significantly to serve its potentially massive market in line with the expected growth of international arrivals, plus increasing domestic tourist demand (Pine, 2002a, b).

China's own increasingly affluent population is also traveling more and more within the country, adding to the need for additional hotels. Affluence has resulted from continual average annual economic growth in China of 9.8 per cent between 1979 and 1997 (State Statistics Bureau, 1998). The dynamic economy stimulates more business travelers. Changes in government policies have also loosened travel restrictions, introduced a strict five-day working week and three weeks of annual holidays, swelling the already massive leisure tourism movements. This resulted in a total of 784 million domestic travellers in 2001 with revenues of around US\$40 million (CNTA, 2002).

Firms have a variety of inducements to expand, but also external and internal difficulties to overcome in expansion. Such difficulties create conditions enhancing or restricting the profitability or practicability of expansion. Limitations might include managerial ability, product or factor markets, and uncertainty and risk (Penrose, 1995). In addition to these general factors, the barriers to hotel chain growth in China have some particular aspects, which influence not only the development of indigenous hotel companies, but also expansion by multinational hotel corporations.

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The global hotel industry is dominated by hotel chains. In 1998 there were a total of 15.4 million rooms in hotels and similar establishments throughout the world (WTO, 2000a, b). In that same year over five million rooms were controlled by just the top 300 hotel chains, and 2.7 million by the top ten alone (Hotels, 1998). Given this situation, it is not unreasonable to speculate that a significant part of China's future hotel industry will be in the form of hotel chains.

This paper will look at barriers to such development within four main areas:

- (1) economic and political systems;
- (2) hotel ownership;
- (3) management capability and resources; and
- (4) competition between local and foreign chains.

## 2. Methodology

The research was undertaken in three stages. First, a comprehensive literature review was undertaken to understand the concepts of hotel chains; then, secondary data were collected and analyzed to describe hotel chain development in China; finally, primary data were collected to further explore chain formation.

For primary data the case study approach was employed to examine several hotel chains and independent hotels in three of China's gateway cities. Qualitative methodology was deemed more appropriate, as it emphasizes processes and meanings that cannot be rigorously examined or measured in terms of quantity, amount, intensity, or frequency, and it seeks to answer questions that focus on how social experience is created and given (Denzin and Lincoln, 1994).

After an extensive literature review and examination of secondary data, a research instrument for use in in-depth interviews was developed. Both closed- and open-ended questions relating to hotel chains and independent hotels were used during interviews to obtain extensive insights into hotel chain formation and expansion in China. Of all the qualitative methods, the in-depth interview may be argued as being the most powerful tool to gain insights into the socially constructed realities of individuals (Kvale, 1983;

McCracken, 1988). By using the in-depth interview, the interviewees are introduced to the topic through general questions. Then through probing and prompting of interviewees for deeper descriptions (Howe, 1985) the interviewer could understand replies from their respondents' perspectives and then interpret them for contextualization. In April 1999 pilot testing of the interview questions was conducted in Beijing with three local and two international groups plus the Department of Industry Management of the China National Tourism Administration. Subsequently, two final instruments were developed; one for chain hotels and one for independent properties. (The complete question lists are reproduced in the Appendix.)

### 2.1. Hotel management companies survey

Of the 39 hotel management companies in China at the time of the research, ten companies in the gateway cities of Beijing, Shanghai and Guangzhou were selected for interview. These three cities were the earliest to start the modern hotel industry in China and have a relatively higher standard of development. More importantly, most hotel chains are headquartered in these three cities, using them as a base for expansion. The criteria of selection of companies were their size, portfolio and location of hotels in China, management style and ownership to try and ensure that all possible types of hotel management companies were included. The Guangdong Provincial Tourism Administration was also interviewed.

### 2.2. Independent hotels survey

Each of the three target cities has more than 100 hotels, most being independently operated. Several hotels in each city were selected for in-depth interview to explore the major factors and problems of independent hotels joining hotel chains. The major considerations in selecting hotels were their star level, ownership, location, business type, history, and the need to cover all types of hotels.

## 3. Findings

The combination of literature review, secondary data and interview findings indicated

four main categories of barriers to chain development, namely: economic and political systems; hotel ownership; hotel management capability and resources; and competition between local and foreign firms. These four areas will be discussed in the following sections.

### 3.1. Economic and political systems

#### 3.1.1. *Paradox of a transitional economy*

Since 1978 China has adopted an opening and reforming policy to gradually transform towards a market-oriented economy. This kind of reform created a better business environment for hotel development; even the investment in and management of hotels were a reflection of this reform. However, China has not yet finished its economic transition and remains a mixed economy system, where market principles and the central planning system interact and conflict. Although China is in a period of transition from planned to market economy, state-owned hotels are still obedient to the traditional administrative system. State hotels, which account for the great majority of hotel rooms, belong to different government bodies and administrative departments and their ownership is very complicated. They are not actual firms and cannot act like a commercial business. Even though the government has conglomerated some hotels, they still cannot break the barriers of ownership and protectionism to generate market competitiveness.

