

Hospitality Review

Volume 10

Issue 2 *Hospitality Review* Volume 10/Issue 2

Article 6

January 1992

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Recommended Citation

Strick, Sandy K.; Montgomery, Rhonda J.; and Grant, Charlotte (1992) "Restaurant Service for the 90's," *Hospitality Review*: Vol. 10 : Iss. 2 , Article 6.

Available at: <https://digitalcommons.fiu.edu/hospitalityreview/vol10/iss2/6>

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Restaurant Service for the 90's

Abstract

Much has been written about servicing the customer. In fact, every issue of Restaurants USA or Nation's Restaurant News offers an article designed to help restaurateurs more successfully service their customers. While the restaurant market has carefully zeroed in on the specific products and services customers require, no one has carefully addressed the heart of the issue. The authors discuss the "hospitality" in restaurant service.

Keywords

Sandy K. Strick, Rhonda J. Montgomery, Charlotte Gant, Restaurant Service for the '90s, Hospitable, CARE, Dissatisfied Customer

Restaurant Service for the '90s

by
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and
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and
Charlotte Gant

Much has been written about servicing the customer. In fact, every issue of Restaurants USA or Nation's Restaurant News offers an article designed to help restaurateurs more successfully service their customers. While the restaurant market has carefully zeroed in on the specific products and services customers require, no one has carefully addressed the heart of the issue. The authors discuss the "hospitality" in restaurant service.

Products and services are important to the customer, but in the end the most important aspect of the dining experience is how well or poorly the customer is treated by the people involved with the restaurant. Service is the point of distinction in a fiercely competitive market.

In 1972, there were 209,000 eating places in the country and 1002 potential customers per unit. By the end of the '80s the number of units had grown to 330,000 and the number of potential customers had fallen to 732. In other words, the restaurant industry is growing faster than its customers.¹

Patrons and operators do not always agree on whether or not the guests are happy with how they are being treated. In the 1990 Tableservice Operator Survey, a survey of 456 tableservice restaurant owners and operators, the National Restaurant Association found that nine out of 10 restaurateurs believed that their customers were either satisfied or very satisfied with the level of service they were receiving.²

However, in an association Gallup survey it was found that only six out of 10 adults were satisfied with the service they received.³ Perhaps the reason the restaurateurs do not have an accurate view of the customers' perceptions of service is because dissatisfied customers often do not complain. They just do not come back.

"Hospitality" is a word that has become estranged from the industry that borrowed it for its identity, and yet hospitality is the key to a successful restaurant. Hospitable service in theory is the key to success in the hospitality industry, but in reality it is a lost art form. Perhaps hospitable service is a lost art form because people today do not even understand what service is. In a 1990 study by

Callan regarding the assessment of service quality, industry experts defined service quality as “the application of a level of hospitality which unobtrusively leads the guest to feel at home, well cared for and anxious to return.”⁴

Many times diners go to a restaurant supposed to be one of the most outstanding restaurants in the city and leave saying, “So what?” Those feelings were probably not based on the atmosphere of the restaurant, nor even on the food. They were more than likely a reflection of the lack of hospitable service received from the people caring for the diners’ needs. People enjoy spending time in places where service is the organization’s top priority. Unfortunately these places are in the minority. The industry today is interested in providing the physical amenities and food that will increase revenues, but managers lose sight of the fact that their most important asset is their labor force. Until they sell their staff on the importance of interjecting warmth and understanding into their service, the customer will still leave saying “So what?”

Restaurants Lack Warmth, Understanding

This lack of warmth and understanding within service attitudes is extremely detrimental when coupled with the new trends within customer preferences. Faith Popcorn, founder of BrainReserve, aptly described one new trend in customer preferences as cocooning, or “the increasing tendency for people to stay home.”⁵ Popcorn says, “[People] aren’t going out to restaurants as much. And when people travel they want their room to be like their home — a small cocoon so they will feel safe.”

Today’s diners are more selective in how many times they eat out because of this cocooning behavior. Betsy Balsley, food editor of the *Los Angeles Times* for 17 years, was asked what she considered the mistake restaurateurs make most often. She answered, “They forget service. When I go out to eat, I want to be pampered and babied.”⁶ Diners want to be treated with warmth and understanding while they are away from their homes. Those restaurateurs who focus on maintaining a “cocooning” philosophy, and who instill this attitude in all those who have contact with their customers in the restaurant, will ensure that customers’ needs are met.

The primary goal of a restaurateur is, therefore, not always just the nuts and bolts of planning a menu or designing the kitchen. All of these things are necessary, but the restaurateur must know how to find, train, and keep employees who have the right attitude toward service.

Although this idea seems obvious and simplistic in nature, most decisions regarding managing a restaurant concern cost control or the product itself, food. Managers often overlook the importance of developing the attitude and philosophy toward service that employees must have. According to Costello, the right attitude includes Courtesy, Attentiveness, Responsiveness, and Effort or

Extra Effort (CARE).⁷ Such service should be found in all employees, from the host or maitre d' to the bus person. The physical manifestation of this caring attitude will be a well-run facility, the primary goal of which is to provide complete and competent service to guests.

