CHAPTER 1

Introduction to Revenue Management

CHAPTER OUTLINE

CHAPTER HIGHLIGHTS

1. Explanation of why an excessive internal focus on profits or owner's return on investment is detrimental to the long-term success of a hospitality business.
2. Explanation of why businesses exist to create wealth for their customers and how effective RM helps them do that.
3. Overview of the RM-related information contained in the remaining chapters of this book.

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INTRODUCTION

Professionals in the hospitality industry increasingly understand that management of their **revenue** (revenue management) is critical to their organizations' success.

It may seem surprising that only fairly recently has the full-time position of revenue manager been created by forward-thinking hospitality organizations. What is somewhat surprising is that it has taken so long. What these progressive entities now recognize is that nearly every member of their hospitality organizations has a role to play in revenue management (RM).

The professional hospitality associations that provide critical operating information to their members have only in the past decade created coursework, certification programs, and continuing education/ professional development classes focusing exclusively on RM. Even today, most of the materials used for instruction in RM have been developed primarily for the lodging rather than foodservice and other important segments of the hospitality industry.

Essential RM Term

Revenue: The total amount of sales achieved in a specific time period. Revenue is calculated as follows:

Number of units sold × Unit price = Revenue

Increasingly, however, professional hospitality educators worldwide understand that the management of revenue is a topic of sufficient depth and complexity to warrant its own course content. These enlightened educators are now discovering that virtually the entire hospitality curriculum could (and perhaps should) be designed around the basic tenants of RM.

This book has been developed to assist hospitality organizations, associations, educators, and, most importantly, those professionals who wish to become very highly skilled at managing revenues in the hospitality industry. The book emphasizes the importance of strategic pricing as a key tactic in effective RM, simply because the prices charged by a company communicate a great deal of information to its customers and determines, in great part, the total sales revenue the company will achieve.

Because of the importance of a business's revenue generation, it would seem that implementing effective business strategies designed to optimize revenues would be crucial and fairly easy. It is indeed crucial, but for a variety of reasons, it is not so easy. Among the most significant of the reasons is that most traditionally trained hospitality managers do not understand the basic tenants of RM, nor do they fully appreciate the large number of organizational misconceptions, biases, and misunderstandings that actually work against them when implementing effective RM strategies.

This book is designed to address and dispel many of those misconceptions, biases, and misunderstanding. The reasons it is important to do so are fundamental to business success because, in the final analysis, effective managers of an organization's revenues simply *must* do three things:

1. Understand the importance of RM
2. Understand the many complex factors that influence RM strategy and tactics
3. Become better at making RM decisions than their competitors

Interestingly, these goals should not be new. Those in business have, since the beginning of commerce, grappled with the complexity of how to best price the products they make and the services they provide, and especially so in the face of competition from others offering similar products and services. These early entrepreneurs understood the importance of strategic pricing because of a simple mathematical truth; in a service business, the *sum* of prices paid by a business's customers equals the total *revenues* received by that business.

Unfortunately, despite all that has been learned over thousands of years of commerce, the question of how much to charge for hospitality products has too often been viewed as one best answered by rule-of-thumb, or mathematical formula; and thus, it has been addressed primarily by those who specialize in hospitality accounting. The rationale for doing so has been the widely held belief that prices for hospitality products should be directly related to the cost of producing or delivering those products or services.

Knowledgeable revenue managers understand that costs and price are related, but that the latter is not dependent on the former (nor should it be). Yet the firmly ingrained idea that costs should dictate price is just one good example of the misconceptions held by those who do not truly understanding the complexities of selling hospitality products to consumers in today's Internet-driven economy.

Readers of this book will find that it presents hospitality professionals with a significant number of additional concepts that may, at first, appear counterintuitive or just plain wrong. Consider this sentence taken from a later portion of this chapter:

> *It is important to recognize that if an organization's primary focus is the generation of profits, it will inevitably go out of business because it will lose out to organizations that know enough not to focus on profitability.*

Initially, statements such as this one might seem controversial, but they will be presented only when supported by fact, illustrated with real-world examples, or failing those two, proposed for the reader's consideration based on a preponderance of evidence garnered by the author teams' 75-plus years' experience as, collectively, a hotel owner, director of sales and marketing, front office manager, foodservice director, data scientist, professor, writer, and, most importantly, life-long student/observer of the fascinating field of hospitality management.

The preliminary response to controversial ideas (those that have the potential to change the "status quo" of RM thought to "Status Go!") may be the informed reader's initial disbelief or even strong disagreement. If, however, that is followed by vigorous debate and open-minded and spirited discussion and ultimately by increased sophistication in the application of RM strategies and tactics in the hospitality industry, then the industry and its customers can only benefit from the exchange. It is the authors' desire that, in concert with open-minded readers, we can together begin a meaningful exploration of the intriguing topic of RM in the hospitality industry.

THE PURPOSE OF BUSINESS

Essential RM Term

Hospitality business: An organization providing food, beverages, lodging, travel, or entertainment services primarily to people away from their homes.

We start our examination of RM at the very beginning. If you are reading this book, it is most likely because you are now, or in the future want to be, in the **hospitality business**. If that is true, it would be fair to ask: What will be your purpose? Stated differently, if you plan to go into business, what is the purpose of business? Even more specifically, what is the purpose of a hospitality business? Ask that question to many hospitality professionals and you are likely to get one of two seemingly reasonable answers:

1. To achieve profits
2. To generate returns on investment for the business's owners

Despite their initial appeal, both answers are flawed, and if you hope to successfully manage revenues in a hospitality business, you need to understand why.

The Profit Fallacy

If you want to be in the hospitality business, you likely want to be involved in a profitable hospitality business. That would be a logical choice because, in the long run, only profitable organizations will stay in business. It is important to recognize, however, that if an organization's *primary* focus is the generation of profits, it will inevitably go out of business because it will lose out to organizations that know enough not to focus on profitability.

The two previous sentences are not contradictory. The critical nature of profits should not lead those in business (and especially those in a hospitality business) to focus their efforts on maximizing their companies' profit levels. The organizational focus must be elsewhere. To understand precisely where organizations should direct their primary attention, you must first analyze the commonly accepted (but unsatisfactory) definition of profits, and then come to a deeper understanding of the concept of profits.

To many hospitality owners and managers, profit is defined as a firm's total revenue minus its total operating costs or expenses. That seems logical. If you know basic accounting, you also know that, with a very few exceptions, hospitality accountants and managers use the words *expense* and *cost* interchangeably. Specific types of costs (expenses) may be identified in a variety of ways. Some common accounting terms used to identify various types of costs include fixed costs, variable costs, controllable costs, and noncontrollable costs, but they are all considered costs.

Similarly, the terms *sales* or *income* are often used as a substitute for revenue. The result is that it is not unusual for accountants to define profits utilizing one of the following two basic versions of the accountant's profit formula:

Accountant's Profit Formula

Revenue – Expense = Profit[1]

Applying basic algebra, and substituting more familiar and commonly used industry terms, the accountant's formula becomes:

$$\text{Profit} = \text{Sales} - \text{Costs}$$

As you will learn in this book, the accountant's formula (as well as the economist's profit formula, which you will learn about later in this chapter) is not completely on target, although both do touch on some important aspects of truth regarding profits. You likely are fairly familiar with this commonly accepted but inadequate meaning of the word *profit*. But being familiar with a concept does not necessarily mean that the concept is fully understood or is particularly useful. To actually *generate* significant profits in a hospitality business by successfully managing revenues, you must comprehend profits both *completely* and *differently*. You must acquire a revenue manager's understanding of the meaning of profits.

To begin, you should recognize that successful revenue managers understand well that in any rational business transaction, both the seller (the business) *and* its buyers (customers) seek a **profit**.

Essential RM Term

Profit: The net value gain by a seller *and* a buyer in a business transaction.

A careful reading of this definition reveals that, in a successful business transaction, both buyer and seller gain. If you are reading this book because you are interested in becoming an outstanding manager of your business's revenues, it is critical that you stop reading now and memorize this profit definition. It is the crucial foundation of effective RM and yet it is most often neglected when organizations, in the quest for profits, establish their prices.

This somewhat-unorthodox definition of profit is most certainly *not* a new concept. Consider the advice given in the early 1900s by retail business legend Herbert Marcus (co-founder of Neiman Marcus) to his son Stanley when he said:

> *There is never a good sale for Neiman Marcus unless it's a good buy for the customer.*[2]

Think about it and you will recognize it is true. Buyers seek a profit as much as sellers. To illustrate; if you have ten dollars and purchase an item priced for that amount, you (the buyer) seek to acquire something that you want *more* than you want to keep the ten dollars you already have. If you *willingly* part with your ten dollars, it is only because you see a value in exchanging the ten dollars for something worth *more* than ten dollars *to you*.

To keep this illustration very clear, consider Figure 1.1, a recap of a typical buyer's likely interest in three alternative business transactions (propositions) that have been offered by a business organization whose stated goal is to make profits for itself. In this illustration, the prospective buyer is holding one ten-dollar bill.

