

The rationale behind investments in tourism ventures – lock in or deliberate economic decisions? Model and outline for a research agenda analysing business sustainability

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0 Abstract

WTO figures may lead to the conclusion that tourism growth doesn't lead to better occupancy rates and most probably better business profitability. Therefore questions about profitability and sustainability of tourism investments arise. Investments only are profitable if they create economic value. The discounted free cash flow has to outweigh the capital invested. The investment has at least to sustain itself and to guarantee cash flow sufficient for depreciation or re-investments. Key words related to this concept of business sustainability are interest rates, branch economics, revenues and costs. For example two of the key branches of alpine Tourism in Switzerland are hotels and cable cars. Only between 25 – 30% of all companies reach a sufficient ratio of cash flow to capital invested. Despite signs of a mature industry hardly any consolidation takes place. An analytical framework, based on allocation concepts, is being developed. There seems to exist quite important exit barriers, for example the unity of professional, societal and financial identity of the owners, the lock in situation to specific plans, and incentives to entry, for example emotional gains or macroeconomic returns. Different examples for Swiss tourism companies support a two dimensional conceptualisation framework. Further research has to tackle macroeconomic / societal desirability of this situation and managerial optimization of investment decisions.

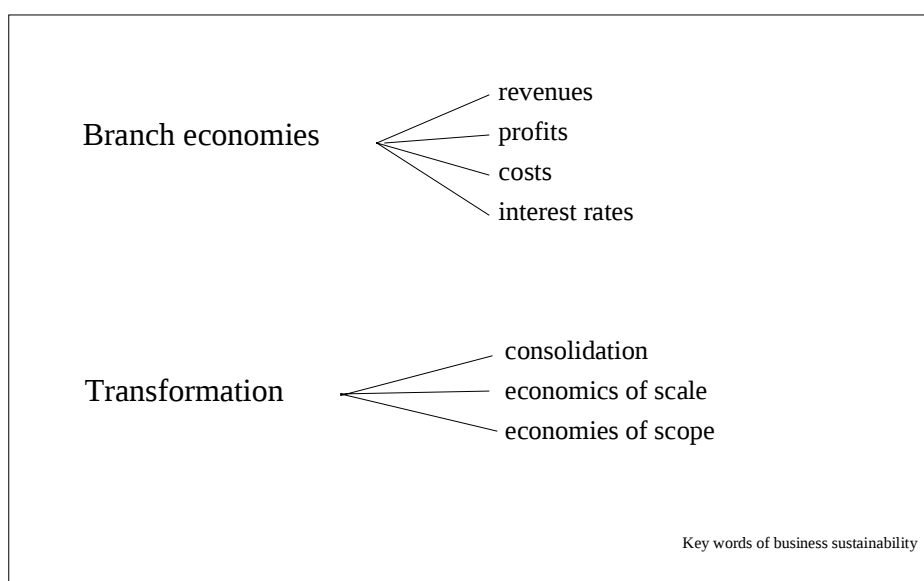
1 Business Sustainability of tourism – overview of the state of the art

1.1 Tourism growth – a supply driven branch development?

World wide Tourism organisations praise tourism as one of the fastest growing industries besides telecommunication and information technology. The World Tourism Organisation estimates an average annual growth rate of international tourism for the next decade up to 5-7% (cf. WTO 2000: 35) Part of this growth can be explained by structural phenomenons like the fragmentation of the former big countries in Asia and Eastern Europe which generates by itself more international arrivals from former national tourism and the increased integration of the European Union triggering greater mobility between the member states. Second important growth driver is the structure of international airline networks with an increasing weight of hubs. For example, everyone who passes a hub on his travel to an other country generates two international travels. There are also lots of demand side driving forces like increasing wealth and income in many countries as well as increasing importance of international connections and international competency in a globalised world. Increasing importance – at least in the economically strong countries – to make best of the short days of vacation and therefore concentration on the demand of the very best places for a specific travel need, which often implies international travel, is another example. But there are also important supply side driving forces for example:

- ◆ Increasing recognition of tourism as an important strategic sector for the growth of a national economy, therefore more and more local, state or national government subsidise tourism investments which contributes to a growth of facilities and capacities.
- ◆ Many tourism branches like the hotel industry or the airline industry generate important network effects. The existence of network effects leads to situations where no optimal company or plan size exists anymore. Companies have to compete for size to take as much advantage of network effects as possible. They try to exploit demand side net effects (means mostly economies of scope that lead to increased readiness to pay) and supply side net effects (mostly economies of scale that leads to reduced costs). Therefore companies have to grow as much as possible and to outgrow their close competitors to get a better strategic position (cf. Shapiro/ Varian 1999). Companies invest therefore in their growth beyond the short term business rational.

Figure 1: Key words of business sustainability



Looking at the development of demand and capacities and the resulting stagnating occupancy rates of different countries, one might hypothesise that indeed for many countries capacity growth is about the same as demand growth and therefore supply pulls demand. But in many countries the occupancy rates aren't sufficient to guarantee an economically reasonable operation of the different companies (cf. Figure 2).

