Empty Airline Seats Or Vacant Hotel Rooms...

Both Offer Opportunity For Profit

By J. David Berry, Professor at Niagara College

In issue #59 we published one of the most informative articles ever to appear in the pages of BarterNews. *Titled "The Marginal Cost of Barter," CPA George Kopecky broke down the variable and semi-variable costs which should be considered if rooms were traded.*

In "Turning Vacancy Into Profits," issue #60, we disclosed how an increase in occupancy will provide additional revenues to other departments. Thereby providing more profits to the property in absolute terms.

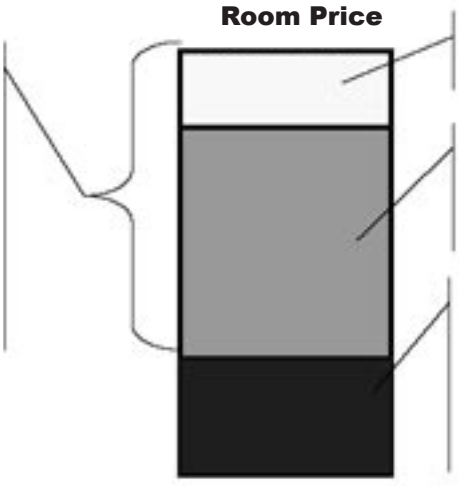
In this issue we look at the perishable hotel room and how discounting can be part of a strategic marketing plan. Companies that acquire discounted inventory will often then trade or sell the rooms into non-competitive markets which will benefit the hotelier.

Why should hotels be any different than airplanes? Both have perishable products. Both have high capital cost. Both have low variable cost. Gone are the days when a plane will take off with half the seats empty.

Next time you're in an airplane, compare the price of your ticket to the occupied seat beside you. Don't be surprised if the difference is as much as 50%. Airlines know that vacant seats are lost profit. Hotels are exactly the same. To see the logic of this, let us review the basic economics.

Price Structure

Contribution: Excess of price over variable cost. Amount of price that is contributed to fixed cost or profit once fixed cost is covered.

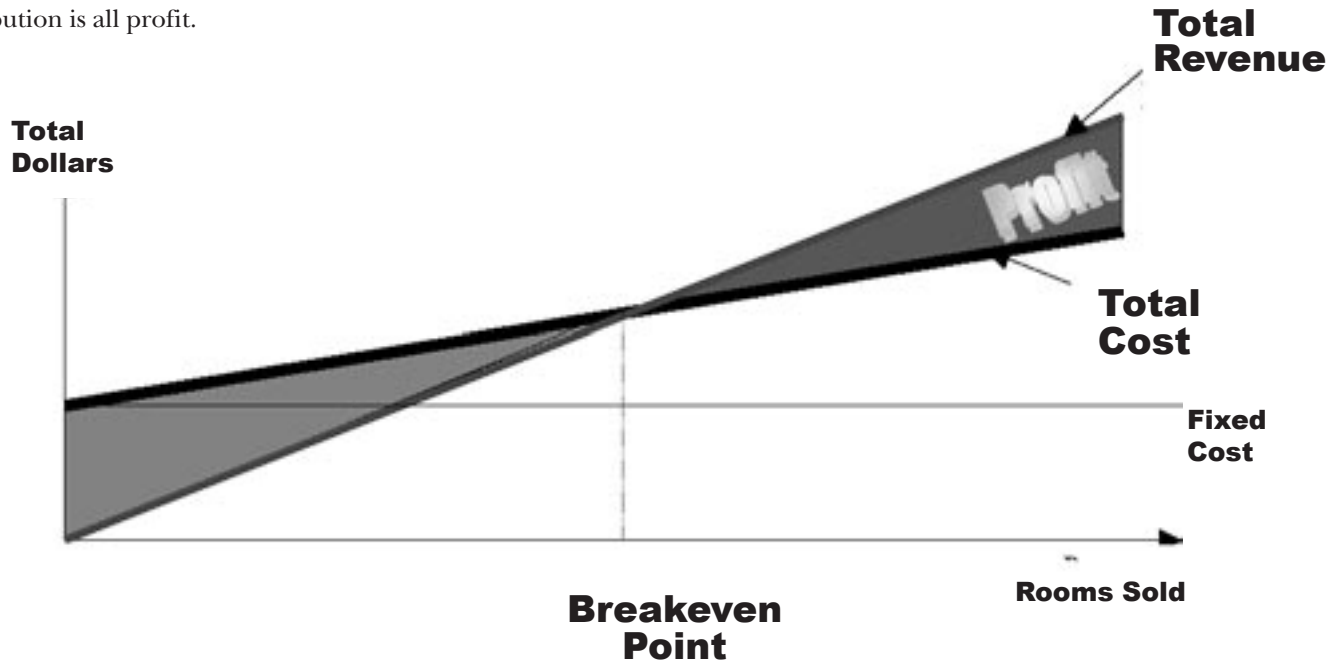


Profit: Yours to keep.

Fixed Cost: Costs that do not fluctuate with the number of rooms sold.

Variable Cost: Costs that vary as rooms are sold. If no rooms are sold there will be no variable costs.