Note that in this example (as in the real world), the informed buyer would have a high interest only in proposition #3, the trade that results in a clear profit for the buyer. That same buyer will likely have zero interest in proposition #1, which would result *only* in the seller's profit. It is important to understand that it matters not that the item traded in this example is money. In fact, the use of money as the item to be exchanged in this example clearly illustrates a fundamental truth about the

Figure 1.1 Three Business Propositions Related to a Ten-Dollar Buyer/Seller Transaction

Seller's Proposition	Resulting Profit	Informed Buyer's Willingness to Accept and Repeat the Trade
#1. Trade nine $1.00 bills for the buyer's $10.00 bill.	$1.00 to the seller	Zero
#2. Trade ten $1.00 bills for the buyer's $10.00 bill.	$ 0.00 to seller and buyer	Possible, but unlikely
#3. Trade eleven $1.00 bills for the buyer's $10.00 bill.	$1.00 to the buyer	Highly likely

twenty-first-century economy; namely that our current technology-driven economy still operates in much the same way as every other **barter system** used in the history of humankind. Revenue managers can learn important lessons from that time-tested trading system.

Essential RM Term

Barter system: A trading system in which goods and services are exchanged without the use of money.

All of today's business transactions have evolved from the barter system. Bartering is an economic activity that consists simply of two individuals *trading* one item for another. In such a system, the terms *buyer* and *seller* are essentially irrelevant because both individuals participating in the trade take on the dual roles of buyer *and* seller.

To illustrate a barter economy that does not use money as a medium of exchange, assume a baker trades two loaves of bread for a poultry farmer's single chicken. As you can readily see in this example, the baker and the farmer take on the role of buyer *and* seller. Just as a barter system erases the lines between buyer and seller, it erases the lines between sellers' costs and their profits. If both participants in this transaction were voluntary participants in the trade, it could be said that they agree the *cost* of a chicken is two loaves of bread. The *cost* of a loaf of bread is one half a chicken.

It is important to understand that, in this example, the accountant's definition of a *profit* in the trade is not a major consideration of the baker or the farmer. This is so because *both parties involved in this trade achieved a gain (profit)*—which you will recall is *the net value achieved by a seller and buyer in a business transaction*. The gain for the farmer is ownership of desired bread; the baker's gain is ownership of a desired chicken.

Barter economies can work well in some cases, but they do have built-in problems. For example, perhaps the farmer in this scenario would really like to begin eating one of the loaves of bread today but would prefer to receive the second loaf next week, when the first loaf has been eaten and the second loaf will be freshly baked. Similarly, the baker may want to cook only half a chicken today with the remaining half desired for cooking in a coming month. The limitations of a barter system in this example are evident. There are others. For example, in a barter system, an apple grower who wished to obtain shoes would have to not only locate a shoemaker who wanted apples but also find a shoemaker who wanted to own some apples at the time the grower's crop of apples were available for trading. The invention of **money** solved both these types of problems (and made the construction of Figure 1.1 in this text much easier!).

Essential RM Term

Money: An acceptable medium of exchange used as the measure of the value of goods and services.

It is important to recognize that money actually has no fixed inherent value. You cannot eat coins or currency, nor can the owners of money do much of anything useful with the metal, paper, cryptocurrency, or any other items people generally accept as money. Money is highly useful; however, because if those who have it can jointly agree on its worth, it greatly facilitates the many trade transactions that can take place in a money-based economy. Its use is simply more efficient and more convenient than a barter system.

It should now be clear to you, however, that money is not the same as value, nor does it represent stored-up value. Money is simply an easy way to quantify the amount of one item its owner will give up in order to get another item. Applying this truth to the hospitality industry, it would be foolish to think that simply because a chicken dinner is offered for sale by a restaurateur for ten dollars, that its value is ten dollars. If, in fact, a guest willingly purchased the ten-dollar chicken dinner from the restaurateur, it would simply mean that both parties in this trade valued the new item each received (chicken dinner for the diner and money for the restaurateur) *more* than they valued keeping what they originally had. If the trade of the chicken dinner for the money were made, it would be a historical fact that, at a certain time and place, this trade between two trading partners occurred. This historical fact would not necessarily establish the intrinsic "worth" or "value" of a chicken dinner to you or to me. In fact, if you are a vegetarian, you would not likely place any personal value on the chicken dinner. If you were extremely hungry, you might value the chicken dinner at much more than ten dollars. The point to remember is that one consumer's view of a chicken dinner's value may, or may not at all, be influenced by what other buyers would exchange for it. This *variance* in buyers' willingness to trade their money for goods and services is another important concept that will be fully explored in this text.

To further make an important point about the variable worth of items, let's return to our barter economy example. Assume that the baker awoke one day to discover he had become extremely allergic to chicken. In such a case, would the worth of one chicken still be equivalent to that of two loaves of bread? Not to that baker. Not surprisingly, an incredibly large number of external and *non-cost-related* factors work to influence the willingness of two individuals to take part in a specific trade. The critical point for those in hospitality businesses to remember is that in each case of a willing exchange, an independent decision will be made by *both parties* regarding what will be given up and what will be received in exchange.

In today's Internet- and smart-device-influenced economy, never have so many potential trading partners had more up-to-date trade-related information available to them. As a result, never have consumers been able to consider their alternative trade options more carefully and thoroughly. In fact, the wealth of information about potential trades available to the average consumer has changed our money-based economy as radically as money changed the barter-based economy (a fact that is especially true for those money-for-rooms trades taking place in the lodging segment of the hospitality business, a phenomenon addressed in detail later in this book).

Now that you more fully understand barter systems, money, and the roles of both parties in a trade transaction, you are in a better position to reexamine the information in Figure 1.1. Note first that the terms *seller* and *buyer* should seem less important to you. In fact, you now likely would be just as comfortable if the terms used were trading partner A and B, rather than seller and buyer. If that is true for you, then you have come to a realization that consistently eludes many in the hospitality business. There are no buyers (customers). There are no sellers (businesses). There are only potential trading partners.

Profit (whatever that term may mean to either party) is *not* the trader's main concern. What is given up versus what is gained is the main concern. Lest, however, you begin to think the author is proposing that the hospitality business consists simply of one happy group of organizations blissfully seeking to assist like-minded trading partners, read the Red Lobster story presented in RM in Action 1.1.

In this classic Red Lobster example, a hospitality business simply found that its eager trading partners behaved very normally and maximized what they got in exchange for what they gave up. Alternatively, the Red Lobster company did not; and for that mistake, experienced industry observers might conclude its former president simply paid the price.

Now that you understand that profit (value) is a factor of interest to those who *buy*, as well as those who sell, products and services, it should be easier to understand the limitations of the accountant's business-focused and rather one-sided formula for calculating profits. It should also be easier for you to revisit and understand the wisdom of the statement of Herbert Marcus:

There is never a good sale for Neiman Marcus unless it's a good buy for the customer.

RM IN ACTION 1.1: ALL-YOU-CAN-EAT CAN BE TOO MUCH

Some believe that Red Lobster's chief executive was ousted after a crab promotion lost money. The parent company says that wasn't the reason.

In 2003, television commercials for the nation's biggest chain of seafood restaurants invited diners to "*Red Lobster's Endless Crab: A celebration of all the hot, steaming snow crab legs you can eat.*" What top management of the 645-restaurant chain apparently never expected was a plethora of customers who would eat so much crab that they ate up all of the chain's profits, as well!

Management vastly underestimated how many Alaskan crab legs customers would consume during the promotion that ran one year from July 21 through September 7. As a result, Darden Restaurants of Orlando replaced the president of Red Lobster; its biggest chain.

"It wasn't the second helping, it was the third one that hurt," company chairman Joe R. Lee said in a conference call with analysts. "Yeah, and maybe the fourth," added Dick Rivera, Darden's chief operating officer. Rivera has taken over as president of Red Lobster.

The former president, who had been in the job only 18 months, and who personally approved the Crabfest promotion, has left "to pursue other interests," the company said.

Many of the chain's locations reportedly started out by charging about $20 for an entree of all-you-can-eat crab and side dishes. When profits started slipping, managers raised the price by as much as $5 per diner, depending on the market, but it still wasn't enough!

Excerpted on 11/11/2007 from www.stpetersburgtimes.com/2003/09/26/State/All_you_can_eat_was_t.shtml.

The lesson from Marcus and Red Lobster for the savvy revenue manager is that business exchanges have to be good for both parties of the exchange.

The Return on Investment Fallacy

Experienced businesspersons having read the previous portion of this chapter may (if somewhat reluctantly) agree that maximizing company profits should not be the primary purpose of a business. They would recognize that customers are equal parties to every trade, and thus it is part of their jobs to ensure their own customers make a profit (gain value) on every transaction. These same businesspersons may steadfastly maintain, however, that maximizing returns on an owner's investment, or increasing a business owner's wealth, is the true purpose of a business. The question of the purpose of business as it relates to the creation of wealth has occupied the thoughts and writings of countless bright and insightful individuals, including many studying in the field of **economics**.

Essential RM Term

Economics: The area of study concerned with the production, consumption, and transfer of wealth.

As part of their examination of wealth, economists study businesses and business profits. Like those in the field of accounting, economists have a formula for profits that should be understood by revenue managers:

Economist's Profit Formula

Profit = The reward for risk

What an economist wishes to communicate by using this formula is simply that business organizations are not guaranteed a profit. Stated another way, profit is

the compensation accruing to entrepreneurs for the assumption of risk in (a) business enterprise.[3]

Thus, business owners who actually do achieve a profit have done so as a result of their willingness to accept the very real risk of not making a profit.

Economics is the area of knowledge that describes how humans earn and spend their resources (money). When business owners elect to spend their own money by investing in a business, they do so to achieve investment returns that, when added to their original investment amount, increase these investors' total wealth.

Essential RM Term

ROI: The shortened version of "Return on investment":

ROI is the reward to investors for taking an investment risk.