Figure 2: Occupancy (Source: WTO 2001)

Occupancy rate	1996	1997	1998	1999
France	50.30%	53.50%	55.60%	57.50%
Germany	32.70%	32.20%	32.30%	33.40%
Switzerland	36.80%	38.50%	39.70%	40.10%
Canada	62.40%	63.70%	64.00%	63.40%
USA	N/A	N/A	N/A	N/A
Egypt	63.00%	62.00%	46.00%	67.00%
Dubai	66.76	64.79%	58.72%	59.04%

Brazil	N/A.	62.40%	61.70%	63.10%
Mexico	53.34	56.42%	56.44%	56.19%

1.2 Goal of this paper

This paper hypothesises on the above mentioned basis that in many cases tourism development and growth doesn't guarantee business sustainability. It tries to investigate on the case study of Swiss alpine tourism, up to which extend business sustainability is achieved and what might be the reasons that no adjustment or consolidation takes place or in other words what limits the work of the market forces. In the last section the model of consolidation processes is going to be developed and discussed.

1.3 Concept of business sustainability

For about a decade, sustainability has been one of the major concepts for assessment of growth in particular tourism growth. Going back to the Bruntland-report, sustainability or sustainable development can be defined as follows:

"Sustainable development is development that meets the needs of the present without compromising the ability of future generations to meet their own needs.

It contains within it two concepts:

- *the concept of 'needs', in particular the essential needs of the world's poor, to which overriding priority should be given; and*
- *the idea of limitations imposed by the state of technology and social organisation on the environment's ability to meet present and future needs."* (cf. Bruntland, 1987)

A strong sustainability asks for sustainability in each sphere (economic, social and ecological) itself. For example in the ecological sphere no non-replaceable resources may be used because this would reduce the options for the future generations. Therefore no substitutions – for example between economic and ecological sphere – are allowed. A weaker concept of sustainability which has to be applied to legitimise tourism at all, asks for an over-all persuasion or increase of potentials and options for the next generation (cf. Müller/Flügel, 1999: 43f). In the economic sphere, there can be a division between regional economic sustainability and corporative or business sustainability. Regional economic sustainability means a region as a

whole economic entity is able to produce enough value added to finance the resources needed. In particular in tourism replacing investments of fixed assets and enough salary for a decent life for people living in the region is necessary. (see for regional economic effects and regional sustainable development, Vanhove, 1999; Maskell/Törnqvist, 1999 or Thierstein/Walser, 2000).

Business sustainability can be defined as a state where companies are able to preserve its productive and economic value or increase this value. For the assessment of a company value there exists a whole range of different concepts and tools e.g. the economic value added approach (EVA) or the dividend based approaches (for an overview see Spremann/ Pfeil/ Weckbach, 2001; Rappaport, 1998). For companies in the so called “old economy” and in particular in the investment intensive tourism sector, the method of discounted free cash-flow seems to be the most appropriate and most applied (for ex. in Switzerland most of the lending banks as well as the government agency for credits for the hotel sector, the SGH, rely on this method). To calculate the discounted free cash-flow, an interest rate, the future cash-flows as well as the future depreciation or re-investment amounts are needed.

$$DFC = \sum_1^n \frac{\text{future free cash - flow}}{(1+i)^n}$$

Where “i” stands for the market interest rate for non risk investments plus the venture specific risk. Based on concepts of the transaction cost approach (cf. Williamson/ Masten, 1995) or on qualitative risk assessments (see discussions of cluster risk in destinations with small and medium size companies in Bernet/Bieger, 1999) one can assume that besides climatic risks, business risks related to demand and others size, integration and governance structure of a company are major determinants of the overall risk. For example a small company that concentrates on a specific part of the integrated destination service chain and that is not organised as a shareholder company, so with no control instruments, involves a much bigger risk than a well organised public company like the North American Ski-resort consolidates.

The future cash flows can be derived and assessed through the work on a business plan. Important factor in the capital intensive tourism sector is the depreciation and re-investment. There exist nowadays schemes to assess the depreciation needed for a sustainable operation for example in the hotel

sector (cf. Nanzer, 2001: 33) or in the cable car industry (cf. Bieger et al., 2000).

Table 1: depreciation needed for Hotels in Switzerland (Source: Nanzer, 2001: 32)

hotel category	* & **		***		****		*****	
recovery costs	CHF		CHF		CHF		CHF	
Ø recovery costs								
-per room	90'000		117'000		155'000		260'000	
-per place in gastronomy	13'500		16'500		20'500		25'500	
construction categories	% of total costs	lifespan in years	% of total costs	lifespan in years	% of total costs	lifespan in years	% of total costs	lifespan in years
cat. I (shell)	36,0	96,0	33,0	96,0	30,0	86,0	26,0	82,0
cat. II (operation technology)	39,0	42,0	40,0	39,0	41,0	31,0	42,0	30,0
cat. III (equipment)	25,0	19,0	27,0	16,0	29,0	13,0	32,0	10,0
total	100,0		100,0		100,0		100,0	
Ø lifespan		38,0		33,0		26,0		20,0

An over all annual depreciation rate between 3% and 5% is necessary depending on the amount of re-usable constructions. Business sustainability therefore means a situation/ condition in which a business is able to create economic values that means it should be able to generate more cash-flow than it is needed to finance its own re-investments.