Employees learn this attitude in many ways. Modeling, personality, and training are three methods which contribute to the development of a hospitable staff. All these aspects interact with each other to foster an attitude of service among employees.

Manager Is Role Model

Don Shapiro, president of First Concepts Development, a training and consulting firm, points out the importance of the manager as a role model. He says, "Treat your employees the way you want them to treat your guests."⁸ Employees who feel appreciated by their superiors will convey that sense of appreciation to the customers. As Shapiro points out, employees notice if a manager smiles at guests or pitches in to help when the restaurant is busy, and they will learn by watching.

David Romm from the Cornell School of Hotel Administration discusses the role that an employee's personality plays: "People who have good contact skills generally gravitate to high-contact jobs." He cautions, however, about depending too much on finding employees with a natural ability to be hospitable. With labor shortages and the growing demand for "the crafting and delivery of specific kinds of interaction,"⁹ more on-the-job training may be required.

Gary Penn, president of the Professional Waiters School in Los Angeles, states, "Ninety percent of the responsibility for awful service falls directly on management. . . Waiters are hired on the basis of a 20-minute interview and then are expected to learn the ropes by 'shadowing' another waiter for a week. . ."¹⁰ Although traditional on-the-job-training is vitally important to the hospitality industry, it cannot be expected to fulfill all the service training needs. It is imperative to develop a training program that will teach service attitudes to the people responsible for providing service to the guest.

Training Programs Are Fundamental

Therefore, actually training employees to exhibit more service-oriented behavior is fundamental in today's competitive environment. Fortunately, it is also very possible, as many studies and programs prove. For instance, Barbara Whitaker Shimko reports on an employee training program called Project Transition, "created to screen, train, and place welfare recipients in full-time jobs in cooperating restaurants." Coaches helped these new employees learn such skills as smiling at customers, having a professional appearance, establishing eye contact, and being able to make small talk. Shimko reports that "not one of the 57 participants in Project Transition went back on welfare during the first year."¹¹

Project Transition proves that certain skills necessary to the hospitality industry can be taught. More training of new employees would only be beneficial to the restaurant industry. However, they will be more hospitable; overall service will improve, and increased employee satisfaction will decrease turnover.

A restaurant does not have to implement a "special" program specifically and solely designed to improve service, however. An ongoing empowerment program for employees can be equally effective. By adopting a policy which gives employees the power to make immediate decisions regarding service, a restaurant will be able to improve its overall focus on hospitality.

Customers Are the Ultimate Beneficiaries

Once the restaurateur has established this attitude in his or her employees, this philosophy of warm and hospitable service must be conveyed to the customers. From the patron's first contact with the restaurant, the experience should be one of friendly concern for the needs of the diners. This concern should address all aspects of the customer's visit to the restaurant. Diners calling to make reservations should be warmly greeted, and every effort should be made to seat the party promptly upon arrival. If a group must wait for a table, the host should give a fair estimate of the waiting time. Kathleen Talbert mentions the importance of giving special attention to frequent customers. She says, "If a regular customer wants to entertain a special guest, he'll go to the place where he'll be greeted by name, fussed over, given his favorite table, and brought his usual drink."¹² If handled correctly, this initial contact with the restaurant will communicate the caring attitude of all those involved with the facility.

This level of service must continue even after customers are seated. Starting with giving their order and ending with being thanked as they leave the restaurant, customers must receive a consistent quality of service. Restaurant consultant Karen MacNeil discusses the importance of service at the end of the meal. After all, says MacNeil, the last impression is the most important one. Small services like checking back with the guests for that second cup of coffee and offering desserts are often forgotten.¹³ MacNeil also discusses the importance of properly busing the table, after the diners have finished eating, a service that restaurateurs often disregard. She says:

Because clearing takes place at the end of dinner, it has great impact. If you serve someone a wonderful meal, only to later disgust them with sloppy clearing, have you really enhanced the restaurant's reputation?¹⁴

The language of service plays an important role in portraying this hospitable service attitude. Gen LaGreca, president of

Hospitality Industry Training, states that “employees need to understand the proper language of service.”¹⁵ Simple statements such as, “Hello,” “Thank you,” and “I’m sorry,” coupled with smiles and eye contact, are important in proper service language. When in the restaurant, managers should try to pay attention to verbal and nonverbal communication because these things exemplify the organization’s attitude regarding service. The fact that employees can be trained to use the proper language of service allows for great possibilities of service improvement in the industry.

Above and beyond servicing the average customer, restaurateurs should always consider individuals with special needs. Doorways, hallways, bathrooms, and some tables must be accessible. Hosts or hostesses and maitre d’s should be prepared to help elderly or handicapped patrons get to their table with ease and comfort. Baby chairs should be easily accessible and kept clean. Waiters and waitresses should be knowledgeable enough about the menu to be able to suggest meals that would be appropriate for heart patients, dieters, vegetarians, or others watching their food intake. All these individuals should receive the special attention necessary to enable them to dine comfortably and pleasantly.

“Service is as important as facilities in hosting people with disabilities,” says blind industry consultant Harold Snider.¹⁶ A restaurant staff, in being sensitive to special needs of a group or guest, should be constantly alert for ways to offer help. Individuals committed to providing hospitable service will continually reevaluate their treatment of their customers to ensure that they are not overlooking the needs of their special guests.