A simplified formula for expressing an owner's **return on investment (ROI)** is stated as a percentage related to the owner's initial investment. ROI is commonly calculated as:

$$\frac{\text{Owner's investment return}}{\text{Owner's original investment}} = \text{Owner's return of investment (ROI)}$$

To illustrate ROI, if an owner invests \$800,000 in a business and achieves \$200,000 in investment returns (defined as revenue in excess of all expense), that owner's ROI would be 25 percent (\$200,000 investment return/\$800,000 original investment = 25% ROI).

In reality, calculating ROIs can be quite complex. In ROI calculations, legitimate questions about the process include whether investment returns before or after taxes should be considered, as well as how to accurately determine the amount initially invested (e.g., questions arise about whether the investment should include debt and equity financing and how to value assets).

Regardless of the finer points of ROI calculation, certainly it would *seem* it could be safely stated that *the purpose of business is to increase the wealth of the business's owners.* In fact, the opposite is true.

The only legitimate purpose of a business is to increase the wealth of its *customers.* In fact, the only thing that can safely be said about business is that a business will not continue to exist simply because it is efficient, does a good job controlling costs, or creates many jobs. It should, and will, continue to exist *only* to the degree that it creates wealth for its customers. Over 65 years ago, noted management consultant Peter Drucker put it another way:

The purpose of business is to create and keep a customer.[4]

Businesses do so by ensuring that each customer transaction results in an increase in wealth *for the customer*. Amazon founder (and 2020 world's richest man) Jeff Bezos recognizes this same concept when he states:

> *When given the choice of obsessing over competitors or obsessing over customers, we always obsess over customers.*[5]

Sometimes the owner or managers of a company lament that their customers do not appreciate the fact that their business must make a profit (or earn investment returns) if it is to survive. Actually, this is not surprising at all when you recognize that customers are absolutely indifferent to the profit or ROI needs or goals of a business. Nor do customers care about a business's costs, its long-term financial goals, or its internal workings, excepting for how those factors directly affect the value (wealth) gained by the customer in a transaction with that business.

In fact, if asked, most customers would likely maintain that the *lower* the profits of a business, the more its customers benefit in a seller/ buyer exchange. As a result, if a businessperson bemoans the fact that he or she is not making a profit on a specific sale, or desired levels of ROI, that information will most often be met with the customer's glee, not sympathy.

Just as a focus on maximizing operating profits is a short-sighted business strategy, so too is overemphasis on maximizing owner/shareholder investment returns. If it seems to you that an inordinate amount of time in this chapter has been devoted to examining what businesses should *not* do, it is because much too often the same philosophical errors that confuse business professionals' views of their own purpose also affect their views about the true purpose of RM.

THE PURPOSE OF REVENUE MANAGEMENT

Business profits are the result of two tasks: generating revenue and controlling expenses. However, revenue managers who purchased this book thinking they would learn how to cleverly increase their prices to unsuspecting customers and thus maximize their own company revenues and profits as a result of that clever pricing likely recognize by now that that is not the approach that we will be taking.

Thus far, you have learned that the primary purpose of a successful hospitality business must be to provide profits to its customers (not itself), and as a result, increase those customers' wealth (not the wealth of the businesses' owners). Businesses that effectively service their customers' needs will, however, prosper and achieve high levels of their own operating profits. They will also produce attractive ROIs for the owners of the business. Auto maker Henry Ford nicely summarized this truth:

> A *business absolutely devoted to service will have only one worry about profits. They will be embarrassingly large.*[6]

This same concept is understood by outstanding hospitality leaders as well. Ray Kroc, founder of McDonald's, put it this way:

> *If you work just for money, you'll never make it; but if you love what you're doing and you always put the customer first, success will be yours.*[7]

The purpose of professional RM should be to significantly increase company profits and owners' ROIs through the effective management of trade interactions with customers. These trades must generate profit for both parties (one of those parties being the business itself). To do so, revenue managers must begin with the correct mindset, which must always be customer-needs driven, not company-needs driven. As a result, to make best strategic decisions, they must also be aware of and informed about the real-world information that drives these interactions. That information is most often referred to as **data**.

Essential RM Term

Data: A collection of factual information used to make decisions.

Essential RM Terms

Revenue manager: The individual or team responsible for ensuring that a company's prices match its customers' willingness to pay.

Customer-centric (revenue management): An RM philosophy that places long-term customer gain ahead of short-term revenue maximization in RM decision making.

Essential RM Term

Channel: A source of business customers. Also, a vehicle used to communicate with a source of customers. Also known as a distribution channel.

Revenue managers effectively manage revenue. What does it mean to *manage* revenue? The answer is too complex to provide in one or two sentences. In fact, it will take the entire contents of this book for you to learn what it truly means to become a professional at managing revenue in a hospitality setting. And it is important to recognize that this book will teach you to be a **customer-centric** manager of revenues.

You have already learned that only those businesses that provide their customers true value will continue to stay in business. As a result, one way to consider the overall purpose of successful revenue managers is to recognize that their role is to help their businesses succeed by ensuring that customers receive true value in every transaction made with that business. For hospitality businesses, that means employing pricing strategies that result in charging prices that well-informed customers will willingly pay for the right products, in the right quantities, through the right **channel**, and at the right times.

RM can be thought of as the entire set of strategies addressing the issue of value offered to customers. Strategic pricing is concerned with establishing a selling price that best *communicates* the value provided to customers.

When businesses set prices at levels their customers choose to pay freely, and willingly, the businesses acknowledge that their customers are seeking the value provided by what they choose to buy. As a result, the customers' own wealth will increase. The process of setting those prices, however, is complex. It requires revenue managers and those responsible for marketing and operations to understand their customers well and to apply and communicate sophisticated pricing strategies with great skill. This book will show you exactly how to do just that.

THE PURPOSE AND DESIGN OF THIS BOOK

If you can agree that your primary role as a revenue manager is to make your company, its owners, and you prosper by *first* making your customers prosper, you are ready to learn how revenue managers create prices that customers are willing to pay.

To help you learn how to make your customers rich, this book is divided into four major parts.

- Part I: Revenue Management Principles
- Part II: Revenue Management for Hoteliers
- Part III: Revenue Management for Foodservice Operators
- Part IV: Revenue Management in Action

Each part contains information that all revenue managers must understand. This is so because just as hoteliers initially learned much about rooms pricing from other businesses (e.g., the commercial airline industry), today's hoteliers can learn a good deal about RM and pricing from professionals in the foodservice industry. Likewise, restaurateurs and other hospitality professionals can learn much about pricing from those in the lodging business. All revenue managers need to understand the application and evaluation of effective RM strategies and tactics.

The following will give you an overview of the specific information that is contained in this book's remaining chapters, as well as why it is important for you to know about it.

Part I: Revenue Management Principles

Part I of this book consists of five chapters. These chapters will introduce you to the foundational principles of RM. In business, managing revenue means accomplishing the very complex task of establishing and managing prices for the products and services the business offers for sale. Understanding how to do this well is critical to the success of your business.

You have now completed most of Chapter 1 (Introduction to Revenue Management).

In Chapter 2 (Strategic Pricing), you will learn about the important role that thoughtful pricing plays in business, as well as the serious limitations of utilizing either a supply and demand–based or a cost-based, rather than customer value–based, approach to pricing.

While it is easy to take the position that a hospitality operation's prices should be based on the economic theories of supply and demand, a closer look at those theories reveals that they are not a solid foundation for establishing prices or for managing revenue in the hospitality industry. In Chapter 2, you will learn why this is so.

In Chapter 2, you will also learn that the rationale for the traditional cost-based pricing approach was that, because revenue minus costs equal profits, costs were the single most important consideration in the creation of business profits. As a result, to maximize profits, it was believed, an organization should carefully manage its costs. It would then be following the advice given by U.S. Steel company founder Andrew Carnegie, who stated that a business should

> *Watch costs and the profits take care of themselves.*[8]

As reasonable as Carnegie's statement appears, you will discover why an undue focus on costs and relating production costs directly to selling price are both woefully inefficient and ineffective RM strategies.

In Chapter 3 (Value), you will come to know what all successful sellers must learn—namely, that individual consumers' own perception of the value and worth of a product is the primary reason they are willing to buy it. In addition, you will discover why consumer perceptions of value are more important to them than the supply of your product, its scarcity, your production costs, or your planned profits. This chapter carefully examines the profound but frequently unrecognized business truth: *Value (like beauty) is in the eye of the beholder.*

In this same chapter, you will see why lessons you can learn from public auctions such as those held on eBay.com are critical to your understanding of consumer buying behavior and, ultimately, to your strategic pricing. In an eBay auction, there are many bidders when the price is low. As the amount bid increases, the number of potential buyers decreases. Finally, all but the winning bidder drops out. The resulting lesson is *not* that only a few consumers are willing to pay high prices. Rather, the lesson to be learned from an eBay auction can be briefly summarized as follows:

> *Different people, with identical information, about identical products, but under different buying circumstances, assign different personal values to the same product.*

For virtually every product on the earth, different customers will hold different opinions about the worth of that product. This is why some buyers are willing to pay over $4,000 for one pound of Tsar Imperial Beluga Hybrid caviar, while others would not consider paying even $4.00 to eat it but might be willing to part with $4,000 rather than to be forced to eat it.

Applying lessons from an eBay auction to your own RM activities will allow you to differentiate among your customers and your prices. Doing so will help you identify the customers who *willingly*, and gladly, will pay the prices charged for your products and services, as well as those who may resist buying from you regardless of the prices you charge.

