

Chpt 5 : Pricing Decisions and Profitability Analysis

Case: The Merrion Hotel

Source: Irish Independent (2015) :

<http://www.independent.ie/business/irish/merrion-enjoys-fivestar-profits-as-revenues-climb-to-1764m-31530317.html>

This hotel is the hotel of choice for visiting dignitaries and famous people when they come to Dublin. President Obama, Bruce Springsteen, Rihanna and members of the Troika (!) have stayed there. The multi-award winning hotel comprises 123 rooms and 19 suites and guests can pay €310 for a standard room per night to €3,200 for the penthouse suite, although discounting is used to give deals on these rates. The hotel also has a two-star Michelin starred restaurant.

In the year just ended 31 October 2014, staff costs went up from €7m to €7.2m as staff numbers grew from 278 to 281. At the Merrion, the revenue per room for the 2014 year of operations was €126,923, taking into account food and beverage sales as well. In January 2015, the hotel embarked on a 22 month long construction programme that added 12 new private residences, a new spa and restaurant overlooking the hotel garden.

Rooms in a hotel, seats at an event, seats on a plane, tables in a restaurant- the same limitation applies- that any spare capacity today is lost forever, a room not sold today is a roomnight lost forever. Therefore the perishability of the inventory means that once a sale has passed, it is gone forever. The roomnights or theatre seats cannot be stockpiled and sold later, unlike manufacturing businesses, where production and product selling can happen independently. In the short to medium term, hotels have a fixed capacity but in the longer term, extra capacity can be built such as more hotel rooms, bigger planes or additional planes being added to a route at short notice etc. Changing capacity changes cost, so this needs to be remembered.

Most hotels experience fluctuations in demand for hotel rooms such as peaks and troughs depending on the time of year and the day of the week. Weddings are most popular on Saturdays; business travel is mainly taken Mondays to Thursdays, but slackens in the summer as holidays are taken; short-break travel is mainly at weekends; major local, national and international events impact on demand for hotel rooms in Dublin and other cities- such as a Bruce Springsteen concert.

Yield management works well in situations where there are relatively low variable costs and high fixed cost structures. Hotels have low variable costs- usually they comprise (on the accommodation side) the costs of cleaning a room and of letting a room. This means that there is price discretion or that discounting is possible, because of minimal variable costs and substantial fixed

costs in a hotel. Therefore, it opens up the possibility of using dynamic room rates in pricing rooms. As the *variable* cost per occupied room is normally very low in relation to the average room rate in hotels, even a 50% reduction in the selling price leaves a sizeable contribution per occupied room. It also means that hotels must focus on maximising revenue rather than simply control of costs, as they have high fixed costs to cover, such as costs of insuring the hotel building, depreciation of fixtures and bedroom furniture and administration costs.

Yield Management (YM) is a *formal approach to room discounting* which focusses on price and market segment using technology to develop a room pricing policy (Adams, 2006). It assists in the maximisation of revenues from the sale of a product or service with the characteristics described above:-perishability, relatively fixed capacity, fluctuating demand and suitable cost structure (Jones et al, 2012). Clearly, hotel rooms fit this profile.

According to Harris (1992), the overall effectiveness of a YM system is dependent upon the implementation of the following market focussed principles:

1. Identification of a customer base, using a detailed segmentation strategy;
2. Developing an awareness of customers' changing needs and expectations;
3. Estimating the price elasticity of demand per market segment;
4. Responsiveness of management to cope with changing market conditions;
5. Accurate historical demand analysis, combined with a reliable forecasting method.

Yield management is concerned with maximising revenue yield from the combination of selling price and volume of activity. Ideally, hotel managers would like to sell all rooms at the highest (rack) rate but a trade-off develops between high occupancy and high room rates. The problem becomes one of determining how much to sell, at what price and to which market segment, so as to maximise revenue and profit.

The basic yield management formula for identifying the percentage yield achieved is simply to compare the actual revenue achieved with the maximum potential revenue:

$$\text{Yield statistic} = \text{Realised revenue} / \text{Maximum potential revenue} * 100$$

Realised revenue is the actual sales revenue generated. Potential maximum revenue is the maximum sales that could be obtained if all the available rooms were sold at full rack rate.