In an intensely competitive market, restaurateurs must change their focus which has been on quality food, competitive prices, interesting ambiance, promotion and publicity, on anything other than the customers’ needs. To remain competitive the focus must be on the customer. Hospitable service has to be at the root of all that is done. Focusing on making customers feel comfortable and happy to have come to the establishment will improve the chance that they will come back to eat at the restaurant again soon.

“If one aspect of the hospitality industry in the ‘90s is almost universally agreed upon, it is that the demand for better service will be greater than ever before,” says Karen MacNeil. “Those operators who succeed at all levels will see themselves as serving service.”¹⁷

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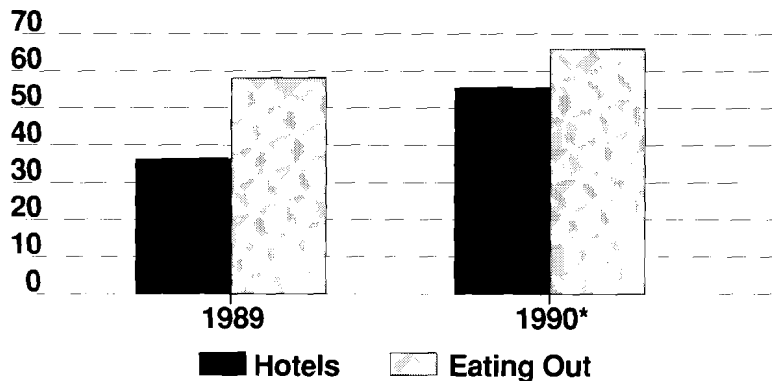
Financial Failure in the 1990s: the Case of Prime Motor Inns

by
Elisa S. Moncarz

Because of widespread overbuilding, operating cost increases, a decline in economic activity, and other problems, a significant number of hotels and restaurants have recently sought Chapter 11 protection under the Federal Bankruptcy Code. Many other firms have experienced some degree of financial distress that could lead to bankruptcy. The author presents statistics of hospitality firms in financial distress, focusing on Prime Motor Inn's initial success and the principal causes of its failure, which resulted in the filing of protection from creditors in Federal Bankruptcy Court.

In 1990 business failures rose across the United States and in every major industry sector, a clear indication of the economic downturn that the country was experiencing. In fact, "most of the 25 largest bankruptcies in U.S. history were filed in the last three years."¹ Financial failure for hotels and other lodging places increased 58.1 percent in 1990, whereas failure in eating and drinking places rose 10.9 percent.² Exhibit 1 shows the failure rate per 10,000 listed concerns in both the lodging and eating out sectors.

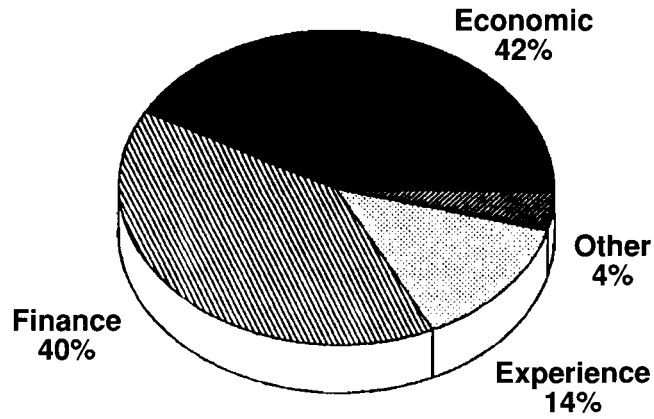
Exhibit 1
Failure Rate Per 10,000 Listed Concerns



Source: Dun & Bradstreet, The Business Failure Record, 1991 and 1990 editions.
*1990 preliminary data

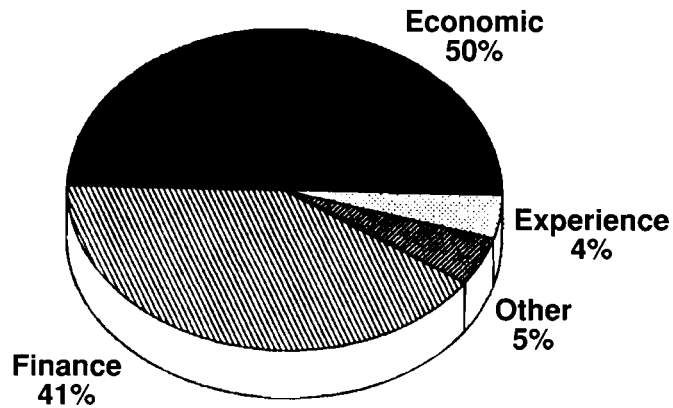
Exhibit 2

**Causes of Business Failures in the Services Industry – 1989
(Hotels and Other Lodging Places)**



Source: Dun & Bradstreet, Business Failures Record, 1990.

**Causes of Business Failures in the Services Industry – 1990*
(Hotels and Other Lodging Places)**



Source: Dun & Bradstreet, Business Failures Record, 1991.