In this important chapter, you will also learn about the four key buyer-types who purchase hospitality products and exactly what motivates each of them to buy. You will explore how variations in quality, service level, and price directly impact these buyers' views of value and the importance of communicating the value of your own products and services to them.

In the hospitality industry, some professional revenue managers emphasize the importance of data management when making RM-related decisions. As a result, data collection and analysis rightly

▶ RM ON THE WEB 1.1

Establishing prices strategically is a challenge for businesses in every industry. The Professional Pricing Society (PPS) is an association made up of individuals responsible for managing prices and revenues in many business segments. PPS offers its members workshops, conferences, training, and certification. You can learn more about this very specialized professional organization by entering "Professional Pricing Society" in your favorite browser and viewing the website.

take on great importance to them. Other revenue managers emphasize the importance of their own insight, skill, and experience in making good revenue-optimization decisions. Chapter 3 concludes with a detailed examination of the role data collection and analysis will play in your effort to optimize revenue. It then contrasts the importance of these processes with the equally important task of successfully applying your own insight, experience, and intuition to your future RM-related decision making.

Chapter 4 (Differential Pricing) begins with a brief review of RM principles you will have studied thus far. The chapter then investigates in detail precisely how consumers' differing perceptions of value lead logically to the practice of charging different prices to different customers. You will learn that the best revenue managers do not seek to establish a single price for their products and services but, rather, establish a set of prices that best satisfies the desires of all their potential customers. In fact, effective revenue managers utilize a variety of well-established *differential* pricing techniques that allow them to increase their company's own profitability by charging different prices to customers with different willingness to pay. Of course, price differentiation must be carefully planned and implemented. As a result, you will learn about the limits associated with differential pricing, as well as eight specific techniques you can use to apply differential pricing effectively.

With thoughtful planning and understanding, differential pricing strategies such as offering unique prices based on customer characteristics (e.g., student or senior citizen discounts), the location at which a sale is made, the timing of the sale, and the quantity of product purchased can all be implemented. The specific ways revenue managers can utilize these approaches will be examined in detail.

The distribution channel in which a sale is made (e.g., a third-party Internet site, franchisor website, or travel agency) can also be used to affect pricing, as can the unique version of product to be sold. In addition, the concept of bundling (combining) items for special pricing and the practice of altering price based on payment terms will be presented as effective strategies that can be utilized when implementing differential pricing.

Perhaps just as importantly, in Chapter 4 you will discover why differential pricing serves to benefit all members of society by ensuring that the maximum number of customers have access to fairly priced hospitality goods and services that can enhance their lives. The chapter concludes by examining the conceptual difference between a revenue manager who practices revenue *maximization* and one who practices revenue *optimization*, which the authors contend is the far superior approach.

In Chapter 5 (The Revenue Manager's Role), you will examine the rationale for making "Revenue Management in the Hospitality Industry" a specialized field of study. The chapter poses and answers the following simple question:

Why is specialized knowledge required to effectively price and manage the sale of hospitality industry goods and services?

As you will discover in the chapter, lodging and foodservice products and services must be managed differently from other consumer products because of their **constrained supply**.

The effect of constrained supply is evident when you consider that many consumer product industries can react to increased demand for their products simply by making more of them. If, for example, the demand for Apple's newest iPhone version increases significantly, more of them can be rather quickly manufactured. In contrast, a hotel that consists of 400 rooms simply cannot sell more than 400 rooms on a given night, regardless of how many potential guests want to buy a room on that night.

In a similar manner, a restaurant with 200 seats can only offer that same number of seats for sale during its busiest, as well as its slowest, periods of customer demand. The revenue managers in both these hotel and restaurant examples will find their ability to meet the demands of their customers is restricted, or *constrained* due to limited supply. Because that is true, the pricing strategies best used in such situations are highly specialized.

After mastering the nuance and conceptual complexities of **hard constraint** supply and **soft constraint** impact to be explained in Chapter 5, revenue managers will recognize that they are not truly free to charge whatever they wish for the products and services they sell.

Essential RM Term

Constrained supply: The condition that exists when sellers cannot readily increase the amount of products or services available for sale when consumer demand for them increases.

Essential RM Terms

Hard constraint: A supply constraint that cannot be readily removed regardless of product demand.

Examples include existing hotel rooms and the capacity of natural gas pipelines.

Soft constraint: A supply constraint that can, with sufficient lead time and/or a reasonable expense, be removed or lessened.

Examples include the commercial airline and car rental industries, as well as meal deliveries and many foodservice operations.

RM IN ACTION 1.2: THE ROOM RATE WAS . . . HOW MUCH?

Are hotel revenue managers free to price their products in any manner they choose? Not in Texas. Consider what happened in that state when some San Antonio area residents sought to avoid the threat posed by the rapidly approaching Hurricane Harvey in 2017. Some travelers escaped the wind and rain, only to find themselves exposed to hotel rooms offered for sale at nearly three times their normal prices.

"We had a team go out immediately and we found out there was some truth to the claim that there was price gouging going on," Texas Deputy Attorney General Jim Davis told KXAN news during an interview. "Texans know right from wrong. This is an easy one: don't take advantage of people who are vulnerable because they're running away from a flood or affected by a hurricane," Davis said.

The Texas Deceptive Trade Practices Act prohibits any business from taking advantage of a declared disaster by selling or leasing fuel, food, lodging, medicine, or other necessity at an exorbitant rate. Violators can face penalties of up to $10,000 per incident.

As you will learn in Chapter 5, Texas is not the only state that carefully watches the pricing decisions made by hospitality industry revenue managers.

Excerpted on 3/15/2020 from https://www.kxan.com/news/kxan-price-gouging-investigation-leads-to-40-hotel-refunds.

In the United States, businesses have great latitude in setting prices for the things they sell. Revenue managers in the hospitality industry must recognize, however, that they do not have the unrestricted, unregulated ability to determine the fairness of their product and services prices. Nor, in the authors' opinion, should they have it. For example, no legitimate case could be made for charging customers different prices based on the customer's religion, race, or national origin. Doing so would be morally wrong. It would also be a violation of federal law.

Society at large, working through its various governmental entities, now has and will continue to have a direct influence on the prices that may be charged in the hospitality industry. Legislation enacted at the federal, state, and local levels currently influences pricing and revenue optimization decision making in the hospitality industry. This chapter presents and explains the societal rationale for implementing, and the penalties for ignoring, the most significant pieces of pricing-related legislation.

All revenue managers would likely agree that effective revenue optimization must be achieved in a legal manner, but the authors argue further that it should also be achieved in an ethical manner. Because of this position, in Chapter 5, you will also examine in detail the significant issues related to the ethical aspects of RM.

Chapter 5 concludes with an examination of the tasks and responsibilities commonly assigned to revenue managers working in the hospitality industry. As you will learn, the duties performed by these professionals, and the business titles they hold vary, but commonalities among their jobs do exist. This is so because all revenue managers follow a crucial five-step decision-making process, fully explained in this chapter.

Another commonality among revenue managers in hospitality is the fact that most often they will be only one member of a larger group that impacts RM decision making. Members of this important group (which also includes customers) do not necessarily share the same agenda, but they do greatly influence the day-to-day decision making of revenue managers in the hospitality industry. As a result, it is important that you understand the roles and goals of these diverse group members. Upon completing this last introductory chapter, you will be ready to apply what you have learned, and what you will learn, to the fascinating challenge of managing revenues in the exciting hospitality industry.

Part II: Revenue Management for Hoteliers

Part II of this book contains five chapters that present the specific RM strategies and tactics used by revenue managers working in the lodging segment of the hospitality industry. Despite its title *Revenue Management for Hoteliers*, this part's content is applicable to those revenue managers working in full-service hotels, condo-hotels, limited-service hotels, motels, bed and breakfasts, Airbnbs, cruise ships, and any other housing facility facing constrained supply of their product, as well as for limited-seating capacity events (e.g., concerts, movies shown in theaters, banquet halls, and sporting events).

In Chapter 6 (Forecasting Demand), you will learn why it is so important for revenue managers working in the lodging industry to create accurate estimates of the guest demand for their products. Knowing the number of guests who will be staying in their hotels, or seeking to stay on specific future dates, directly affects both the operation of the property and the specific revenue optimization strategies the hotel will choose to implement.

To create accurate demand forecasts, revenue managers evaluate their hotels' past performance as well as the current buyer demand for their products and service. They, then, analyze a variety of additional factors to estimate future demand. In this chapter, you will learn about the specific tools revenue managers use to forecast demand. You will also learn how to analyze and respond to the data these tools produce.

This chapter will also explain to you why it is generally counterproductive for a revenue manager to allow guest demand to dictate the prices that will be charged for hotel rooms. Although the authors recognize that implementing **yield management** as a pricing strategy has long been very popular in the hotel industry, in this chapter you will learn why it can no longer be considered an effective pricing technique.

Essential RM Term

Yield management: A demand-based RM strategy, first initiated by commercial airline companies. It seeks to maximize income via manipulation of product selling prices.

Although the process has been described and practiced in myriad ways, yield management has long been defined in the hospitality industry as "a technique used to maximize the revenue or yield, obtained from a service operation, given limited capacity and uneven demand."[9]

Because of this book's view that all RM strategies must be customer driven, *yield management*, a term sometimes mistakenly used interchangeably with *revenue management*, will be examined chiefly from its historical perspective and its use by the airline companies that originally developed it. You will learn in Chapter 6 that while yield management was an innovative concept when first introduced by the commercial airline industry, it worked best when consumers' price-related knowledge was limited. Today, a lodging consumer's price-related knowledge is clearly not limited. As a result, this chapter presents the case that yield management, as hoteliers have practiced it in the recent past, is not at all an effective strategy for building customer loyalty and repeat business. In fact, honest industry professionals would admit that the practice is now often viewed by the general public as an opportunistic and excessively greedy business strategy.