Example:

If a hotel has 100 rooms available, with a full rack rate of €120 per room, then its maximum potential revenue is $100 * €120 = €12,000$. However, on that night, if it only sold 70 rooms and achieved an average room rate of €90, then its actual achieved revenue was $70 * €90 = €6,300$.

$$\text{YM \%} = \frac{€6,300}{€12,000} = 52.5\%$$

An alternative computation for the yield statistic is to multiply the average rate ratio by the actual room occupancy percentage. The average rate ratio is calculated by expressing the average rate as a percentage of the rack rate ($€90/€120 = 75\%$). The average occupancy is $70/100 = 70\%$, so the second approach computes the yield statistic as:

$$70\% \text{ occupancy} * 75\% \text{ average rate ratio} = 52.5\% \text{ yield}$$

Other more realistic examples would be to compute the yield for a typical sales mix of market segments and rates for one night:-

Rack rate	30% * 100 rooms * €120 =	€3,600
Corporate rate	15% * 100 rooms * €95 =	€1,425
Walk-in trade	5% * 100 rooms * €80 =	€ 400
Travel agency	10% * 100 rooms * €55 =	€ 550
Groups	<u>4% * 100 rooms * €45 =</u>	<u>€ 180</u>
<u>Total Revenue</u>	<u>64 % occupancy</u>	<u>= €6,155</u>

$$\text{So Yield} = €6,155 / €12,000 = \underline{51.29\%}$$

OR

$$\text{Average rate achieved} = €6155 / 64 \text{ rooms} = €96.17$$

$$\text{Average rate ratio} = €96.17 / €120 = 80.14\%$$

$$\text{So Yield} = \text{Average Occupancy} * \text{Average Rate ratio}$$

$$= 64\% * 80.14\% = \underline{51.29\%}$$

The example shows roughly equal yield from the two situations.

Thus, YM is a combination of capacity utilisation/inventory management and pricing efficiency. This simple yield statistic provides a single value for measuring the performance of the hotel in revenue management terms, but it does not probe the profitability earned. To do this would mean deducting the cost of servicing the room from the revenue, so computing a contribution-based yield figure. See Adams (2006, p.112).

The yield statistic above can be maximised by managing both the room rate and the occupancy percentage, "so that when demand exceeds supply, the customer pays more and when demand is low, the price is discounted, while ensuring that each customer pays the maximum possible price" (Adams, 2006, p.112).

"Rate cutting can generate more revenues, but is not always transferred to the bottom line when operating profit per occupied room is falling, owing to expenses increasing at the rate of inflation" (Adams, 2006, p. 110).

However, there are problems, as noted by Adams (2006, p. 113), when a guest, having stayed one night, decides to extend the stay for one or more nights. "If the first night's stay is determined to be a low-demand, low-rate reservation, problems will arise if the ensuing nights of stay are during high-demand periods." To resolve this equitably for the guest, the rate offered for the extra nights might be an average of the low and high rates generated by the YM system.

To use the system effectively, there must be a clear methodology. In particular, there is a need to know the markets well and forecast demand for each market segment. To forecast demand, it is essential to analyse historical data in terms of the patterns of demand, the market segments and price elasticity. Demand analysis is complex- relating the type of room product and package on offer to the market segments requiring this; also the levels of demand from these segments at different times of the year needs to be understood, to capture some sort of estimate of number of rooms needed to meet each segment. The system logs information relating to customer booking patterns and behaviour and the timing of demand in each market segment, supported by data relating to the overbooking patterns and the impact of price changes on demand patterns and occupancy (analytics). This is too difficult a task to accomplish manually, so expert systems have been developed which are "software packages containing a knowledge base that allows the system to approach and solve problems, by interpreting the 'facts' based on decision rules written into the software". (Adams, 2006, p.113). See for example the market leading company: www.ideas.com

Originally, YM focussed on getting the best price for a plane seat, a concert ticket or a hotel room, without considering ancillary spend in other areas such as food, drink, tickets for tours etc, baggage fees. Revenue Management in hotels is now seen as a development of yield management and is considered more strategic, because it looks at the total guest spend on room, food, drink and other sales. Other developments would be to look at profit maximisation rather than just revenue maximisation from the total spend by the guest as well as identifying guest segments that are the most profitable for the hotel to serve- tours versus business traffic, families versus singles and short break markets etc.

Requirements:

1. In the light of the above, identify aspects of pricing discretion that appear to operate at the Merrion Hotel.
2. Suggest whether the Merrion Hotel appears to have moved to revenue management.
3. Discuss the impact on costs of the new construction programme. How will revenue management change with this new development? Consider also the typical impact of costs on hotels? What are the biggest costs faced by Irish hoteliers?
4. Research the website of leading Revenue Analytics company, IDEASL: <http://www.ideas.com/en> to see the latest in advanced revenue management solutions and take a look at their client success stories : <http://www.ideas.com/en/success-stories>

References

Adams, Debra (2006), *Management Accounting for the Hospitality, Tourism and Leisure Industries: A Strategic Approach*, 2^e, London: Thomson Learning.