* 1990 preliminary data

Table 1
Causes of Business Failures in Service Sector

	1989	1990
Economic causes		
Industry weakness	29.9%	34.3%
Insufficient profits	10.3	14.4
Inadequate sales	1.8	0.8
Finance causes		
Burdensome institutional debt	15.9	15.0
Heavy operating expenses	11.8	10.2
Insufficient capital	12.3	15.5

Indeed, the hospitality industry entered the 1990s with a series of challenges that threaten the survival of a significant number of firms, both large and small. "A host of economic and demographic problems have combined to challenge the phenomenal growth pattern set by the industry in the last two decades resulting in slower growth and fiercely competitive market place."³ Moreover, the Persian Gulf crisis and the economic recession that the United States experienced since the latter part of 1990 hit the hospitality industry really hard, compounding the problem. Pleasure and business travel declined, while confidence levels deteriorated.

There are many reasons leading to business failures in the hospitality industry. Fewer than 10 percent of the failures are directly attributable to acts of God, neglect, or dishonesty on the part of management or owner.

According to Dun & Bradstreet's Business Failure Record,⁴ the reasons for business failures can be broken down into seven major types: neglect causes, disaster, fraud, economic factor causes, experience causes, finance causes, and strategy causes.

The Dun & Bradstreet Business Failure Record⁵ for 1989, with preliminary figures for 1990, revealed that the economic factor causes contributed more than any other category to the failure of lodging firms in the last two years (42.5 percent in 1989 and 50 percent in 1990). Exhibit 2 shows that finance causes were also major contributors to business failures in the service sector (40 percent and 41 percent in 1989 and 1990, respectively), an indicator of very tight market conditions.

Table 1 indicates principal economic and finance causes of business failures in the service sector (hotels and other lodging places) for 1989 and 1990.

According to Bjorn Hansen, a partner in Coopers & Lybrand, "60 percent of the hotels in the United States are experiencing a net operating loss. The loss was expected to reach over \$1000 per room

in 1991.”⁶ The recession and the fallout from the Persian Gulf war aggravated the economic problems that the hospitality industry had experienced as a result of the oversupply of rooms triggered by the tax incentives provided to developers in the early and mid-1980s. “Business travel came almost to a halt holding the average occupancy rate to 60 percent for the first half of 1991.”⁷

“Although the impact of overbuilding has tapered off in a number of national markets, the lodging industry is still plagued by many distressed properties.”⁸ This resulted in a significant number of lodging properties not having sufficient cash flow to service the mortgage debt and meet operating costs.

Prime Motor Inns Serves as Case Study

During the mid and late 1980s, a company named Prime Motor Inns (Prime) was considered a success story in the hospitality industry, “the darling of Wall Street.” Prime’s stock was soaring and analysts from large brokerage firms were advising their clients to buy. In September 1990 Prime filed for protection from creditors under Chapter 11 of the Federal Bankruptcy Code and these same analysts were shaking their heads in disbelief.

Prime was founded in 1968 by a group of real estate developers, Melvin S. Taub, Samuel Brodie, Herbert Kay, and Peter E. Simon, though its roots go back to the mid-1950s when it operated as a single family home builder on the East Coast. Since going public in 1969, Prime’s growth was both internal as a builder and operator of motor inns and associated restaurants and cocktail lounges under franchises from national chains (e.g., Ramada, Sheraton, Holiday Inns, Howard Johnson, Hilton, and Days Inn) and external through a series of major acquisitions.

The firm’s early focus was on properties in the Northeast and Florida. “Its early success had rested on its ability to build its motor inns at lower cost than its competitors by doing its own site selection, legal work, financing, design, general contracting, and building and through aggressive marketing of its inns to corporations and the business travelers.”⁹ It targeted the midpriced lodging market, focusing on the corporate and business traveler, a more stable revenue base than the pleasure traveler. Prime established early relationships with nearby corporate travel and meeting planners.

Peter E. Simon, chairman of the board, reported to Prime’s shareholders on August 30, 1983: “During the last five years Prime’s net income and earnings per share have grown at a compounded annual rate of 53 percent and 43 percent, respectively.”¹⁰

During the mid-1980s Prime’s overall growth centered largely around the acquisition of American Motor Inns in 1984 and Howard Johnson Motor Lodges in 1985. The latter’s acquisition transformed Prime from a regional, multiple franchise operator to a national company that was both franchisor and franchisee. Prime’s stock became a favorite investment “with an astonishing increase of some

640 percent from July 1982 to January 1988.”¹¹ The Dow Jones Industrial average increased about 142 percent during the same period.

During the 1980s, Prime’s stock climbed from \$1 a share in 1980 to a peak of over \$45 a share in 1987. The growth in market prices was accompanied by strong increases in revenue, net income, and earnings per share.