In Chapter 6, you will also learn that accurate demand forecasts have a significant impact on legitimate pricing tactics used by revenue managers in the lodging industry. This is so because nearly all revenue managers working in lodging will be managing a hard constraint supply, while their restaurateur counterparts typically encounter soft constraint supply. As a result, the pricing strategies undertaken by lodging revenue managers who create and analyze various types of demand forecasts are different from their restaurant industry counterparts. For lodging industry revenue managers, the impact of demand on price, the impact of price on demand, and the impact of demand forecasts on revenue optimization strategies are all important concepts. After reading Chapter 6, you will know why you must, and how you can, forecast future demand for your business.

In Chapter 7 (Inventory and Price Management), you will learn how lodging professionals monitor their number of rooms available for sale and the prices to be charged for them. By doing so, they can optimize income and actually increase the amount of revenue generated by their properties *without* raising their prices. In fact, effective inventory management can even allow a revenue manager to increase total revenues by reducing selling prices!

The way revenue managers ultimately manage room availability is affected by the type of customer who purchases the room. In this chapter, you will learn the inventory-control techniques revenue managers use when reserving rooms for their individual guests and for guests who are part of a group or those who have a special contractual arrangement with the hotel.

Essential RM Term

Overbooking: To accept reservations for more rooms than a hotel has available or in inventory.

Sometimes referred to as *overselling* or being *oversold.*

One of the biggest issues facing lodging industry revenue managers relates to selling rooms when none are available for sale. The **overbooking** of hotel rooms is a controversial issue within the hotel industry and can be the cause of significant customer and hotel staff frustration. In Chapter 7, you will examine the financial, legal, and ethical aspects of overbooking.

Revenue managers must thoroughly understand the concept of proper pricing. In Chapter 7, you will review the most important of the hospitality industry's *traditional* room pricing theories and strategies. Looking backward prior to looking forward is important in many areas of knowledge, because, as Aristotle stated:

If you would understand anything, observe its beginning and its development.[10]

In this chapter, you will also learn how hoteliers currently establish their room rates as well as how they can impose special restrictions on guests' purchases to impact the amount of income generated from room sales. The chapter concludes with a summary of inventory and price management principles important to revenue managers.

Hoteliers should seek to make it as easy as possible for guests to make room reservations. As a result, today's hotel guests can reserve a room using a variety of different methods. In Chapter 8 (Distribution Channel Management), you will learn how revenue managers administer their various sources of room reservations. As a revenue manager you will manage different channels in different ways because each is unique. For example, in some distribution channels, a representative of the hotel is in direct contact with the guests. This is true, for example, of the guest who arrives at a hotel without a room reservation and immediately seeks information about room availability and rates. Alternatively, for those guests making reservations using the Internet, no direct personal contact takes place, but critical information is exchanged, nonetheless.

In Chapter 8, you will learn that a hotel's distribution channels can be classified in several ways. Nonelectronic channels include those designed to make room sales to individuals who are physically on the hotel property, as well as to those who may call a property directly. In addition to those hotel staff who greet guests in person or answer phone calls, a hotel's sales and marketing staff represents another important distribution channel. In nearly all cases, yet another key source of room sales will be the locally funded nonprofit entity responsible for promoting travel and tourism to the area in which the hotel is located. In this chapter, you will learn how each of these nonelectronic channels can help you optimize your property's revenue.

Direct customer contact is always important, but increasingly, guests utilize one or more electronic sources to secure information about hotels and to make their sleeping room or meeting room reservations. The Internet is a well-known distribution channel, but in this chapter, you will learn that there are at least three distinctly different distribution channels housed on the Internet, and each must be managed differently.

In Chapter 8, you will learn about all of the major channels of distribution and the rationale associated with using each one. As well, you will learn specific principles related to managing each of these channels to optimize your revenues.

In Chapter 9 (Data Analysis and Revenue Management), which is new to the second edition, you will learn that revenue managers in today's hospitality environment most often find themselves awash in valuable data (information), as well as an overwhelming amount of new data management tools and service providers. The chapter begins by introducing a fundamental four-step method for making RM-related decisions that involves obtaining, processing, analyzing, and applying information.

In today's business world, effective data management is critical. In 2017, the *Economist* published an article titled "The world's most valuable resource is no longer oil, but data," which is often credited by establishing the now common phrase "data is the new oil."[11] Because of the importance of data, a large portion of Chapter 9 addresses data in the digital era and how it relates to RM.

The very large amount of data available to revenue managers today must be handled and processed with specific tools designed to work at large scales. Despite being larger, this data is no different from all other types of data historically used by hospitality professionals in that it must be carefully managed and incorporated into strategic decision making. Chapter 9 explains that all of the data available for a revenue manager's review can be understood as falling into one of a few simple categories even though data may come from a variety of sources and analyzed in nearly endless ways. It also includes a discussion of critical topics in managing data, such as data privacy, data security, and the increasing importance of reacting to **user-generated content (UGC)**, the information supplied by the customers of a business.

Essential RM Term

User-generated content (UGC): Content that is posted on the Internet by the posting site's end users. Often referred to as social media, typical content includes news, information, opinion, gossip, and customer reviews of businesses.

Essential RM Terms

Data scientist: An individual specially trained in how to analyze large amounts of data for the purpose of improved decision making.

Big data: Typically considered to be information of a very large in size (usually over 1 terabyte), the term is now generally used to refer to unprecedented amounts of data available for analysis by a business.

Chapter 9 concludes by offering specific strategies revenue managers can utilize in an ever-changing and increasingly data-driven world, including principles they can employ to monitor and, when needed, respond to positive and negative UGC in ways that directly benefit their properties.

Over the past two decades, the sheer quantity of informational data and analytical tools available to revenue managers has increased exponentially. That trend will no doubt continue. While most hotel revenue managers will not need to be trained as a **data scientist**, they may want to benefit from the work of those data scientists, and they will undoubtedly need to know how to make sense of the exponential growth of **big data**. Chapter 9 is added to this edition to address this important and ongoing trend.

In Chapter 10 (Evaluation of Revenue Management Efforts in the Lodging Industry), you will learn how a hotel revenue manager's performance can be evaluated. The assessment of a revenue manager or RM team's efforts can be internal or external, scheduled or sporadic, and in-depth or cursory, but all revenue managers need to understand the tools commonly used for evaluating their efforts, as well as the strengths and weaknesses of each tool.

The chapter begins with an examination of the RM paradox of balancing **average daily rate (ADR)** maximization with that of **occupancy %** maximization.

Essential RM Terms

Average daily rate (ADR): The average (mean) selling price of guest rooms during a specific time period, such as a day, week, month, or year.

The formula for ADR is:

Total room revenue ÷ Total rooms sold = ADR

Occupancy %: The number of rooms sold during a specific time period, expressed as a percentage of all rooms available to sell during that same time period.

The formula for occupancy % is:

Total rooms sold ÷ Total rooms available for sale = Occupancy %

In most hotel markets, it is easy for a revenue manager to raise the selling prices of rooms, and thus increase ADR; however, doing so will most often result in a reduction in occupancy rate. In a similar manner, achieving high occupancy rates is relatively easy, but only if ADRs are significantly reduced. This paradox has resulted in the lodging industry's development of a variety of sophisticated measurements that will be used to evaluate your RM-related decision making. In Chapter 10, you learn about all of these. Knowing about them is important because in most cases one or more of these measurement tools will be used to appraise your personal performance. As well, they will be the same ones used by internal and external reviewers to evaluate the financial results achieved by your hotel.

Today, revenue managers are most often evaluated by using one or more of the following industry-standard revenue generation assessment tools, or minor variations of them:

RevPAR

RevPOR

GOPPAR

In addition, in this chapter you will learn how managerial accountants assess the ability of a hotel and its RM team to convert increased revenue dollars into increased gross operating profit dollars. This ability to cause added revenue to *flow through* to increased operating profits is crucial and can reveal much about a revenue manager's effectiveness in converting incremental sales into profits.

Essential RM Terms

RevPAR: Short for "revenue per available room." It is the average revenue generated by each available guest room during a specific period of time.

Two different formulas can be used to calculate RevPAR, and they yield identical results:

$$1.\ \text{ADR} \times \text{Occupancy \%} = \text{RevPAR}$$

$$2.\ \frac{\text{Total rooms revenue}}{\text{Total rooms available for sale}} = \text{RevPAR}$$

Note that, unless otherwise stated, the revenue figure utilized for calculating RevPAR in a hotel refers only to those revenues generated from room sales.

RevPOR: Short for "revenue per occupied room," the average revenue generated by each occupied guest room during a specific period of time.

The formula for RevPOR is:

$$\frac{\text{Total revenue}}{\text{Total occupied rooms}} = \text{RevPOR}$$

Note that, unless otherwise stated, the revenue figure utilized for calculating RevPOR in a hotel refers to all (total) rooms and non-rooms revenue.

GOPPAR: Short for "gross operating profit per available room." This is the average gross operating profit (GOP) generated by each available guest room during a specific period of time. Also written as GOPPAR.