There exists an interrelation between regional economic sustainability and business sustainability. When no company in a region can guarantee business sustainability no regional economic sustainability can be achieved because in the medium range companies have to disappear if they can't afford the necessary re-investments. If important elements of the destinations service chain disappear other elements will be impacted negatively as well. As long as in a destination network just some few elements can't achieve business sustainability meanwhile regional economic sustainability is achieved it might be hypothesised that these companies generate important external effects what legitimise subsidies to these particular companies. Big integrators and consolidators like the North American ski area companies do this kind of redistribution of income in their system itself (for value flows and net effects in destination networks, see Bieger, 2001).

1.4 Business sustainability as a topic in research journals

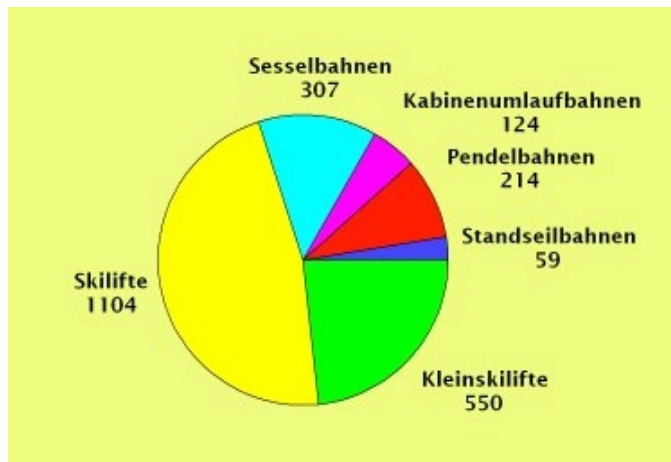
In the last years much research work has been done in the fields of ecological (cf. for an overview Müller/Flügel, 1999) or cultural (for an overview cf. AIEST, 2000) sustainability. Checking a list of key words related to business sustainability and looking for articles related to this key words in three important tourism journals (Annals of Tourism, TTRA Journal and Tourism Review) shows that in the field of business sustainability and branch economics within the last three years (1998 to 2000) only seventeen articles have been published from which only one covers the subject of economic sustainability. The reason for this could be that bigger integrators and public companies in tourism don't have to rely on University scientists to deal with their strategic problems. They have their own research departments or employ large consultancy companies meanwhile small and medium sized companies can't organise the funds necessary for research work, because of huge transaction costs involved.

2 Business sustainability – the situation in Swiss alpine Tourism

2.1 The Cable Car Industry

Cable cars are considered as the major driving force in development of alpine tourism (see Bieger/Rüegger, 1991). In Switzerland the number of cable cars has risen during the seventies and early eighties. Now, the number is stabilising since more and more older installations are going to be replaced by a smaller number of more powerful and more convenient ones. So very often in ski areas two or three older chair or ski lifts are replaced by four-passenger or even six-passenger express detachable chair lifts.

Figure 3: Cable cars in Switzerland (Source: Seilbahnen Schweiz)



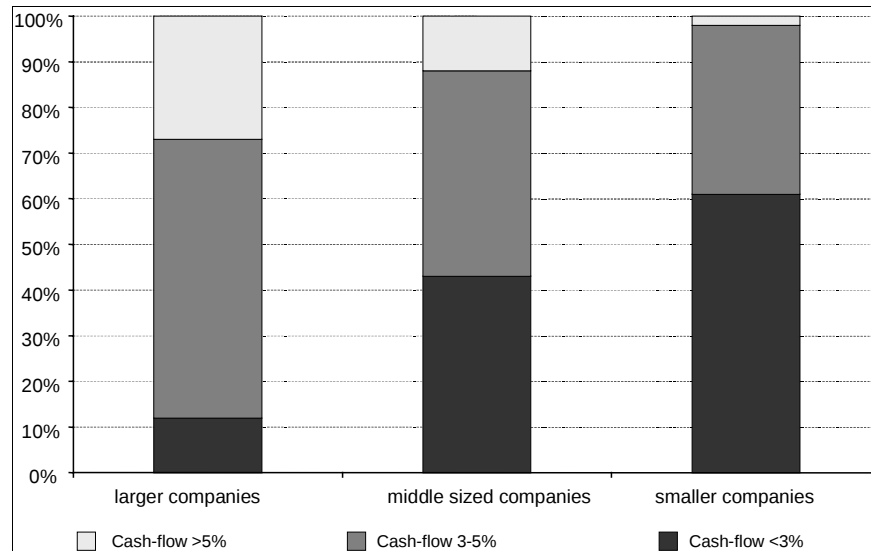
Similar to the whole tourism industry in Switzerland the cable car industry is very fragmented. A large number of small and medium sized companies dominate the picture. During the last years only very small numbers of mergers took place, mainly in regions where several companies serve the same ski area. Hardly any of these mergers have been driven by economic problems concerning at least one of the companies involved.