Irish Independent (2015), "Merrion enjoys five-star profits as revenues climb to €17.64m" [online] Available from: <http://www.independent.ie/business/irish/merrion-enjoys-fivestar-profits-as-revenues-climb-to-1764m-31530317.html> [Accessed 20 Sept 2015].

Harris, P. (1992), *Profit Planning*, Oxford: Butterworth- Heinemann

Jones, T., Atkinson, H., Lorenz, A. and Harris, P. J. (2012), *Strategic Managerial Accounting: Hospitality, Tourism and Events Applications*, 6^e, Oxford: Goodfellow Publishers Ltd.

Outline Solution Case 1 : The Merrion Hotel

1. There is obvious variation in the room rates- depending on the type of room- "guests can pay €310 for a standard room per night to €3,200 for the penthouse suite, although discounting is used to give deals on these rates". These rates are likely to be rack rates, but depending on demand and time of booking, a guest could receive a significant discount on these rates. This might depend for example on say booking a weekend in Dublin, when there is no major event taking place, such as a rugby match, the theatre festival or a major concert. These weekends should not have attracted high demand, so the hotel is likely to be willing to discount from the rack rate, to fill rooms.
2. The Merrion mentions revenue per room taking into account food and beverage sales, so this is including the ancillary spend of the guest, rather than just focussing on the room rate and revenue generated from the room rate itself and no of nights of the stay. However, as they have added a spa, the potential is there to move to more detailed reporting of total revenue from each guest.
3. The extra cost coming from the construction of 12 new private residences, a new spa and a new restaurant overlooking the hotel garden, will confer an enlarged number of rooms to be filled and possibly increase the room rate for standard rooms, given the extra facilities provided. It may also mean that the break-even occupancy will change as there is an increase in fixed costs and so the hotel will have to include a charge for the spa as this is a costly resource to supply, although we are not given details of whether it includes a swimming pool.

Spas can be difficult for hotels to run, as they require staff to be present to serve the customer and bookings may not be predictable. Guests may intend to use the spa but if it is not free, may decline. Alternatively, the hotel may have to bundle some extra charge for the use of the spa into the room rate, but may not disclose the extra charge to the guest, so the guest thinks it is free. Matching staff cost to the occupancy/booking levels of the spa is difficult. Paying staff to attend, if guests do not show up, should attract some sort of cancellation fee. Also the cost of heating a steam room or the cost of cleaning and staffing a swimming pool, can be extremely high. It might be purely treatment rooms for facials, massages etc, but the hotel should ensure that there is an alternative use for these rooms, should the spa not attract many bookings. Also many spas try to ensure that energy sources can be directed at rooms in use only, rather than incurring energy costs centrally, irrespective of use. Some spas contain a café, which can provide high margin energy drinks, coffees etc. Also a spa may be considered a vital part of service to the guest, but

hotels should do market research, to ensure that its guest segment actually would use a spa. Urban hotels can find it difficult to locate the spa within the confines of the space they have- compare this to rural hotels who can sometimes locate a spa with a view over a river- See <http://www.fallshotel.ie/spa-leisure.html>

Also see quote from Stephen McNally, the CEO of the Irish Hotels Federation mentioning the high costs still faced by hoteliers-

He cautions that many premises are operating from a low revenue base following the down turn, which means the *high cost of servicing overhanging debt* is a serious challenge. This continues to weigh heavily on many hotels with some 34% saying they remain concerned about the viability of their business. Other challenges highlighted by hoteliers include the high cost of doing business in Ireland, hotels and guesthouses citing *excessive local authority rates* as the single most pressing issue stifling cost competitiveness within the sector. This is followed by *high labour costs, utility costs* and subdued consumer confidence.

Source: <http://www.ihf.ie/content/press-release-89-irish-hotels-and-guesthouses-seeing-upturn-business-2015>

4. See for example : <http://www.ideas.com/company/company-overview>

IDEaS Revenue Solutions - a SAS Company, was started in 1989 and offers leading edge pricing software and consulting to the hospitality and travel industries. It was acquired in 2008 by SAS, a leading business analytics software and services company.

See for example some of their client success stories:
<http://www.ideas.com/en/success-stories>