Until recently, overseas involvement in China's hotel business, whilst encouraged and supported by the state politically and financially, was still under government control. However, China's entry to the World Trade Organization has effectively removed such controls and exposed the local industry to extensive penetration by and competition from foreign companies. China will lose the ability to control the activities of overseas companies within its own borders.

#### 3.1.2. *Government intervention*

Government officials heavily influence the hotel industry, and may interfere with actual hotel management and operation (Tisdell and Wen, 1991). Too much bureaucratic control over hotels may cause a waste of resources, low efficiency and a lack of innovative entrepreneurs

(Yu, 1999), while preventing the growth of hotels and hotel companies. For example, a typical phenomenon in China is local protectionism, when the government of one region bars investment and commodities from other regions into its territory. These policies greatly affect an indigenous hotel company; it is easier for foreign companies to establish a nation-wide presence.

#### 3.1.3. *Policy restriction and interest groups*

There are also policy restrictions and interest groups influencing hotel chain formation. The current regulations limit the free flow of state-owned assets in the market. As state-owned hotels are invested by different government agencies with various interests, most hotels are difficult to incorporate into chains. It is also difficult for existing chains to handle these hotels. For example, the China Post and Telecom Tourism Group is a holding company created by the Ministry of Information Industry (MII) to manage all MII hotels. However, most of these MII hotels are owned in the name of local bureaux, and, during the course of re-organization, there are constant conflicts to shift these assets to the holding company. Different government bodies control hotel assets, and they are seldom willing to give up the right of control that brings them benefits, even though some hotels are losing money. Reform of some basic disciplines of regulations is still needed to create a better business climate for hotel chain development in China.

#### 3.1.4. *Lack of motivation and drive*

Traditional firms are conservative in ideology and new ideas, and lack vitality and sensitivity to changes in the environment and market. They are still backward in internal management and decision-making mechanism. Hotels belonging to government departments rely heavily on the political administrative system to form chains rather than the market mechanism. This mechanism is distorted in China in this transition period. Some firms cannot compete freely in a normal business environment, because government "owners" interfere from a non-business perspective (e.g. influence recruitment, choice of suppliers, etc.).

Market economy approaches have been tolerated for only a few years in China, and have

only recently been encouraged. Hence appreciation and actual utilization of market economy mechanisms are far from mature. The administrative system of the planned economy is being dismantled step by step, while the market mechanism is not yet fully established. Some “firms” cannot be considered as a firm and cannot act like a firm in the existing non-market environment. Also existing obstacles raise their transaction costs, e.g. local protectionism and monopoly by some industries.

### 3.2. Hotel ownership

#### 3.2.1. Complexity and diversity of hotel ownership types

The issue of ownership and control over assets and operations is one of the central problems in the negotiation and subsequent use of hotel-management or partnership agreements (Saunders and Renaghan, 1992), especially in China, where hotel ownership is quite complex. In the “Seventh five-year plan” (State Planning Commission, 1986-1990), a policy called “bringing into play the five sectors” was implemented to attract more capital, which meant that State, departments, collectives, and private capital owners were all encouraged to invest in the hotel and travel industry (He, 1992). This resulted in the intended acceleration of hotel development (Liu and Liu, 1993), but the complicated ownership resulting from decentralization led to a severe lack of coordination in decision making in hotel construction (Tisdell and Wen, 1991).

#### 3.2.2. Dominance of the state-owned hotels

Decentralization resulted in a variety of different types of hotel ownership (Tisdell and Wen, 1991), now totaling nine different categories, i.e. state-owned, collective, private, alliance, share-holding co-operative, limited liability, limited liability shares, foreign-invested, and Hong Kong-, Macau-, and Taiwan-invested (CNTA, 2000, p. 92).

However, state ownership is still the dominant mode, accounting for 64 per cent of total hotels and 61 per cent of total rooms (CNTA, 2000). State ownership can cause many problems for chain affiliation, leading ones being failure to separate hotel

management and ownership (Tisdell, 1990) and lack of effective monitoring of state assets.

Du and Dai (1998) analyzed the behavior of the state-owned hotels that restrict chain operation and found that:

- the non-commercial objectives of the state-owned hotels restrict their renovation; the owner or its representative worries about losing benefits during the course of chain operation;
- the pressure of the vested interest group, including employees, retired employees, etc.; and
- ineffective monitoring of hotel management companies after contracting hotels to the management party.