The formula for GOPPAR is:

$$\frac{\text{Total revenue} - \text{Management controllable expenses}}{\text{Total rooms available for sale}} = \text{GOPPAR}$$

Note that the revenue figure utilized for calculating GOPPAR in a hotel refers to all (total) rooms and non-rooms revenue.

▶ RM ON THE WEB 1.2

The Educational Institute (EI) is the nonprofit training organization that is part of the American Hotel and Lodging Association (AH&LA).

AHLEI has developed a certification program for revenue managers. Titled the "Certified Hospitality Revenue Manager (CHRM®)," the program seeks to recognize those professionals that manage revenue and plot price points that make their properties successful. To learn more about this program, enter "The Educational Institute of the American Hotel and Lodging Association" in your favorite browser. When you arrive at their website, enter "Revenue Management Certification" in the search bar and review the results.

Essential RM Term

Competitive set: A group of similar and directly competing lodging properties to which an individual hotel's operating performance is compared.

Frequently referred to as the individual property's *comp set.*

The hotel industry is highly competitive. In Chapter 10, you will also learn how to evaluate your own property's revenue producing performance relative to that of your **competitive set** via analysis of the Smith Travel Research (STR) company's various data-rich product offerings (dSTAR reports).

STR (a division of the CoStar Group) is an innovative organization that produces a variety of specialized hotel revenue assessment reports. These reports evaluate a hotel or group of hotel's performance *relative* to its competitors.

The ability to read and properly interpret STR's dSTAR reports and others like them is critical to hoteliers' understanding of their own RM challenges and successes. This chapter presents the hands-on information needed to read, analyze, and interpret relative performance on key revenue-generation measures including occupancy, ADR, RevPAR, and market share.

Essential RM Term

Market segment: A subset of a customer group that can be readily identified by one or more common but individual customer characteristics (for example, the customer's income, gender, or purpose of travel).

You can learn a great deal about your own market and the effectiveness of your rate strategies by assessing the revenue-generating performance of those hotels with which you compete. Chapter 10 will show you exactly how to do that.

Experienced revenue managers know that the income-generating potential of their hotels is determined in great part by the features or attributes of the property and the appeal those attributes have for travelers in a specific **market segment.**

Revenue managers who seek a complete understanding of how revenues are generated in their hotels know they must carefully monitor the source of their various customers, as well as the costs incurred when selling to them. Thus, source of business and distribution channel assessment are important, and the chapter addresses how to evaluate each of these critical areas.

Essential RM Term

Pace report: A summary report describing the amount of future demand for a lodging property's rooms or other services and the rate at which that business is being captured.

Also referred to as a *booking pace* report.

Armed with a complete evaluation of their current performance, revenue managers can assess their properties' **pace reports** and related data to fine-tune their financial targets and goals. Using solid information, and their own professional insight, they can then make appropriate decisions about future prices to be charged for their rooms and the best channels for selling them.

Hoteliers communicate the value their hotels offer through a variety of creative pricing strategies. The value message presented to guests is a complex one and depends on a variety of crucial factors:

- Franchise affiliation
- Location
- Distribution channel
- Facility
- Services offered

Essential RM Term

Rack room rates: The price of hotel rooms when no discounts of any type are offered to guests purchasing the rooms.

These factors affect the strategic pricing of guest rooms, including the determination of **rack room rates**, discounted rates, and other room rates.

As a professional revenue manager, you will continually be evaluated on how well you understand your business and how you use available information to improve your decision making. Because that is so, a thorough understanding of how industry professionals assess the revenue optimization performance of a hotel will be critical to your own professional success. Chapter 10 has been written to provide you with that understanding.

Part III: Revenue Management for Foodservice Operators

In this unique section of the book, you will learn how food and beverage (F&B) professionals can implement and assess their own versions of RM and strategic pricing.

Like lodging customers, those guests who frequent a foodservice operation do so in a quest to satisfy their own value-based needs. Those restaurants that consistently meet their guests' needs will flourish, while those that do not simply cease to exist. A consistent theme of this introductory chapter, and this entire book, is that a business exists only for the purpose of providing value to its customers.

RM AT WORK 1.1

"How can you be concerned?" asked Charles Lohr. "Our occupancy last month was 76 percent; that's almost 5 points higher than the same month last year. And our ADR was $144.85—that's about $4.00 more than last year. And our guest satisfaction scores for the month were higher than ever. We had a great month!"

Charles was the front office manager at the Branchwater Hotel, a 225-room full-service property located near a busy industrial park. Charles also served as the leader of the hotel's RM team. The team's role in the hotel was to establish room rates and manage rooms inventory based on the data generated by the hotel's property management system (PMS), as well as the information provided by the hotel's sales and marketing department. He was in his own office, talking with Sara Argote, the GM of the property.

"Well, I'm not looking at how we did compared to last year," replied Sara, "I'm comparing our change to our comp set's change. It's true we were up 5 occupancy points from last year, but the comp set was up just over 10 points."

"But what about their rates?" asked Charles. "What happened there? Did their rates go up or down, and by how much?

"Well, let's take a look at that," replied Sara, "and then we can assess what happened last month and see if we need to make any rate strategy adjustments in the future."

1. Assume that last month the ADR of the competitive set increased significantly (e.g., more than 10 percent). What would likely be your assessment of the Branchwater's RM performance compared to its comp set?
2. Assume that last month the ADR of the competitive set decreased very significantly (e.g., more than 10 percent). What would be your assessment of the Branchwater's RM performance compared to its comp set?
3. Assume you were the hotel's GM. What additional revenue-related information would you want to have before assessing whether your property's RM team did a *good* job last month?

By successfully doing that, it also creates profits for itself. In the two chapters contained in Part III of the book, you will learn how successful foodservice operators strategically manage pricing to increase their customers' view of value and, as a result, increase their own profits.

It is interesting to note that hoteliers and restaurateurs have historically used very different pricing methods for optimizing revenues and profits. In Chapter 11 (Revenue Management for Food and Beverage Services), you will learn about the three most popular methods used to determine a foodservice operation's menu prices, as well as the philosophic rationale put forth by the proponents of each method. You will also learn that in each of these traditional pricing systems, the *cost* of the food or beverage product to be sold is the major factor influencing prices charged to customers. Understanding these traditional approaches to foodservice pricing is important because revenue managers in foodservice operations will so frequently encounter their use.

Understanding traditional cost-based menu pricing systems is also important because it will help you better understand why foodservice operators should carefully *avoid* using any menu pricing method (including the three systems historically used), that is based solely on the prices paid to make the products sold. Instead, revenue managers in foodservice operations, just like their lodging industry counterparts, should employ a differential pricing system to optimize revenues. This is not because an operator's costs are unimportant to pricing but because costs are merely *one* among many factors that directly affect foodservice customers' perceptions of the value they receive for the products they buy.

To better understand the traditional relationship between product costs and pricing in the foodservice industry, it is important to recognize that in the minds of many F&B professionals, the terms food *quality* and food *value* are synonymous. These operators would argue, for example, that because a USDA Prime steak is of greater *quality* than an identical cut of USDA Select steak, the *value* of the Prime steak is higher. That's simply not true. The reason it is not true is that for many, and perhaps most, of the foodservice industry's customers, the terms *value* and *food quality* are simply *not* synonymous.

You can prove this quite easily by considering whether those non–hospitality industry friends with whom you most frequently dine could accurately explain the specific grading criteria used by the

USDA to differentiate between a Prime and Select steak without first asking you! Your friends represent typical foodservice customers.

What is very true today is that foodservice customers are diverse. Within this diverse population, each customer subgroup possesses its own value perceptions and definitions of personal profit in a foodservice transaction. Certainly, for some foodservice customers, the highest-quality levels of food and drink are critically important. For other customers, a foodservice operation's convenience, low menu prices, atmosphere, or speed of service are much more important. What you will learn as you complete Chapter 11 is that your product costs may influence the prices you charge but the influence of at least ten other factors will be *more* critical to your customers and to your own revenue optimization efforts. In Chapter 11, you will closely examine these ten critical factors and you will learn why each must be thoughtfully considered prior to establishing your menu prices.

In Chapter 12 (Evaluation of Revenue Management Efforts in Food and Beverage Services), you will learn how F&B professionals monitor and evaluate the revenue-generating characteristics of their own operations. Doing so is a three-part process that includes:

- The examination of revenue-generating sources
- The measurement of change in revenue generation
- The evaluation of revenue-generating efficiency

Essential RM Term

QSR: Short for "quick-service restaurant," an operation that provides a limited menu and, usually, limited at-the-table services. QSR customers typically order food at a counter or drive-through window. When serving menu items, single-use product wrappings, dishes, flatware, and beverage containers are most common.

Examination of Revenue-Generating Sources

In some foodservice operations, there would appear to be only one area or source of revenue generation. A small diner, for example, would likely contain only one dining area. It does not follow, however, that the revenue manager for such an operation would consider the diner to have only one revenue source. While it is true that in this example only one physical dining area exists, the revenues generated during different periods of the day (e.g., breakfast, lunch, or dinner) and through different delivery methods (e.g., dine-in versus carryout or delivery) may vary greatly.

In a similar manner, revenue managers working in the **QSR** industry are very much aware that revenues generated from their operations' drive-through customers should be assessed separately from

RM IN ACTION 1.3: RESTAURATEURS MUST MANAGE NEW CHANNELS TO MANAGE REVENUE

Channel management is most often associated with revenue managers working in hotels. As the following example shows, however, foodservice operators must understand their own different sources of business as well, because the importance to them of various revenue sources can change rapidly, even when that change was not foreseen or preplanned.

