

Pricing levers for the hotel industry in the current downturn

- By Charles Dimier and David Vidal 02/02/09

As the economic crisis worsens, the hotel industry is in for hard times, as occupancy and investment drop. However, there are a variety of levers at hotels' disposal to stem RevPar decrease. Most of these are to be found through a better use of pricing, as untapped opportunities remain in rate optimisation, customer loyalty schemes and bundling.

This report outlines some of the pricing strategies hotels can take to maximize their revenues and profits, focusing on simple, transparent and customer-oriented approaches, and shifting away from some of the complex, non-manageable revenue management schemes developed in recent years.

Over the past year, the hotel industry entered a phase of sharp slowdown, as a result of the worldwide financial crisis, economic hardship and falling consumer confidence .

As a result, occupancy rates for both corporate and leisure have decreased and will keep on doing so, due to the high elasticity of tourism spending and business travel to the economic situation, but also due to the reduction in routes offered by airline carriers and a significant increase in hotel capacity.

Another effect of the downturn on hotels is a drought in investment. When the economy grinds to a halt, stocks of hospitality chains tend to drop earlier than in other sectors, reducing capital available for new projects or renovations. Hotel attractiveness for private investors has also plummeted, with only a few significant deals done in 2008 compared to the pace observed in recent years.

It may take a while before hotels regain last year's booking levels, or find the necessary funding to finance future expansion plans. So what are the levers left at hotels' disposal to achieve a profit level that enables them to weather the current downturn and maintain confidence of its investors?

The profit equation in the hotel industry leaves two main touch points: acting on prices and costs.

Most hotel companies have already 'variabilised' their fixed costs as much as they could by deferring hotel infrastructure ownership to third parties (large players usually own less than 35% of their network), and outsourcing part of hotels' everyday management (room service, finance ...).

Many hotels are also at a point in their cycle where they have just finished renegotiating their licenses or refurbishing their infrastructures so as to maintain consistent quality levels across the network. These operations are generally repeated only every 7-10 years.

The only cost niches to be reduced during the crisis are some remaining fixed costs (mainly salaries) and the sale of unprofitable hotels, which calls for large scale network audits. These niches require more time than hotel presently have at hand to implement, but should of course form part of the overall crisis strategy.

Act on rates to generate immediate profit improvements

Even in low occupancy times, rates remain the most effective lever hotels have at their disposal, provided it is used well.

A straightforward rate decrease across the board bears the risk of irreversible effects on perceived value of upscale hotels, making it difficult to recover their initial positioning once better times come around.

Rate decreases are certainly necessary in today's economic situation, not the least because competitors are setting up kick back systems, incentives to bookers or plainly dumping their negotiated rates. However, rate decreases must be as targeted and differentiated as possible.

It is for example much more appropriate to decrease contracted (undisclosed) rates rather than public rates. This will limit the harm done to brand value and positioning and is not as likely to trigger a price war. Decreasing public rates to a level below contracted rates would alienate hotel's corporate customers.

Hotels should use smartly their public rate portfolio, by opening early bird rates at an aggressive level, but long in advance, so as to at least secure bookings, and only use last-minute promotions when necessary.

Hotels must optimise their RevPAR by managing properly their ARR rather than focusing solely on occupancy, and accept to see an inevitable decrease in the latter, at least in the short term. Hotels have unsuccessfully tried to use the ARR to boost occupancy in 2001 after 9/11, resulting in lower RevPAR and lower profits. This is quite understandable, given the effect of price on revenues.

Question: How many more rooms must I sell to compensate for a -20% rate decrease?

	Starting situation	Rate decrease	Impact
Price	100 €	80 €	-20%
Variable cost	40 €	40 €	0%
Fixed costs	4,500 €	4,500 €	0%
Profits	1,500 €	Target: 1,500 €	0%
Bookings	100	?	?

Answer: Bookings need to increase to 150 (+50%!) to maintain the same margin level

The example shown in the table asks: 'How many additional room-nights must you sell to maintain your initial profit level after a 20% ARR decrease?'

A 20% rate decrease would have to be compensated by 50% additional room nights, which is hard if not impossible to achieve, even with strong promotions and ad spending. This is without factoring in how competition would react and the possible risk of a price war.

The higher the hotel's cost base (luxury segment) the bigger this effect will be.

Set clear rate strategies and differentiate through fencing

Hotels have different rates (early non-flexible to flexible). However, we have seen times and times again in our projects that these rates are never fully exploited.

For instance, one of our clients had three main rates, from A (fully flexible rate) to C (early bird rate). Most hotels in its network only used A, and C to offer a fall-back option to customers, even for those booking at the last minute. After a review, the rates are now used as follows: rate A displays brand value and drives the average room rate, rate B benchmarks the competition and rate C drives sales through early bookings.