It seems that hotel chain formation in China should start from the change of the ownership system. Wang (1998) suggested that an ownership trading market should be established, leading to restructuring of the assets of Chinese hotels (Xu, 1998; Wan and Hu, 1998).

#### 3.2.3. Comparison between different ownership types

Overseas-invested hotels have better performance than other hotels, as reflected in higher occupancy rates and higher annual average revenue per room of foreign-invested and Hong Kong/Macau/Taiwan-invested properties (Pine, 2002b). This is generally because overseas-invested hotels are usually operated by multinational hotel corporations according to the rules of market economy and international business practice.

Most state-owned hotels lack strategy in management; they pay more attention to the daily operation and management procedures, but neglect branding, corporate culture and innovation and, most importantly, the effective use of capital in the market.

### 3.3. Hotel management capability and resources

#### 3.3.1. Managerial capacity

As the hotel industry in China is a comparatively fledgling one, most local hotel chains are new players in the market and are still weak in providing satisfactory service to their client hotels. Many standard international business practices are unknown or unfamiliar

within China (EIU, 1989). For example, strategies and expertise, such as standardization, branding, ecology programs, frequent guest programs, and strategic alliances are still new concepts. Information technology is another weak point with only one indigenous chain having an online real-time reservation system. Zou (1998) specified four severe problems of Chinese hotel chains: lack of marketing network and reservation system; lack of hotel managerial expertise; problems of the capital market and loans; and protectionism of local authorities.

The weakness of the environment for the Chinese hotel chain development made it difficult to get contracts from individual hotels and to expand. Most Chinese hotel owners would prefer self-management rather than contracting hotel management to an incapable party.

### 3.3.2. *Resources for Chinese hotel companies*

Improvement of management skill and the service provided by hotel management companies are key factors for chain growth and expansion. Further market segmentation and establishment of a central reservation system are major concerns of China's lodging industry (Yu, 1992). According to Horsburgh (1991), a hotel company should use its resources to develop its assets, core competence, knowledge, and the ability to learn to create and sustain a critical competitive advantage for hotel development, such as superior knowledge of brand management, real estate development, operation of management contracts, and franchising. The lack of necessary resources (e.g. human resources, capital, management expertise) makes it difficult for Chinese hotel chains to create their organizational capability.

## 3.4. Competition between foreign and local hotel chains

### 3.4.1. *Presence of foreign hotel companies*

As globalization is an obvious trend, most giant hotel chains have expanded to China, attracted by its rapid economic growth and tourism development potential (Wise, 1993). Among the world's top 300 corporate chains ranked by *Hotels* (1999), about 10 per cent have entered China, e.g. Hilton, Hyatt, Six Continents, Shangri-la, Marriott, Accor,

Club Med, Days Inn and some mega-chains like Starwood and Cendant.

The brands that already have a presence in China are in the higher category of hotels, mainly four- and five-star. Many of the brands held by these companies have not yet entered China, but they represent the diversity of operations and different market level experience of these companies. This is especially important in the budget market, two-star and below hotels, which will prove to be the biggest sector of China's hotel industry and for which there is already a latent demand from increasingly affluent and mobile domestic tourists – 784 million domestic travellers in 2001 with revenues of around US\$40 million (CNTA, 2002). Many hotel chains have set China as a strategic target for their future growth and have increased their stocks in this market.

Joint venture hotels account for only 10.22 per cent of the hotels and 15.75 per cent of hotel rooms, but generate 31.78 per cent of the total hotel revenue in China (CNTA, 2000). Most of the joint venture hotels are managed by multinationals, while state-owned hotels have a worse performance in terms of room occupancy and average room revenues, as discussed previously.

### 3.4.2. *Advantages for foreign companies*

In China, the advantages of chain operation by international hotel management companies are significant. Once a hotel stops its contract with the chain, business is affected greatly. For example, Starwood's distribution channel generates 60 per cent of its hotels' revenues (Wang, 1998). China's hotel management companies are small in scale and unable to fulfill the potential advantages of chain operation. Most of the four- or five-star hotels are operated by international hotel chains, while local chains mostly operate three-star and below hotels (Shi, 1997). The most competitive advantages of multinational hotel corporations over local chains are economies of scale, management expertise and technology, especially networking by their distribution channels and centralized reservation systems, which can directly lead the overseas tourists to chain hotels. In addition, foreign hotel chains entered the Chinese market earlier and dominated the market, enjoying favorable

policies set by the Chinese government (EIU, 1989).

Competition between multinational hotel corporations and indigenous hotels is not fair, as foreign-invested hotels enjoy more preferential policies and treatment than indigenous hotels in taxation, tariff, foreign exchange, pricing, human resources policies, etc. This is an important reason why many investors seek foreign partners for joint venture and hire a foreign hotel management company.