American Motor Inns Acquisition Was Turning Point

The year 1984 proved to be a major turning point in Prime’s history and a new era of company growth. “Prime paid \$238 million for American Motor Inns (AMI), which operated 50 motor inns, primarily in Pennsylvania, Maryland, Virginia, and North Carolina and a resort in the Virgin Islands and held an 84 percent interest in Universal Communications Systems, Inc., an independent telephone interconnect company.”¹² The acquisition “broadened Prime’s assets and operational base and doubled Prime’s size.”¹³

The next year was to be even more outstanding than 1984. Prime was becoming one of the most profitable and rapidly-growing firms in the hospitality industry “with an increase in revenues from \$95,952,000 in 1984 to \$245,734,000 in 1985 (a fantastic increase of 156 percent in one year).”¹⁴ By July 1985, “Prime had sold 23 of the AMI properties to its former owner for \$193 million, or 80 percent of the total amount it paid for all the properties and still retained the remaining motor inns.”¹⁵ At the same time “Prime sold the franchisor’s Reef Beach Resort in St. Thomas for \$100 million to VMS Realty.”¹⁶

In November 1985 another major acquisition was made by Prime, the Howard Johnsons franchise system. “Prime paid approximately \$235 million for the Howard Johnsons name, which included 122 motor lodges and hotels and its 348 franchised motor lodges.”¹⁷ Within two years Prime sold 120 of the properties for \$295 million, while retaining the franchises for which Prime earned royalty fees. “Prime received more funds through sales of a number of units than they had paid for the entire deal and their financial position improved greatly.”¹⁸

Prime Revived Foundering Howard Johnsons

Prime invested \$70 million to renovate the company-owned properties while Howard Johnsons’ franchisees spent an additional \$250 million by 1987. Besides refurbishing, two new products, Plaza Hotels and Park Square Inns, were introduced, a new reservation system was developed, and a major marketing effort was adopted by Prime. “Development was stepped up from an average of 3.6 openings per year during the decade before 1985 to 20 per year for the period 1986-1989.”¹⁹ The reservation system was modernized so operators could do everything at the property level. National advertising campaigns were launched, with promotions from “turned upside down” to “this is Howard Johnsons” to “this is Howard

Johnsons now.” “Prime went after the business traveler using print, television and radio campaigns which were very intrusive.”²⁰ All this served to get franchisees excited about the Howard Johnsons brand.

Peter E. Simon, chairman of the board and chief executive officer of Prime, commented in the company’s 1988 annual report:

Fiscal 1988 was another setting year for Prime in net income, earnings per share, and revenues, sustaining a pattern that the company repeated for 13 consecutive years. Since 1970 Prime has achieved a compound annual rate of growth in net income of 49 percent, in earnings per share of 42 percent and in revenues of 26 percent.²¹

He further explained Prime’s focus on internal development: “Prime is intensifying its internal development of new hotels and additions to existing properties. Complementing our development activities with others, we have in the planning stages or under development more than 14 new hotels or room additions totalling nearly 1500 rooms in proving or emerging markets.”²²

During the 1985-1988 period, Prime sold 2.3 million shares of common stock for net proceeds of \$89 million and sold \$115 million of convertible subordinated debentures. Prime also invested in 16 Holiday Inns properties financed by a publicly-traded Master Limited partnership, which netted \$80 million.

In 1988 Prime paid \$82 million for 18 Wellesley Inns; its plans were to develop about 10 new units per year. It sold nine of the original 18 for \$52 million and retained management contracts for the properties.

As a result of these deals and Prime’s obvious success, it received raving reviews from several analysts and other interested parties: “One of the savviest operators in the lodging industry.”²³ “Prime’s emergence as a force to be reckoned.”²⁴ “Prime is expected to be the biggest hotel company in the country by mid-1990.”²⁵

Prime Reported Fiscal 1989 As a Record Year

Simon began his letter to Prime’s shareholders on August 1989 by stating: “Prime realized another record year in fiscal 1989 in terms of revenues, net income and net income per share.”²⁶ Net income and net income per share had increased 15 percent on a revenue increase of 11 percent. Moreover, “there were dramatic increases in room rates that reflected Prime’s aggressive growth through acquisitions, franchising and internal development from 1984 through 1989 (total room count included franchised property increases from 6054 in 1984 to 162,300 in 1989).”²⁷

Prime’s apparent success was attributed to “smart management,” low cost development and operations, tight control, and an undercurrent of intelligence in development, operations and franchising of lodging properties.”²⁸

In April 1989 Prime signed an agreement with New World Development Co. Ltd. of Hong Kong in which Prime "would participate in the acquisition of the hotel business of Ramada Inc. domestic franchise system. The agreement was part of New World's 540 million deal to acquire Ramada's hotel business."²⁹ The original deadline for the deal to close was postponed when Ramada withdrew plans to offer \$400 million in high-yield securities that would have financed the company's restructuring plans. A new proposal announced in the fall of 1989 would change the amount of cash and stock Ramada's shareholders would receive. In addition, Aztar, Ramada's remaining casino business, would be required to raise \$170 million in debt secured by the company's assets. The purchase of Ramada domestic franchise system vaulted Prime "into national prominence."³⁰

In the summer of 1989 Prime unveiled aggressive expansion plans that called for 50,000 additional rooms by 1994. The growth was to be achieved primarily through new construction, though conversions were to play a major role. Prime's plans called for about 150 all suites properties, whereas Howard Johnsons would build 50 hotels to be managed by the Continental Companies. The Wellesley Inns were to be renamed Wellesley Inns by Howard Johnsons; 14 properties were under development and plans well made for an additional eight to 10 per year for the next several years.