As mentioned above, a cable car company has to be able to generate a cash-flow of at least 3% to 5% of total investments in fixed assets. That means investments can be depreciated between 20 and 33 years. This is a reasonable time considering that in Switzerland every 20 years cable cars have to apply for another licence and therefore very often major investments are necessary to fulfil the required safety standards (cf. Bieger et al, 2000). Indeed many authors and especially the big integrators and consolidators even ask for higher depreciation rates, for example „Téléverbier“, a public company owned by 1/3 by the French „Compagnie des Alpes“ asks for 4–7% depreciation for cable cars or the big North American integrator Intrawest even asks for 5–8% depreciation. The reason for this is that very often a cable car that has to be replaced is going to be replaced by a more convenient and expensive one since in the mean time the customers demand higher quality levels in transportation.

Only 30% of all Swiss cable car companies can fulfil the requirement of a minimum cash-flow of 5% of capital invested.

It can be easy to show that the bigger the company the better their cash-flow performance.

Figure 4: Cash-flow of Swiss Cable car companies by company size 1997 (Source: Seilbahnen Schweiz, 1999)



An interesting picture can be derived from the economic situation of the cable car companies. Companies can be positioned in a kind of matrix, according to their indebtedness (a smaller indebtedness means bigger management options and less risk as well as easier opportunities to finance further re-investments) and their profitability measured in their ability to create value (using the indicator cash flow in % of fixed assets). The picture can be structured in four groups: Companies with low indebtedness and excellent profitability don't pose any problems at all. Companies with high indebtedness and low profitability don't have any economic future. It is also not wise for the government to subsidise these companies because of their low profitability and low ability to produce enough cash flow. They always will rely on subsidies and will never be able to stand on their own.

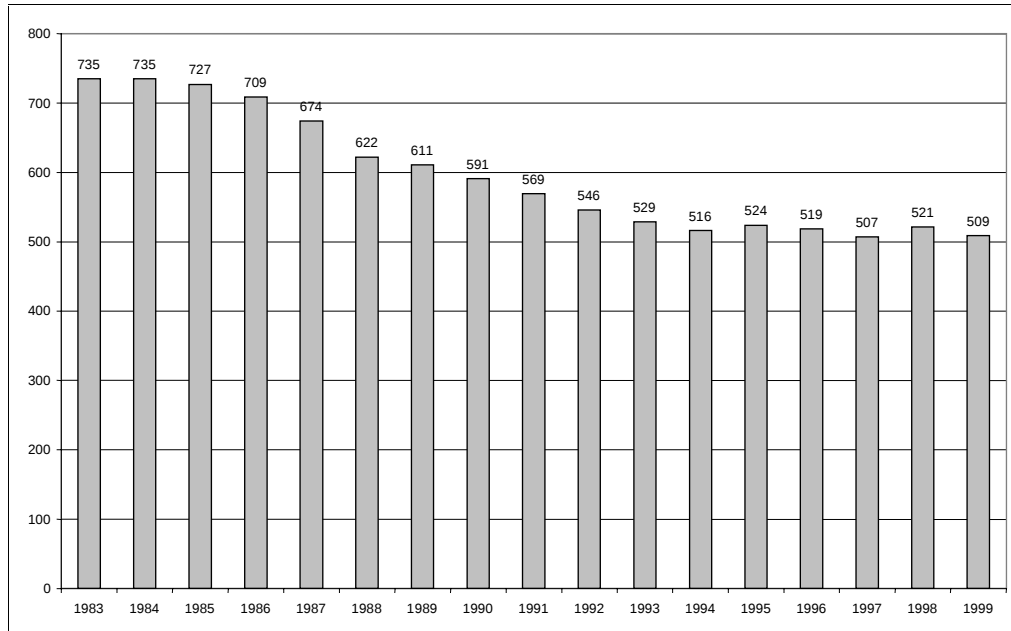
Companies with low indebtedness and insufficient profitability can be characterised as a kind of question marks. Either for example because of better management, they can improve their profitability and develop themselves to the second category, or they have to finance the next re-investments through additional loans which puts them into category two. Interesting category for tourism policy is category 4 which consists of companies with high indebtedness but good profitability. These companies can survive under the condition that they are able to put down their burden of loans. The government should consider to help these companies to get rid of their loans and develop themselves to important economic drivers for their regions.

Despite this clear economic picture hardly any cable car company disappeared during the last years. An entirely different picture shows the development of the United States cable car sector (see Figure 5).

