Cost Approaches to Pricing

Chapter 8

Price

Price indirectly affects profits because total revenues is a function of price and quantity, and profits are a function of total revenues and total costs:

$$P = TR - TC$$

$$TR = f(P,Q)$$

Price (cont.)

For this reason pricing is of critical interest to operators. Another reason is that price reflects value to the customer. Depending on the positioning of a product or service a relatively high price will suggest a more valuable product or service while a relatively low price will suggest a less valuable one.

Price (cont.)

- Therefore, if a price is set too low the hotel or restaurant may be unable to cover its operating costs and the product may be perceived as cheap,
- while if the price is set too high customers may resist from purchasing because the product or service is perceived as over-valued.

Menu Pricing

1) Ingredient mark-up pricing or cost-plus pricing or factor method.

A product's mark-up: difference between selling price and cost.

Cost? Total ingredient costs. Prime ingredient mark-up highlights only the prime ingredients rather than total ingredient cost.

Mark-up can be expressed as:

- a percentage of cost, or

Selling price = Cost + (Markup percentage x Cost)

- as a multiple of cost

Selling price = Cost x pricing factor where pricing factor is 100 / Food cost %

Steps:

- Determine desired food cost.
- Calculate pricing factor.
- Determine selling price

Selling price = Raw food cost x pricing factor

This method is very useful in pricing individual menu items. The method attempts to cover all other expenses besides food cost by use of the mark-up.

2) Bottom-up approach to pricing

- estimates all operating and fixed charges of a restaurant including net profit
- determines the total revenues that will cover all of the estimated expenses
- using the total revenues and total expected number of covers information, calculate the average check.

Rooms Pricing

1) $1 per $1000 method

Rule of thumb used in hotel development analysis to determine feasibility of hotel development or acquisition. A measure of $1 of room revenue supporting $1000 of hotel value is utilized, albeit naively, to set room rates.

Assumptions:

- hotel is large, has hundreds of rooms.
- 70% minimum average occupancy.
- income from non-rooms departments will cover fixed charges.
- Other operated departments will be self-supporting and their residual incomes will cover service department costs.

Steps in applying the method:

- Determine number of rooms to be constructed or existing in a property
- Determine total construction cost
- Determine average cost per room
- Divide average cost per room by $1000.

Example using $1 per $1000 method: 200-room property with $9.75million average construction cost.

Drawbacks to this approach

- Emphasis on property's construction cost ignores current market value
- Has less relevance to existing and older properties than to brand-new hotels or those under construction
- Does not appropriately account for revenues and expenses generated and incurred from other operated departments.

Current Practice

In spite of these drawbacks it is the best known method for estimating hotel room price. In a recent HVS International study – Elaine Sahlins (HVS San Francisco), considered average construction cost, land cost, ADR, average occupancy rates, and REVPAR of 28 hotel brands.

Current Practice (cont.)

She found an ADR to cost ratio that ranged from 0.75 to 1.46 (to $1000) with the average of 1.04. Her conclusion was that in practice the average room rates charged by most hotel brands in relation to their average total construction costs is not significantly different from the naïve $1 per $1000 rule of thumb.

Hubbart Formula

This is also the **bottom-up approach** to room pricing. This formula estimates operating costs for the upcoming operating period. Net income is included as a cost of doing business, so it begins with calculating the net income required. All operating costs are estimated after that. Then the revenues that are necessary to cover all of the costs follow this. Finally, the average check or average room rate is estimated.

Steps:

- Calculate desired profit by multiplying the desired rate of return (ROI) by the owner's investment. This is your net profit.
- Calculate pre-tax profits by dividing desired profit above by **1-t**, where **t** is tax rate.
- Calculate fixed charges and management fees – depreciation, interest, property taxes, insurance, rent, amortization, and management fees.

- Calculate undistributed operating expenses. This calculation includes estimating administrative and general, human resources, marketing, property operation and maintenance, and other operating costs.
- Estimate non-room operated department income or losses – income or losses from F&B, telephone department, and so on.

- Calculate required rooms department income. The sum of pre-tax profits, fixed charges and management fees, undistributed operating expenses, and other operated department losses, **less** other operated department income, equals the required rooms department income.

- Determine rooms department revenue. The required rooms department income plus rooms department direct expenses of payroll and related expenses plus other direct expenses equals rooms department revenue.
- Calculate average room rate by dividing rooms department revenue by the number of rooms expected to be sold.

Hubbart Formula/Bottom-up Approach Illustration