Prime Entered Financial Deal With Servico

In 1989 a subsidiary of Prime "invested \$64 million and made a bridge loan of another \$74 million to FCD Hospitality Inc, a private company that was acquiring Servico (a hotel operating company) from the Southmark Corporation."³¹ Prime also entered into a consulting agreement with FCD Hospitality to help reposition Servico over the next several years. "Prime and FCD Hospitality intended to jointly develop the Royce Hotel chain (an upscale brand of Servico) domestically and internationally."³²

Investors began "to feel uneasy about Prime since the Ramada and Servico transactions were completed amid declining values for hotels."³³ As a result, Prime's stock prices experienced a steady decline in market value to the low \$20s from the peak of over \$45 in 1987.

Prime had achieved formidable increases in net income and net income per share during most of the 1980s. Yet, an article published in the *Wall Street Journal* in March 1989 focused attention on Prime's quality of earnings:

Prime's recent gains have largely come from hotel sales and from interest income. By contrast, analysts estimated that Prime's per share income from its basic business—lodging, food and beverage and hotel franchises— had fallen a penny a share, to 73 cents over the past two years.³⁴

Thornton O'Glove, an analyst specializing in earnings quality, noted: "Prime had been reporting a lower quality per share earnings, which will continue to erode the price-earnings multiple."³⁵

Along these lines, by examining Prime's income statement included in the 1989 annual report,³⁶ interesting observations concerning Prime's reported profitability and quality of earnings can be drawn.

First, net gains on property transactions of \$26.9 million, \$25.2 million, and \$18.4 million were included in Prime's revenues³⁷ reported for the fiscal years 1989, 1988, and 1987, respectively. In addition, interest and dividend income of \$53.8 million, \$38.1 million, and \$33.9 million were reported for the same fiscal years. These amounts represented 64.3 percent, 58.2 percent, and 62.5 percent of the income from continuing operations before income taxes reported for those years. Accordingly, Prime's increases in net income and earnings per share were heavily impacted by non-core activities, as opposed to lodging and food and beverage sales.

Second, this interest and dividend income reflected a major increase in mortgages and notes receivable from property sales and construction and development projects in 1989, the full year impact of a 1988 loan to a major Howard Johnsons franchisee, and the interest derived from the Servico 12.25 percent subordinated notes and the loan to FCD Hospitality Corporation, which financed the stock purchase of Servico.

Moreover, the examination of Prime's statement of cash flow for 1989³⁸ reveals that the cash flow received from operating activities showed major deteriorations in 1988 and 1989, in spite of the increases in net income of 29 percent and 15 percent reported in those years. In fact, in 1989 only \$1.8 million in cash was provided by operating activities (on net income of \$77.4 million), whereas in 1988 a negative amount (\$37.9 million in cash) was used for operating activities (on net income of \$67.5 million).

Cash flow from operations shows the cash impact of all transactions that enter the determination of net income. As a result, the net cash flow received from operating activities (cash inflows less cash outflows) will normally differ from the amount of net income for the period (reported on the income statement). The latter reflects the revenue earned from selling goods or rendering services net of expenses incurred in earning these revenues based on the accrual basis of accounting.

Also, in 1989 \$262.2 million of cash was used for investment activities, resulting in a net decrease in cash and cash equivalents of \$73.3 million. Some of the major contributing factors to the deterioration of Prime's cash flow were as follows:

- an adjustment to net income of the net gains on property transactions and notes receivable, arising from operating revenues since these transactions did not contribute to cash flow

- the disbursement for mortgages and notes receivable of \$179.9 million and \$42.4 million in 1989 and 1988, respectively (these amounts included the Servico loan and other property transactions)
- major acquisitions of property and equipment to implement the expansion and growth plan
- major increases in long-term debt (\$222.4 million and \$195.5 million in 1989 and 1988) to help finance the acquisitions of property and equipment and the Servico financing deal

1990 Began With Major Challenges For Prime

An article in the November 1989 issue of *Lodging Hospitality*³⁹ outlined Prime's three-part strategy for capturing the lion's share of the business:

- rapid new development (minimum 50 hotels per year for the next five years)
- an aggressive marketing program targeted to the business traveler
- Prime to continue buying up successful small regional chains like the limited service Wellesley Inns and AmeriSuites

With the purchase of the Ramada domestic franchise system at the end of 1989, "Prime was to benefit from Ramada's presence in the Western U.S. where Howard Johnsons was only beginning to build momentum."⁴⁰ In addition, the Ramada deal was estimated to bring in about \$50 million a year in professional fees."⁴¹

Yet, the aforementioned optimistic vision of Prime becoming the industry leader took a different turn at the beginning of the new decade. In the January 22, 1990, issue of *Forbes*,⁴² Dana Wechsler reported a recent cancellation of a new proposed issue of 300 million convertible debentures by Prime. More importantly, the article focused on Prime's quality of earnings reported in the 1989 annual report to shareholders, its weak financial position, and controversial deals completed in 1989. "While Prime managed to report pretax income of \$125 million in fiscal 1989, only \$9 million came from core operations... the rest came from interest, sale of properties, construction fees, and the like."⁴³ Hotel financing had dried up and there were huge numbers of properties on the verge of getting in trouble. Prime responded to this problem by financing the transaction itself, which resulted in increases in holdings of mortgages and notes receivable of 80 percent over the past two years to \$593 million; some of the loans were second mortgages.