Table 2: Operating figures of Swiss cable cars (Source: own calculation based on BSF)

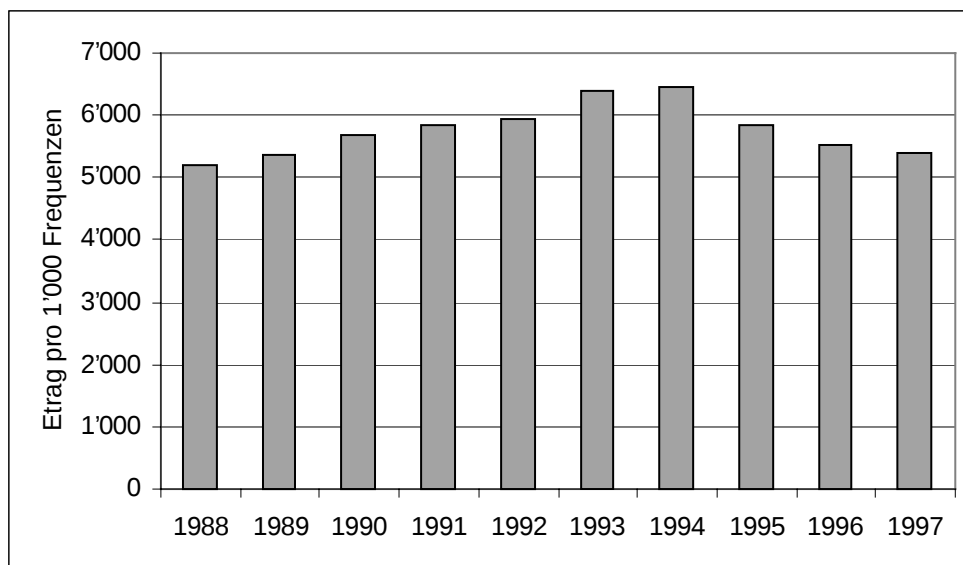
equity capital		CF in % of capital invested		
		<3%	3-5%	>5%
< 20%	Number of business units	7	7	4
	Headcount	181	438	222
	Balance sheet total in 1000 CHF	80'385	286'936	99'611
	Asset worth (balance)1000 CHF	69'955	253'156	84'144
	Asset worth (constr. account) 1000 CHF	132'752	572'728	208'519
	Supply in 1000 place-km	13'596	96'084	40'279
	Profit in 1000 CHF	34	1'080	949
20-40%	Number of business units	18	21	10
	Headcount	504	1'337	699
	Balance sheet total in 1000 CHF	285'765	615'749	133'886
	Asset worth (balance)1000 CHF	263'678	552'343	115'219
	Asset worth (constr. account) 1000 CHF	598'864	1'292'518	230'062
	Supply in 1000 place-km	141'030	279'549	64'555
	Profit in 1000 CHF	-287	6'304	972
40-50%	Number of business units	8	10	9
	Headcount	92	391	272
	Balance sheet total in 1000 CHF	67'219	142'003	138'916
	Asset worth (balance)1000 CHF	59'342	124'330	111'831
	Asset worth (constr. account) 1000 CHF	100'107	342'497	306'140
	Supply in 1000 place-km	19'839	83'647	84'711
	Profit in 1000 CHF	-1'060	1'326	5'258
50-80%	Number of business units	11	15	15
	Headcount	10	391	337
	Balance sheet total in 1000 CHF	50'958	107'799	116'035
	Asset worth (balance)1000 CHF	43'900	88'707	91'487
	Asset worth (constr. account) 1000 CHF	104'657	392'597	258'087
	Supply in 1000 place-km	26'886	71'531	83'239
	Profit in 1000 CHF	-292	4'227	1'986
>80%	Number of business units	2	3	5
	Headcount	10	21	117
	Balance sheet total in 1000 CHF	1'784	4'773	22'312
	Asset worth (balance)1000 CHF	1'247	661	13'033
	Asset worth (constr. account) 1000 CHF	4'434	6'955	41'503
	Supply in 1000 place-km	974	2'324	14'264
	Profit in 1000 CHF	-61	185	-71

Figure 5: Number of skiing areas in the USA (Source: National Ski Areas Association)