So how does this relate to the number of rooms sold? As the number of rooms sold increase over a fiscal year the contribution accumulates towards fixed cost until breakeven. After this the contribution is all profit.



Therefore, in theory, as soon as sufficient rooms have been sold to cover their variable and all fixed cost for the year (breakeven), any amount of the room price over the variable cost (house keeping, laundry, soaps, etc.) is all profit.

Consider that variable cost is about 30% of room sales. That leaves a whopping 70% going into the bottom line. If only it were that simple.

Hotels don't operate this way. Overhead costs and cash flows continue all year, while operating expenses are not easily subdivided into fixed or variable cost.

Hoteliers have to serve several markets with various demand elasticities. Within this framework, setting prices can be as dangerous as "Day Trading" on the stock market.

Hotel Revenue Managers must contend with business travelers or walk-ins that book late and are willing to pay higher prices, while higher occupancy levels can be ensured with lower paying conventioneers and vacation travelers that book in advance.

So the balancing act is between high occupancy rate at lower average room rates, or lower occupancy rates at higher average room rates. Since every room-night is perishable, managers are like air traffic controllers, navigating the next 365 days of this complex market to a successful landing.

Even if a hotel is well managed and the market responds to their efforts, success can usually be measured at 75% occupancy levels. This simply means that 25% of the annual room-nights do not land.

So the question facing the Revenue Manager is simple. Normal marketing efforts have not allowed the 25% unoccupied rate to decrease; so do we discount prices? The idea of discounting must be introduced as a secondary pricing policy.

You discount only when the room-night will be otherwise lost. Normal pricing allows for a range of product price to satisfy a range of market segments.

Discounting comes into effect when supply is guaranteed to be greater than demand. This would be normal fluctuations during a day of the week or month of the year. It is at these periods when the discounting can use the contribution method of pricing.

Here's the rule: ***The price can be set low but must cover the variable cost.***

Since every room-night is perishable, managers are like air traffic controllers, navigating the next 365 days of this complex market to a successful landing.

The rule must be applied with caution and care, and only if the rooms are going to be excess capacity.

If applied too liberally in periods of low demand, it can undermine the primary pricing policy and alter the market elasticity. Discounting should be part of a strategic market plan to enter alternative markets.

CTEX Group (www.ctex.com), with offices in Toronto, New York, London and Barbados, is a company that offers specific solutions to vacancy by way of private capital and travel management programs.

Well applied discounting can be a true advantage, increasing:

- ❑ Occupancy levels
- ❑ Total revenues
- ❑ F&B sales
- ❑ Yield percentages

The table below is a simplified example of:

150 room hotel

$120 average room rate

Normal 75% annual occupancy rate

Increase occupancy rate by 10% all at 1/2 average room rate.

The result is to increase revpar and yield by 6.6%; total revenue is increased by $650,000 or 8.7%.

The critical concept here is that a prudent manager can obtain better revpars, revenues, cash flows, and profits by carefully applying discounting to the normally vacant rooms. To the right manager, vacant rooms can be thought of as an opportunity for profit.

[J. David Berry (B.A.Sc.; MBA), Professor Co-ordinator Post Graduate Studies, Hospitality & Tourism Division, Niagara College in Niagara Falls, Ontario. E-mail: dberry@niagarac.on.ca]

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			Current Occupancy		Increased Occupancy		% Increase
Number of Rooms			150		150		
Occupancy Rate			75%		84%		
Annual Rooms Available			54,750		54,750		
Occupied Rooms			41,063		46,063		10.9%
Rack Rate			$ 140.00		140.00		
Average Room Rate			$ 120.00		114.57		-4.7%
Revenue Per Available Room (RevPar)			$ 90.00		$ 96.39		6.6%
Yield % (Actual/Potential)			64%		69%		6.6%
Departmental Revenues							
Room			4,927,500		5,277,500		
Food & Beverage	per room =	$50.00	2,053,125		2,303,125		
Other	per room =	$10.00	410,625		460,625		
Total Revenue			7,391,250	100%	8,041,250	100%	
Departmental Costs							
Room	% of Room Revenue =	25.0%	1,231,875		1,319,375		
Food & Beverage	% of F&B Revenue =	45.0%	923,906		1,036,406		
Telecommunication	% of Room Revenue =	0.75%	36,956		39,581		
Other	% of Room Revenue =	0.50%	24,638		26,388		
Total Departmental Costs			2,217,375	30%	2,421,750	30%	
Departmental Income			5,173,875	70%	5,619,500	70%	
Undistributed Operating Expenses							
Admin. & General	% of total revenue =	10%	739,125		804,125		
Management Fee	% of total revenue =	3.5%	258,694		281,444		
Marketing	% of total revenue =	5%	369,563		402,063		
Repairs & Maint.	% of total revenue =	3%	221,738		241,238		
Utilities	% of total revenue =	5%	369,563		402,063		
Total Undistributed Operating Expenses			1,958,681	27%	2,130,931	27%	
Income Before Fixed Expenses			$3,215,194	44%	$3,488,569	43%	7.8%