"Making matters worse, Prime sometimes guarantees hotel buyers and their bankers a certain level of fee income in the form of either leases or a promised return. When profits decline, Prime makes up the difference and only a portion of those contingent liabilities were reported."⁴⁴ A major emphasis was made in the

Forbes article on the April 1989 financing transaction to help purchase Servico. Servico had agreed to pay Prime \$55 million in consulting fees. Those fees and interest on the deal accounted for about 30 percent of Prime's earnings in the first quarter of fiscal 1990 (i.e., quarter ending September 30, 1989), whereas no cash had been paid to Prime.

The negative impact of this, coupled with the high leveraged position and the weak performance of the lodging industry in early 1990, resulted in a further decline in Prime's prices, closing at \$14 on January 31, 1990, a 68 percent drop from the mid-40s level it was trading in August 1987.

Prime's earnings per share for the quarter ending March 31, 1990, declined by 98 percent to .01 cent a share (from 55 cents a share in the same period of the third quarter of fiscal 1989) on a revenue decrease of 17 percent. David Simon noted on the third quarter 1990 report to shareholders:

Revenues and earnings decreased because no development income or property sales gains were generated in the quarter as compared with \$13.6 million in development income and \$546 million in property sales generated in the third quarter of fiscal 1989.⁴⁵

Although some analysts continued their buy recommendations in early 1990, their belief was that Prime's share price decline, and that of the lodging group in general, was a function of negative investor perceptions relating to institutional financing of hotel development. Thus Prime's management had to prove that financing was still achievable to meet its development objectives. By May 1990, Prime's common shares were selling at a low of \$10 a share. This major price decline has been considered "what analysts call Wall Street's loss of confidence in Prime's ability to expand its business in the current market."⁴⁶

Prime Announces Agreement to Sell Interests

In May 1990, pressured by soft hotel and real estate markets and a hefty debt load, Prime announced an agreement to sell a 65 percent interest in its Howard Johnsons and Ramada franchised systems to Blackstone Capital Partners L.P. for cash and notes totalling about \$200 million. The sale was expected to help "reduce significantly Prime's bank debt and improve liquidity."⁴⁷ Furthermore, the sale of Howard Johnsons and Ramada "guaranteed Prime enough liquidity to hold onto the Servico hotels if necessary and avoid selling them at fire sales prices."⁴⁸

Indeed, "Prime was under pressure to reduce its bank borrowings because both the size of its debt and a downturn in the lodging and real estate industry had fueled investor speculation that the company could face a cash squeeze."⁴⁹

Simon believed "that the Blackstone deal would enable Prime to maintain a significant stake in the future earnings potential of the franchises and allow the company to focus on growth in specific market niches: economy and limited service hotels..."⁵⁰

Standard & Poors contended that the Blackstone transaction would help to significantly reduce Prime's debt and improve liquidity. Yet, Standards & Poors decided to keep Prime's double B plus subordinated debt on its Creditwatch because "Prime would be parting with the bulk of a stable source of revenues from the franchise system while increasing reliance on lesser known businesses."⁵¹ Margo L. Vignola, an analyst for Solomon Brothers, stated in a May 12, 1990, *New York Times* article, "A combination of events have really crushed Prime."⁵²

Prime Files For Bankruptcy Protection

Shortly after the Blackstone transaction closed, Prime sought protection from creditors under bankruptcy law proceedings. On September 18, 1990, Prime and certain of its subsidiaries, saddled with huge debt and heavy losses, "filed for protection from creditors under Chapter 11 of the Federal Bankruptcy Code in the southern district of Florida court."⁵³ Prime had indicated it might have to file for bankruptcy court protection unless its banks agreed to approve another \$25 million loan and to restructure its debt of \$550 million. Since Prime was unable to work out a satisfactory arrangement, the filing became necessary.

Prime's petition for reorganization coincided with a similar filing in that court by Servico Inc., the principal asset of FCD Hospitality, and "one of the straws that proved to break Prime's financial back."⁵⁴ At the same time of the bankruptcy filing, Prime was stressing its operations' consistency. Joseph Gaynor, Prime's vice-president of corporate finance, indicated that "little change was being made operationally and no major layoffs were anticipated...Prime was expected to emerge from bankruptcy in a period of time typical of such actions, 12 to 18 months."⁵⁵ He further noted that "Prime's ability to emerge after Chapter 11 was contingent on financing situations for hotel construction If that should happen Prime would move forward with conservative financing as an operating and managing company."⁵⁶

Although Prime was expected to emerge from Chapter 11, "a report issued by the bankruptcy courts indicated that more than one quarter of Chapter 11 cases filed prior to 1987 were still pending in 1989, while only 10 to 12 percent of Chapter 11 cases result in a successful reorganization of the debtor's business."⁵⁷ Additionally, the report asserted that approximately half of the Chapter 11 cases filed prior to 1987 were closed in Chapter 11 without confirmation of a plan of reorganization or were closed as no asset Chapter 7 cases. "From the Chapter 11 cases whose plans were eventually confirmed, an average of 740 days elapsed from date of filing until confirmation."⁵⁸