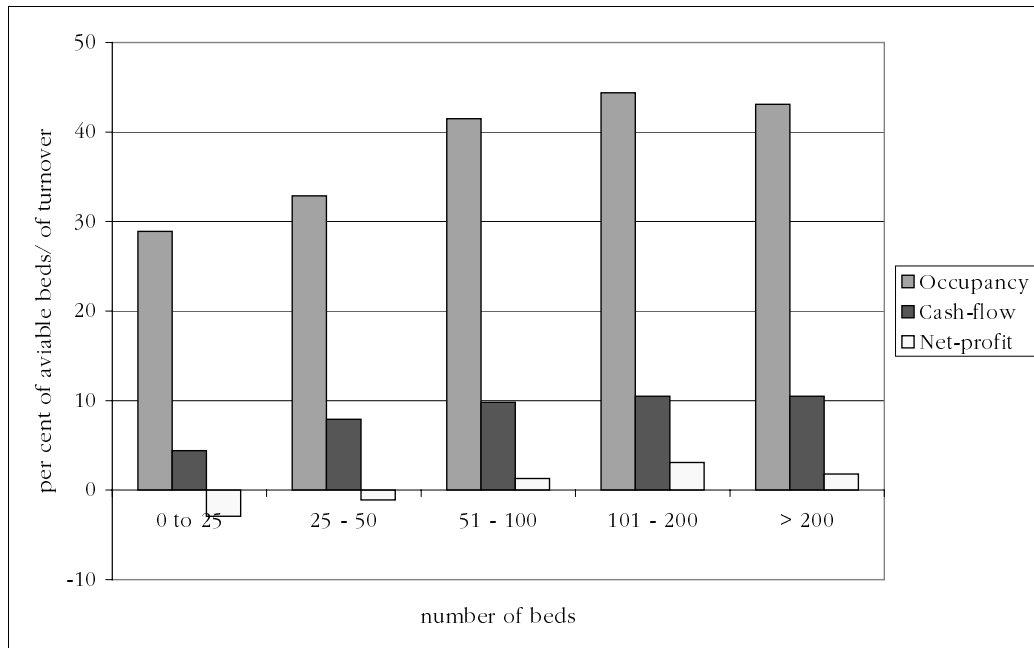
When they need additional funds to finance re-investments Swiss cable car companies very often get subsidies either from the local, state or federal government. As a result of this supply policy the average revenue per skier transported declined during the last 10 years dramatically. A consolidation of the industry would therefore be necessary.

Figure 6: Average earnings per 1000 frequencies of cable cars (Source: Own calculation based on BfS)



2.2 Hotel Industry

The Swiss hotel industry shows a similar picture. The debts per bed, according to the figures of the Swiss government agency for financing and credits for the hotel industry (SGH) which operates a quite representative panel of hotel operations and companies, have risen in each of the hotel categories. The number of hotel beds declined during the last decade but the occupancy rates are still on a very low level (see also Figure 2). Like in the cable car industry the bigger companies have better abilities to show a profitable operation.

Figure 7: Operating results by business size

Over all the average operational result of the hotels is just about sufficient to cover the depreciation necessary.

Assuming that the operational results of the Hotels follows a standard distribution one can hypothesise that half of the hotels in Switzerland are not able to generate economic value and therefore don't show any business sustainability (see Table 3).

Table 3: Income statement by hotel category (source: SGH, 1999)

Income statement	*****	****	***	**+*
+ earning on hostelling	41.5%	47.8%	58.1%	65.4%
+ earning on food & beverages	51.7%	48.0%	38.9%	31.6%
+ other earnings	6.8%	4.2%	3.0%	3.0%
Total Earnings	100.0%	100.0%	100.0%	100.0%
- expenses on goods and services	15.0%	17.9%	21.4%	25.3%
Gross Profit 1	85.0%	82.1%	78.6%	74.7%
- personnel	39.5%	38.1%	36.7%	31.9%
Gross Profit 2	45.5%	44.0%	41.9%	42.8%
- other expenses	16.0%	13.6%	13.0%	12.0%
Operating Profit 1	29.5%	30.4%	28.9%	30.8%
- management	5.1%	5.3%	6.3%	8.3%
Operating Profit 2	24.4%	25.1%	22.6%	22.5%
- total maintenance and replacement	7.3%	5.3%	4.4%	4.0%
Gross Operating Profit	17.1%	19.8%	18.2%	18.5%
- facilities and insurance	0.6%	0.4%	0.3%	0.3%
+ other earnings	3.0%	2.9%	1.8%	1.6%
- rental and leasing	2.5%	2.3%	1.3%	0.8%
+/- other financial earnings/ losses	4.8%	8.6%	9.8%	10.2%
Business Cash Flow	12.2%	11.4%	8.6%	8.8%
+/- exeptional earnings/ losses	3.5%	0.4%	0.9%	2.1%
Over all Cash Flow	15.7%	11.8%	9.5%	10.9%
- depreciations	14.8%	9.1%	8.7%	8.6%
Net Profit	0.9%	2.7%	0.8%	2.3%
average debt per bed (CHF)	CHF 86'455	CHF 76'359	CHF 60'252	CHF 49'644
average yeald per night (CHF)	CHF 239	CHF 121	CHF 75	CHF 60

2.3 Conclusion – lack of consolidation or re-allocation of capital

It seems that in the two most important tourism branches in Switzerland and especially in the Swiss alps half or even more than half of the companies operate in a situation that is not sustainable. That means they are not able to

generate enough cash-flow to finance their re-investments necessary guaranteeing their future operation. One could assume that the number of companies would have to decline. But as shown above a consolidation process doesn't really take place. Most companies stay in operation mainly thanks to public investment or the consumption of owners equity or even the banks policy to renounce on loans or selling them to other banks for a much deeper value. This lack of consolidation leads to a situation where