#### 4. Conclusions and recommendations

There is no doubt that the hotel industry in China will need to grow, and grow significantly. China's entry into the World Trade Organization should open the door fully to foreign hotel companies, and these hotel companies are looking to the very significant growth potential in China. As most of these companies, especially the giant ones, involve the business formats of management contracting, franchising or consortia, they need to continue getting bigger to provide a meaningful increase in company revenues. China is a very obvious target for their necessary expansion.

At the same time hoteliers within China are making great progress in adapting overseas hotel-operating and business concepts, and initiating their own ideas. Local companies have learned a great deal by studying how foreign companies work within China. This process of technology transfer (Pine, 1992) started with attention to the physical facilities and service standards needed to match international hotel offerings. Attention was then given to the different management and business techniques used by foreign companies. Finally local companies are now adapting hotel facilities and business formats to the particular needs and advantages of the China environment. In addition to being able to match foreign companies in these three areas, local companies benefit from having excellent knowledge of the internal workings of the Chinese political, regulatory, financial and social systems.

With China's increasingly important role as a major destination for international travelers,

and with its own internal growth in domestic travelers, there is no doubt that vast expansion will be needed in hotel provision throughout the country. Much of that expansion will be achieved by the growth of existing local and international hotel chain companies as well as the creation of new ones, but an awareness and appreciation of the potential barriers to such expansion are crucial for the success of both local and foreign hotel companies.

In principle the formation of hotel chains appears to be a logical way to develop and advance China's hotel industry, but care must be taken to fully understand and appreciate the full range of consequences and possibilities before fully committing to that direction.

The following considerations are recommended:

- ensure that any policy for chain development creates the most appropriate formats within the peculiar China context;
- be fully aware of the intensely competitive business environment that exists, which is dominated globally by giant hotel companies; and
- appreciate the national and organizational differences in culture that determine differences in behavior and expectations of domestic travelers, hotel staff and, especially, the large variety of types of owners.

Understanding and appreciation of such differences are crucial for any foreign company considering entering the China domain.

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## Appendix. Interview questions

### Questions for hotel management companies

- (1) Can you briefly describe the origins and historical development of your company?
- (2) What is the current situation of your hotel management company in terms of:
  - (a) size; (b) speed of expansion; and
  - (c) performance?
- (3) What drives your company to expand and grow – internal and external factors?
- (4) *Environment issues:*
  - Do you scan the business environment when expanding? If you do, what factors influence the growth and expansion of your hotel management company?
  - How do government policies and regulations influence hotel chain development?
  - What could be improved in the environment for hotel chain development?
  - How do you evaluate the competition between hotel management companies?
  - How do you evaluate the competitiveness of Chinese hotel management companies vs. foreign hotel management companies?
  - What do you think about the impact of China's WTO entry on hotel chains?

(5) *Ownership and mechanism:*

- What is the ownership type of your company?
- How is the decision made for such an ownership system?
- How does the ownership type affect the growth and expansion of your chain?
- Are management rights separated from the ownership? Why or why not?
- Which type of hotel would you like to manage? Why?

(6) *Formation issues:*

- How do you expand, e.g. direct investment, merger/acquisition, management contract, franchising, consortia, referral system, or any other?
- Why do you use that form of expansion?

(7) *Management and operation issues:*

- Do you have a management model or management style in your company? If yes, can you describe it?
- How do you look upon branding for hotel chains? Do you have a branding strategy? If yes, what is your branding strategy?
- How do you finance chain development?
- How do you operate and manage your hotel management company?
- How about the application of technologies in your hotel chain?
- How do you manage the individual hotels in the chain?
- What are the factors influencing independent hotels joining your chain?
- How is the effectiveness of your management in those hotels? What are the major achievements and barriers?

- What are the advantages and disadvantages of your company?

(8) *Strategy issues:*

- What factors influence the future expansion and growth of your company?
- What are the future development plan and strategy of your company?

**Questions for independent hotels**

- (1) Briefly describe your hotel: its history, investment, facilities and performance?
- (2) Are you willing to join a hotel chain? Why or why not?
- (3) How is the business environment of your hotel – internal and external?
- (4) How do you compare the differences between chain-operated hotels and independent hotels?
- (5) What are the major considerations in joining chain operation?
- (6) If joining a hotel chain, what considerations are used to choose a hotel management company?
- (7) Which way would you choose to join a chain, e.g. direct investment, merger/acquisition, management, franchise, consortia, referral system? Why?
- (8) What are the emerging issues in the operation and management of a hotel after joining a chain? Why is that important to your business?
- (9) How will you deal with the relationship with the hotel management company after they take on management of your hotel?
- (10) What would be the main influence on your hotel to join a chain?
- (11) What are the major difficulties or problems for your hotel business?
- (12) What is the plan or strategy for your hotel's future development?