In the summer of 1991, Prime announced that it wanted to merge with Servico, which was also operating under bankruptcy law protection. "The merger could settle substantially all the claims between Servico and Prime."⁵⁹ Prime loaned FCD Hospitality, the parent of Servico, \$74 million in cash and took over \$64 million in FCD Hospitality debt in 1989. The proposed plan, subject to approval of the bankruptcy court, would allow Prime and Servico to combine some assets to form a new corporation. "The new firm would provide cash and newly issued securities that Servico would distribute to creditors under its reorganization. The new firm would assume Servico's debt."⁶⁰

Many Factors Accounted for Prime's Bankruptcy

There were, indeed, many reasons that led to Prime's collapse in September 1990. Among them are the following:

- Prime acquired an astronomical amount of debt in 1989 caused by two major transactions: the acquisition of Ramada's chain domestic franchise system, and the investment and bridge loan to FCD Hospitality Company to help finance the Servico acquisition.

- Prime's plan to repay debts with the proceeds of the FCD Hospitality loan and with public offerings of securities did not materialize. On the contrary, Prime had to extend the FCD loan repayments in order to avoid bankruptcy. In retrospect, Prime should have seriously considered the merits and demerits of developing the joint venture to purchase Servico in light of the significant amount of financial difficulties experienced by Servico's parent company.

- Prime relied too heavily on non-operating income sources. Its quality of earnings had been questioned by several analysts for some time. A major portion of its increasing earnings was generated from property sales, interest income, and other non-operating sources. Moreover, "Prime was using deceptive practices by reporting property sales as operating earnings."⁶¹

- In spite of reporting record increases in earnings and earnings per share, Prime experienced a decrease in cash flows, especially from operating activities. Prime reported a decreasing trend in cash flow generated from operating activities in 1988 and 1989. Nonetheless, investors ignored this negative trend since stock market prices were relatively high in those years.

- Several liquidity and solvency measures declined.

- Hotel and real estate markets were depressed.

- Financing sources of hotels dried up, partly because of problems in the high-yield, high-risk junk bond market and an oversupply of rooms. Prime became very vulnerable because a major portion of its earnings came from acquiring and selling hotel properties and retaining management contracts.

- Finally, in 1990 investors lost confidence in Prime's long-term prospects and its ability to withstand difficult economic times. This resulted in stock prices dropping "from \$38 in 1989 to \$23 in 1990 and down to 50 cents at the time of filing for bankruptcy."⁶²

Table 2 sets forth major events affecting Prime Motor Inns' stock performance between 1982 and 1990.

Table 2
Prime Motor Inns, Inc.
Major Events and Corresponding Market Prices
1982-1990

Date	Major Event	Market Price Per Share*
Aug. 1982	Rush to buy consumer stocks began	\$6 3/8
June 1983	Prime reported a 39 percent increase in earnings and a rise of 24 percent in earnings per share in 1983.	9 1/4
Oct. 1984	Prime acquired American Motor Inns for \$238 million.	11 3/8
Nov. 1985	Prime acquired Howard Johnsons for \$235 million.	26 5/8
Aug. 1986	Prime began the successful sale of the collection of properties acquired under the Howard Johnsons brand.	34 1/2
Aug. 1987	Prime had successfully disposed of the majority of the acquired Howard Johnson's assets for approx. \$250 million. Moreover, Prime reported a 39 percent increase in earnings in fiscal 1987.	44 3/8
Nov. 1987	Prime took an especially hard hit during the October 1987 stock crash. Its decline was the largest among lodging firms.	25
March 1988	Prime posted a very strong recovery from the crash lows of 1987. It reported a 40 percent growth in earnings per share in the first half of fiscal 1988.	39

Table 2
(continued)

Date	Major Event	Market Price Per Share*
Aug. 1988	Prime paid \$82 million for 18 hotels, land and related assets with the intention of converting them to Wellesley Inns by Howard Johnsons.	32
April 1989	Prime signed an agreement with New World Development Co. Ltd. of Hong Kong to participate in the acquisition of Ramada domestic franchise system.	28
May 1989	Prime invested \$64 million and made a bridge loan of \$74 million to FCD Hospitality Co. to help finance the Servico acquisition.	31
Aug. 1989	Prime unveiled aggressive expansion plans that called for 50,000 additional hotel rooms in five years.	35
Jan. 1990	A 1/22/90 <i>Forbes</i> article focused on Prime's deceptive accounting reporting of property transactions and questioned controversial deals completed in 1989.	13 3/8
April 1990	Prime reported a 98 percent decline in earnings per share for the quarter ending March 31, 1990. Also, Wall Street lost confidence in Prime's ability to expand its business in a declining economic environment.	9
May 1990	Prime signed agreement to sell 65 percent stake of Howard Johnsons and Ramada to Blackstone Capital Partners for approximately \$200 million	10 3/8
July 1990	Prime extended FCD loan repayment dates raising doubts of its collectibility.	7 1/4
Sept. 7, 90	Prime attempted to restructure debt while preparing to file for bankruptcy	4 3/8
Sept. 18, 90	Prime filed for bankruptcy	1/2

* On the last day of the month, unless otherwise noted; adjusted to reflect stock splits of 4:3 declared in January 1986 and January 1985 and a 3:2 stock split in May 1983.

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