DETROIT, MI, USA (March 16, 2020)

Michigan bars and restaurants, as well as gyms, spas, theaters, and other public spaces, were ordered closed starting at 3 p.m. Monday, except for restaurant delivery and carry-out services because of the coronavirus pandemic, the governor's office announced today. The executive order from Gov. Gretchen Whitmer is effective through March 30. It applies to restaurants, cafes, coffee houses, bars, taverns, brewpubs, distilleries, and clubs.

In this example, restaurants in Michigan (as well as all over the world) were ordered by their area governments to close or radically change their delivery methods if they were to stay open in the face of the global COVID-19 pandemic that began in 2020.

Those foodservice operators who understood and were able to rapidly ramp up and expand their delivery and carry out menu offerings were simply better prepared than others to weather this once-in-a-lifetime event that disrupted the restaurant and hotel industries worldwide.

Excerpted on 3/16/2020 from Detroit Free Press; Michigan bars, restaurants, gyms, theaters ordered to close doors because of coronavirus.

Essential RM Term

Revenue source (foodservice): A subsection of an operation that contributes a definable portion of the operation's total income. Typical factors used in foodservice to differentiate revenue sources include product sold, location, time of day, and the method of product ordering or delivery.

that of their dine-in guests if they are to optimize operational revenues in both areas.

Increasingly, revenue managers in foodservice find that examination of their unique **revenue sources** must be undertaken in new and innovative ways. Thoughtful readers will no doubt recognize that, for purposes of revenue analysis, a foodservice operation's various sources of revenue are in many ways similar to a lodging operation's various distribution channels.

Measurement of Revenue Change

Are foodservice unit sales increasing? Decreasing? By how much? In which sources of revenue? Why? Revenue managers working in foodservice must be experts within their organizations at accurately answering questions such as these. In this section of Chapter 12, you will learn about the data, formulas and calculations revenue managers use to address such complex questions.

Evaluation of Revenue-Generating Efficiency

All foodservice units generate revenue. Of great interest to revenue managers, however, is the issue of how efficiently that revenue is generated. A variety of important factors can affect this assessment. For example, larger foodservice units typically produce more income than smaller units. Effective revenue managers would want to know, however, if the increased revenue generated justifies the larger building and operating costs associated with maintaining the bigger unit. In a similar manner, one foodservice operation may generate a higher level of revenue than another, but it incurs significantly more labor cost in doing so. Is the revenue vs. labor cost trade-off beneficial in meeting the operation's profit goals? Revenue managers should know how to answer such a question and, in this chapter, you will learn how to do just that.

Finally, the efficiency with which a foodservice operation is managed greatly affects its revenue-generating capability. There are a variety of useful performance traits and indices currently used to evaluate the effectiveness of foodservice managers. From the perspective of a revenue manager, however, the calculation and interpretation of **RevPASH** is one of the newest and most useful. In Chapter 12, you will learn how to calculate and interpret results from this innovative and foodservice-specific RM tool developed by Dr. Sheryl E. Kimes.[12]

Essential RM Term

RevPASH: Short for "Revenue Per Available Seat Hour." It is the revenue generated during a specific time period divided by the number of seat hours available during that period.

The formula for RevPASH is:

$$\frac{\text{Total period revenue}}{\text{Number of available seats} \times \text{hours of seat availability}} = \text{RevPASH}$$

Part IV: Revenue Management in Action

In the two chapters that make up the final part of this book, you will learn how revenue managers in hospitality and hospitality-related industries can apply innovative revenue optimization strategies to creatively achieve their own unique RM-related objectives.

In Chapter 13 (Specialized Applications of Revenue Management), you will discover that a variety of organizations providing products and services to their customers can use the revenue optimization principles presented in this book. Examples include golf courses, nightclubs, ski resorts, and concert venues, to name but a few such businesses. Those revenue managers working in businesses possessing specific and readily identifiable characteristics will find that they can apply the concepts of demand forecasting, inventory allocation, and differential pricing just as effectively as their colleagues working in hotels and restaurants. In this chapter, you will learn to identify the specific organizational characteristics that allow the application of effective RM principles.

As you progress through this book, you will no doubt recognize that it has been written primarily for revenue managers who are responsible for the sales optimization efforts at a single business site. Increasingly, however, talented and effective revenue managers are being given the responsibility for overseeing the revenue optimization efforts in organizations that operate multiple business units. Thus, for example, a company operating several hotels or restaurants may choose to assign one district or regional revenue manager the task of overseeing the RM-related work undertaken at each of its individual properties. In this chapter, you will learn about the unique responsibilities and challenges of those revenue managers assigned multiunit management responsibilities.

Yet another specialized RM role is that of assisting franchisees in utilizing RM-related resources provided by their franchisors. The hospitality industry is heavily franchised. In this chapter, you will learn how those revenue managers employed by franchise companies work to support their franchisees, as well as other important partners located inside and outside their companies.

Chapter 13 concludes with an overview of the responsibilities and challenges faced by those professionals working in the area of **destination marketing**, yet another specialized application of RM.

Essential RM Term

Destination marketing: The advertising and promotion of travel and tourism activities in a specifically designated geographic area.

Anyone who has ever heard the city of New York referred to as *The Big Apple* or Florida as the *Sunshine State* understands well the power of a cleverly designed and professionally implemented campaign to promote travel and tourism to a specific geographic area, rather than to a single business in that area.

Because geographic areas have many of the same characteristics as do hotels and restaurants (e.g., constrained supply of goods and services available, seasonal demand that can vary widely, and a diverse range of potential customer types), you will learn that the skills you will have acquired when you reach this chapter can be directly applied to an array of destination marketing settings and jobs.

Chapter 14 (Building Better Business) is the final chapter of the book. The chapter begins by emphasizing the importance to revenue managers of high-quality revenue. Not all revenue is created equally. Some sources of revenue are simply better for business than are others. For example, $1,000 in revenue from one customer source might generate $100 in profits, while that same amount of revenue from another customer type or channel might generate $200 in profits. It is the goal of a revenue manager to *optimize*, not merely maximize, revenues. In this chapter, you will learn about four key strategies revenue managers can use to build better, more profitable, business within their own organizations.

Building better business in very good economic times can be fairly easy because revenue managers may be able to choose the best one among several potential buyers of their products (it is usually more difficult in slower economic times because buyers are scarce). In this chapter, you will learn techniques that can be used to differentiate and choose among various pieces of potential business based on the amount and quality of revenue offered by each alternative. Using such information, revenue managers can immediately assess the impact of replacing one source of revenue with another. The chapter also examines two additional management concepts that revenue managers must consider as they seek to optimize their revenues during periods when business is very good.

It is simply true that, due to the cyclical nature of the hospitality business, most revenue managers will find they must try to build better business in periods of weak economic activity, as well as in times of strong activity. When customers are scarce, some revenue managers immediately turn to price discounting to maintain high revenue levels. In this chapter, you will learn how such a discounting strategy negatively affects an operation's bottom line. You will also learn how to utilize a tool designed specially to help evaluate the impact on a business of price discounting.

For a variety of reasons, local, regional, and even global pullbacks of consumer spending can occur. These economic pullbacks typically result in short-term or longer-term reductions in a business's ability to generate revenue. In fact, most revenue managers will, at some point in their jobs, encounter strong, as well as moderate, or weak demand for the products and services they sell. For that reason, this chapter examines two concepts (in addition to discounting) that all revenue managers must consider when seeking to build better business during a weakened business climate.

Throughout this book, the authors will make the case that applying revenue optimization strategies to the hospitality industry is both an art and a science. The art lies in knowing your customers so well that it is possible to discover ways in which your **target market** can be divided into unique segments such that higher prices can be charged to the high-willingness-to-pay segments and lower prices charged to the low-willingness-to-pay segments.

Essential RM Term

Target market: The potential customers to whom a business's marketing activities and message are directed.

The science involved in RM requires the application of various analytical techniques used to manage data. This analysis is then used to set and update prices and control product inventories in a way that optimizes revenues from each of the various willingness-to-pay segments. The science, and especially the mathematical background, required to utilize advanced analytical techniques can be significant. In this text, however, the mathematical background required to utilize the analysis tools presented will be limited to arithmetic and basic algebra.

In all cases, the information presented in this book was selected to help revenue managers do their best work. The authors recognize that information is not the same as knowledge. Today's revenue managers can easily find themselves virtually drowning in information. It will be those managers' understanding of how to sort, analyze, and apply that information that will determine their success. As a result, the book takes both a conceptual and very hands-on approach to RM.

In selecting all of the content for this book, the authors were ever mindful of management scholar W. Edward Deming's insightful observation:

It is not enough to do your best; you must know what to do, and then do your best.[13]

Let's get started!

RM AT WORK 1.2

"According to my calculations, it's about $2.55 per delivery," said Connie.

"That's includes everything?" asked Chad. "Labor costs, vehicle costs, . . . packaging?"

"Everything" replied Connie.

They were discussing the additional costs associated with starting their new on-campus pizza delivery service. Connie and Chad were partners in one of the country's largest franchised pizza chains.

Business was good, their product tasted great and because their store was adjacent to the campus, the University supplied a large, hungry, and built-in market. It was service to that market Connie and Chad wanted to expand by offering their new "To Your Dorm Room" delivery program.

"Well, I guess that means we need to charge at least $2.55 more per pizza," said Chad.

"Not necessarily" said Connie. "One dorm room might order two or more pizzas. Maybe we should charge a flat $2.55 delivery fee instead?