- ◆ capital is blocked in bad use. This means that infrastructure, buildings or land can't be given for other use, for example younger, more innovative hotel managers or alternative plants.
- ◆ equity from the owners (very often families) is consumed through operation which leads to huge social problems. Equity in a hotel often is the most important source of retirement income for many owners.
- ◆ the prices in the tourism industry are declining. Businesses staying in operation despite their economic losses increase supply and reduce prices which affects also the profitable companies negatively.
- ◆ in an over all view of sustainability it is questionable whether tourism can be legitimised at all when in specific areas companies involved, let's say the cable car companies and the hotels, produce insufficient financial results. This is the case in many smaller and medium sized alpine destinations. Since tourism affects the natural environment and since in these cases, as stated above, even regional economic sustainability is to be questioned. Tourism can only be legitimised through cultural sustainability what would prove to be very difficult.

3 Economics of consolidation – outline of an explanatory model

3.1 The model in overview – allocation theory applied

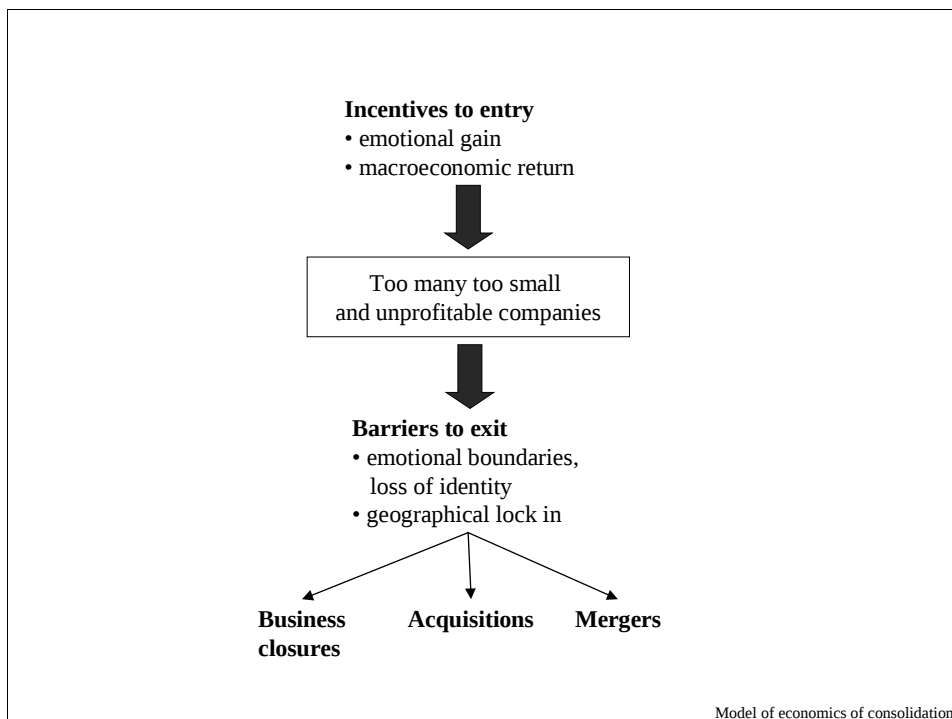
Economic allocation theory states that assets and resources are going to be employed in those uses where they are able to generate most profit. Several prerequisites are necessary to guarantee this use of assets and resources:

- ◆ Information transparency. Information about profits in different uses have to be available to the decision makers and they have to perceive these information as right and reliable. As shown above, in the case of tourism, at least on the macro economic level, data about the economic situation of different branches are available.

- ♦ Entry barriers. Resources and assets have to be able to move into new, more profitable employment. This ability can be hampered by regulations, dominating market positions or lack of accessibility to the profits.
- ♦ Exit barriers. Very often, resources and assets are blocked in less profitable use because of huge sunk costs mental barriers etc..

It seems that in the case of tourism, on the one hand, important exit barriers are working and on the other hand, quite strong incentives to enter still exists.

Figure 8: Model of economics of consolidation



3.2 Exit barriers

Small and medium sized entrepreneurs in tourism, especially in smaller communities, experience a unique unity of their professional, social and also financial identity. They are regarded and appreciated as owner of a specific hotel, they have their professional experience and field of relevance in hotel operation and very often they have the most of their money blocked on investment on this tourism company (cf. also Bieger 2001). A closure of their company therefore would affect their professional career, their social identity and would show them the before hidden consumption of capital. Retraining

programs for hotel managers or owners of other non-profitable tourism companies therefore hardly show any effects because they just deal with one sphere of problems: The sunk costs are very considerable. When a company would close down a mountain area all investments in this area, particularly in restaurants, snowmaking equipment and so on, would get lost. Therefore there is always a reason to finance a smaller investment that guarantees operation for the next few years and gives some hope in a better future.