It is indeed crucial that hotels use the full extent of their rates to offer comparable rates to competition (B), encourage discounted early bookings (C) and yet display best available rates in line with the customer's perceived quality and pricing identity of the hotel network (A). Having a clear pricing is more important than ever as both leisure and corporate customers are shopping around for everything, especially for travel.

Many hotel companies use complex and well-engineered revenue management models to optimize their pricing, which is great to optimize price points, but sometimes without enough rules to ensure clarity of the price offering to the customer. Revenue management systems should only be considered as the implementation tool of a customer-oriented pricing strategy, which must provide rules and boundaries for the optimization run by the revenue management models. This is a pitfall that many hotel chains have discovered in the implementation process of these revenue management systems, and which requires significant time and efforts to adjust.

Rate differentiation and fencing is also a key factor which hotels need to take into account better. This involves all measures aimed at leading customers with specific needs and requirements to certain rate types and conditions.

More often than not, such 'fences' do exist but they are simply not implemented. For example, hotels offer advance purchase rates that offer discounts for customers who book well ahead of their arrival date. But in many cases these advance purchase rates simply remain open until the arrival date, or are re-opened to create a last-minute promotion, sometimes hopefully under a different name (but not always).

Another example is when discounts are given for booking consecutive nights. When customers cancel part of the stay, many chains still apply the discount.

Fencing must support a rate differentiation strategy ultimately aimed at boosting the ARR. This aspect is in many cases not professionally managed or implemented by hotels. A thorough monitoring of pricing implementation is required, especially for chains with a large and heterogeneous network.

Monitor local implementation of brand's pricing policy

All previous steps are only good as long as they are followed at hotel level. Many hotel chains have left hotels with a high level of flexibility in their pricing decisions. Knowledge of local competition/customers is essential and must be integrated into price setting decisions, but we often see hoteliers implementing pricing in a way that is inconsistent with their brand strategy. Let us hope that hoteliers have learnt the lesson of 9/11 and the disastrous impacts of shortsighted price slashes.

Inconsistency in the brand's pricing policy leads to distorted customer perception, and ultimately dissatisfaction. In a recent project for a large international hotel chain, 60% of multi-destination customers travelling in various hotels of the chain believed each hotel within the network had its own pricing structure and policy. In reality all hotels were supposed to implement a centrally defined brand pricing strategy.

Regular pricing training of commercial hotel staff is required, but most importantly, monitoring functions and systems should be developed to ensure that the brand's pricing identity is correctly applied...and thus the 'pricing promise' delivered. This is all the more important for existing customers who in hard times stick to brands they trust.

Strengthen your loyalty program

Loyalty programs also need to be reassessed and potentially adjusted to maximize loyalty and maximize loyalty of existing customers, in times where these will test multiple hotel brands, looking for the best price/quality offer. If your hotel is not the cheapest in the marketplace, now is the best time to test the efficiency of customer loyalty programs.

More often than not, hotels' loyalty programs are much weaker than airlines' to retain the two most important customer segments: frequent travellers (travelling more than one month per year) and high potential travellers (with the highest room night growth). These two segments tend to accumulate multiple loyalty cards of different hotel chains. Customer research conducted for several chains shows that hotels' loyalty schemes usually fail at offering the right level of discount or upgrades to these categories, as well at communicating clearly the benefits of the programs ('earn & burn' rules are usually considered more complex than for airlines).

Our experience leads us to believe that the rewards and redemption rules of loyalty programs, because of the sheer amount of room nights they bring, should be set with the same level of precision as all other rates, by testing customers' 'willingness to stay' for a given incentive.

Customer profiles also provide a valuable source of information to develop further loyalty through packaging / bundling. If goods or services are bundled in an appropriate manner (incl. F&B, in-room entertainment services, location specific elements etc.), gains can be achieved by both the customer and the seller.

The benefits of bundling and ever-further customisation are found every day. In May 2008, Affinia hotels launched 'My Affinia', where customers are asked which amenities they wish in their room, from electrical equipment to cosmetics, hotel services and even six types of pillows.

Even though this program focuses more on creating customer loyalty (through recognizing and storing customer preferences) than on generating revenue, one could easily imagine a small price tag attached to some of these offers to encourage up-selling. These surcharges would be welcomed by hotels at a moment when their core rate levels are under more intense scrutiny.

In the current downturn, success will be determined by the ability of hotels to define short-term pricing improvements. Rate differentiation, fencing, adaption of loyalty programs, smart bundling and up-selling are some of the key ingredients of successful crisis management.

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