"Connie, maybe it should be $3.00 per delivery," said Chad. "We need to make a profit on the delivery service as well as the pizzas we sell, or we shouldn't offer the service. Right?"

1. Assume Connie discovered a mathematical error in her calculations that, when corrected, increased the estimated cost of the pizza delivery program from $2.55 to $3.55 per delivery. Would such a discovery also immediately increase by $1.00 the value to students of the pizza delivery program? Explain your answer.
2. Do you think that the value students would associate with the "To Your Dorm Room" delivery service is directly related to the costs incurred by Connie and Chad? Why?
3. What factors do you think would most affect student perceptions of the value provided by the "To Your Dorm Room" delivery service? What steps would you advise Connie and Chad to take if they wished to learn more about the importance of those factors?

❖ ESSENTIAL RM TERMS

Revenue
Hospitality business
Profit
Barter system
Money
Economics
ROI
Data
Revenue manager
Customer-centric RM
Channel
Constrained supply
Hard constraint
Soft constraint
Yield management
Overbooking
User-generated content (UGC)
Data scientist
Big data
Average daily rate (ADR)
Occupancy %
RevPAR
RevPOR
GOPPAR
Competitive set
Market segment
Pace report
Rack room rates
QSR
Revenue source (foodservice)
RevPASH
Destination marketing
Target market

TEST YOUR SKILLS

1. Shanna Alexander is the owner of a 120-room franchised hotel. Her total investment in the hotel is $675,000. Last year Shanna's before-tax investment returns on the property were $135,000. Her after-tax investment returns were $110,000. Use the spreadsheet she has prepared to answer the questions that follow.

Shanna's Hotel		
	Amount	%
Total investment	$ 675,000	
Before-tax ROI	$ 135,000	
After-tax ROI	$ 110,000	

A. What was Shanna's before-tax return on investment (ROI) percentage last year? _____
B. What was Shanna's after-tax return on investment (ROI) percentage last year? _____
C. Why is return on investment (ROI) so important to business owners?

2. This chapter posed several variations of the word *profit*, but noted that in a barter situation, profit is gained by both parties involved in the exchange. Do you agree or disagree that equality of profit is also a valid concept in a money-based trading system? What implications

does this have for consumers who seek to purchase hospitality products and services as well as for those hospitality professionals responsible for establishing prices?

3. This chapter introduced you briefly to the concept of a hard constraint. In the short run, all hotels face hard constraints if demand for rooms exceeds the number of rooms available to sell. In such sell-out situations, the per-unit selling costs of guest rooms would typically decline (due to a hotel's fixed operating costs). In such a situation, however, room prices typically increase, not decrease. Assume you were a hospitality accountant attempting to explain your hotel's pricing strategy to a potential guest. How would you defend the notion that increased costs justify selling price increases for your rooms, but decreased costs do not result in decreased prices? Assume you were the potential guest. How would you likely react to this cost-based pricing explanation?

4. Assume you own and operate a hotel near a busy international airport. Your property caters directly to business travelers. Assume also that your historical records indicate a complete rooms sell-out every Tuesday and Wednesday night for the past six months. Your hotel's Director of Sales (DOS) informs you that she forecasts Tuesday and Wednesday night sell-outs for the coming six months as well. What does that information tell you about business travelers' willingness to purchase rooms on those specific nights? Would you encounter an ethical dilemma instituting a differential pricing strategy that valued the rooms you have available for sale on Tuesday and Wednesday nights higher than those rooms you sell on other nights? Explain your position.

5. Jona Wheeler is the Revenue Manager at the 425-room Carlton Suites hotel. The hotel's room sales and rooms revenue results for last week are shown below. Complete the missing information to help Jona answer the questions that follow.

Carlton Suites Hotel						
	Rooms Available for Sale	**Rooms Sold**	**Occupancy %**	**Rooms Revenue**	**Revenue Per Available Room (RevPAR)**	**Revenue Per Occupied Room (RevPOR)**
Monday	425	377	88.7	$ 81,475	$ 191.71	$ 216.11
Tuesday	425	385		$ 83,240	$	$
Wednesday	425	366		$ 78,545	$	$
Thursday	425			$ 79,880	$	$
Friday	425	405		$ 95,230	$	$
Saturday	425	398		$ 93,575	$	$
Sunday	425	266		$ 73,455	$	$
7-Day Total		2568		$	$	$

A. What was Jona's 7-Day total Revenue Per Available Room (RevPAR) last week? __________

B. What was Jona's 7-Day total Revenue Per Occupied Room (RevPOR) last week? __________

C. What was Jona's 7-Day occupancy % for last week? __________

KEY CONCEPT CASE STUDY

"So Damario, what do you think now?" asked Sofia Davidson, the GM at the Barcena Resort. Damario was the newly hired revenue manager at the 480-room Barcena, a five-year-old, *Four-Star* vacation property located on a pristine Caribbean beach. The hotel's physical setting was stunning. To date, the resort's financial results had also stunned its owners, but not in a good way.

Sofia Davidson was also new. She had only recently been selected by the property's owners and had arrived at the resort just eight weeks earlier. Damario was one of her first hires and was the first individual at the resort to hold the title of *Revenue Manager.* Damario had just completed his first week on the job.

"Well, here's what I have learned so far," replied Damario. "The resort opened five years ago, had decent volume, but didn't perform as well financially as the owners had planned. Two years later, there was a new GM., a reorganization of the staff, and some strategic cost cutting. Revenues improve some. But profits not so much. So, another new GM was brought in. This one was a real efficiency expert. Big on cost control. Reorganizes again, downsizes the staff, changes some department heads, cuts budgets, and reduces costs—must have been the type that really excels at financial controls.

The problem was revenues declined along with the costs, and as a result, the profits declined as well. The owners liked the operating ratios, but were even more upset with the results than before—and then you were brought in."

"We do have some real challenges," replied Sofia.

Sofia had just finished her weekly staff meeting with the hotel's executive operating committee. As the property's newly appointed revenue manager, Damario had attended and been introduced. As Sofia and Damario walked back to her office, they were discussing the highlights of that meeting.

"I think you did a good job explaining our owner's disappointment over the current performance of the property and how that could affect all of our hotel departments' operating budgets next year," said Damario.

"Thanks," replied Sofia. "I knew the managers wouldn't be happy about it. But here's what I have observed so far in the eight weeks I've been on site. On the F&B side, our product cost percentages are right where they should be."

"So, Sam's department is doing great?" asked Damario, referring to the hotel's F&B director.

"Not really," replied Sofia, "It's operating break-even at best. The food quality and service are outstanding, but his labor cost is so high it eats up all his departmental profit. It's the same thing on the rooms side," continued Sofia. "Beverly has her amenities costs per occupied room right on target and room cleanliness inspection scores are superb.

"So, Bev's area is O.K.?" asked Damario, referring to the resort's very experienced Executive Housekeeper.

"Well, there are problems in that area, too. Bev's cleaning times per occupied room are great—30 minutes per room, right at her targeted budget. But you know how we sell out nearly every weekend? Well, Bev often must pay her employees overtime on Saturday, Sunday, and Monday to take care of the weekend stayovers and then get the rooms back in shape for the coming week. The overtime pay really drives up our cleaning costs per occupied room. In that area, we are way over budget."

"Why doesn't she just hire more staff"? asked Damario, "that would eliminate the weekend overtime."

"What would she do with them through the week?" replied Sofia. "In the eight weeks I have been here, we have only had two weeks where our Monday through Thursday occupancy exceeded 55 percent."

"Hire them part-time?" asked Damario.

"Good luck with that in this labor market," said Sofia. "Besides, I have real concerns about our ability to maintain high-quality room cleanliness standards with large numbers of part-time room attendants. Especially when we are extremely busy."

"So, do I hear you saying that those two departments are doing a good job?" said Damario. "Or a bad job?"

"They are controlling what they can with what they have. And remember, between them they employ over 80 percent of the resort's entire staff," said Sofia. "And account for most of the property's operating budget."

"And that's why they reacted like they did when you said the owners have talked about asking you to submit operating budgets for next year? With 10 percent across-the-board cuts in all department budgets?" asked Damario.

"Right," replied Sofia. "No one likes budget cuts. And from what I can see, this group has been downsized, reorganized, and outsourced to the point that there is not much fat left to cut. I think we are already down to muscle. And bone. I'm concerned that more budget cuts will have a negative effect on our guests' experience. I don't know of any hotel that has had great long-term success in expanding its market share and revenue by reducing the quality of its guest service. Our problem isn't inefficiency, its insufficient income."

"So, what do we do now?" asked Damario.

"Now that you have met the executive committee, that's where you and the entire RM task force I want you to assemble come in," said Sofia.

For Your Consideration

1. Under what scenarios could a foodservice operation achieve excellent F&B cost percentages, yet incur excessively high labor costs? Which of these different scenarios do you think is likely occurring at the Barcena Resort? Upon what case facts do you base your assessment?
2. Assume you were Beverly. What specific actions would you likely be forced to undertake if you were given a 10 percent cut in your operating budget for the coming year? What impact would each of these actions likely have on your guests' view of the value they receive for the money they spend while staying at the property?
3. Assume you are a guest arriving at the hotel. How important to you will be Sofia's ability to reduce the resort's operating costs? Alternatively, how important to you will be her ability to find ways to increase the value, to you, of the products and services you purchase during your stay?
4. What do you think Sofia seeks to gain from the work of Damario and the new RM task force she has asked him to assemble?

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