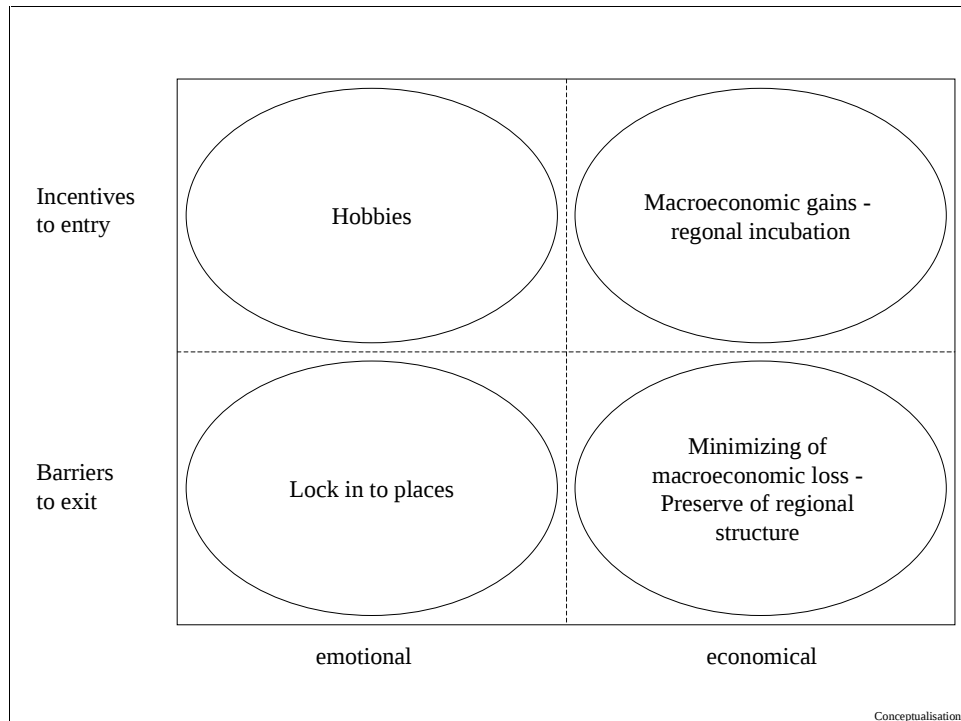
On the macro economic level there exist considerable exit barriers because a community or even the state would suffer significant losses of regional income and identity by the loss of a major regional tourism company. Therefore very often public subsidies are granted or the government renounces on paybacks of such grants or payings for services and land using by a company.

3.3 Entry incentives

Despite the insufficient funds of many tourism companies there still occur a lot of investments in this sector. Parts of these investments can be characterised as hobbies. There are many excellent hotels in Switzerland owned by rich people earning their money in other industries. It can be hypothesised that these companies also are an important part of the owners social life and identity. Very often, new companies are founded by local interest groups to guarantee a regional development. A very successful example is the hotel Hof Weissbad in the Appenzell region. This extremely successful four-star-hotel has been founded by a regional group of politicians and company leaders. This hotel at least is able to prove business sustainability.

3.4 Conceptualisation and case studies

The exit or incentive to stay in business can be characterised in emotional or economical categories. Doing so one can elaborate a matrix of reasons for lack of consolidation in industry (see Figure 9).

Figure 9: Conceptualisation

An emotional example for a barrier to exit could be a local sport shop owner who, despite the fact that he just is able to earn CHF 12'000 a year, stays in business and is not willing to sell his operation to the cable car company. An example for an economical incentive to entry may be found in the case of the above mentioned hotel Hof Weissbad. An economical exit barrier may be found in the cable car "Lungern Schönbüel". Lungern is a village about 30 minutes by car from Lucerne. This village also has other industries like wood processing, lock manufacturer and transport industry. There also exists another ski area about 10 min. away by car. Despite this lack of economic dependency on tourism and alternatives for skiing inhabitants the community decided to support the local cable car company which had gone in bankruptcy for the second or third time in their existence.

4 Conclusions – outline for a research agenda

In chapter 1 of this paper it had been hypothesised that growth in tourism is also driven by the growth of supply. In the case of Switzerland it has been possible to show that the market forces don't work on the supply side. That

means that capacities remain in operation which should - in an economic point of view - disappear. Therefore at least in this case it is possible to prove that supply is bigger than induced by the market forces and that therefore some kind of supply pull could work on demand. We have shown this relations on the example of the Swiss alpine tourism sector because the data are easily available. From our experience in other fields of tourism we can conclude that similar developments exist also in other fields of seasonal tourism.

Further research on the macro economic level has to focus on the issue of redistribution though tourism shows a considerable number of companies destroying equity and losing value. The question has to be asked where these values are going to or who gains through tourism. Further, more advanced frameworks of tourism satellite accounts should be able to answer this question. But then a second question arises: the question about social desirability of this redistribution

On micro economic level research would have to focus on the strategic decision making process in tourism. Since we know that many tourism investments hardly can show any profitability and therefore other even emotional aspects are of relevance, a question of emotional rationality behind tourism investment decisions has to be tackled. From a political point of view questions about how to reduce exit barriers might be of importance.

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