Unit 10: Tour Operations Management

CLASS 6 TOPICS

- **COSTING THE HOLIDAY**
- **TERM PAPER REVIEW**

YIELD MANAGEMENT

WHAT IS A 'YIELD'?

Yield is the **INCOME** minus the **EXPENSES** and also called the "**Profit Margin**".

DEFINING YIELD MANAGEMENT

In simple terms, yield management is a strategy based on selling to the right customer, at the right time, for the right price. Within the hotel industry, this typically means selling the right room, to the right guest(s), at the best possible time, for the highest amount, in order to maximize the revenue earned.

Yield management shares many similarities with the concept of revenue management, but has actually existed for longer. Nevertheless, it is important to note that yield management has a more narrow focus and is concerned only with the selling price and the volume of sales, so that the best possible revenue yield can be achieved.

The basic concept behind yield management is that certain fixed, time-limited resources, such as hotel rooms, can be sold for different prices, based on the time of year, the level of demand, the number of rooms already sold and a wide range of external factors besides.

The same product (i.e. a hotel room) can be sold to two different customers for entirely different prices, because of the amount of variables involved in the process. Yield management strategies take a data-driven approach to ensuring pricing is adjusted in order to maximise business results.

WHY IS YIELD MANAGEMENT IMPORTANT?

Adopting a yield management strategy allows hotel owners to maximize the amount of money they make from a finite number of hotel rooms, which need to be sold by specific times. Through the use of past performance data and general industry trends, managers can anticipate demand and respond accordingly.

Yield management also allows hospitality businesses to focus on optimizing the pricing and selling strategy of their single most important resource – the rooms they have available. This allows hotel owners, for example, to get the basics of their business right, by maximizing revenue from rooms alone.

WHERE DOES YIELD MANAGEMENT WORK?

The airline industry is considered the birthplace of yield management. After deregulation in the late 1970s, airline competition increased, and the airlines tried to operate their planes as efficiently as possible. Yield management was one of the methods developed as a way of increasing competitive advantage and increasing revenue. In airlines, yield management is concerned with selling the right seat to the right customer at the right price so as to maximize yield.

The airline and hotel industries have several characteristics in common that make them ideal candidates for yield-management systems. Both have relatively fixed capacities. Once an airplane has been purchased or a hotel has been built, it is rather difficult and expensive to increase capacity. The idea, then, is to use your capacity in the best (most profitable) way possible.

Yield-management techniques are appropriate when a firm is operating with a relatively fixed capacity, when demand can be segmented into clearly identified partitions, when inventory is perishable, when the product is sold well in advance, when demand fluctuates substantially, and when marginal sales costs are low but mar

WHERE DOES YIELD MANAGEMENT WORK?

Ability to segment markets.

For a yield-management program to be effective, the firm must be able to segment its market into different types of customers. For example, business and pleasure travelers can be split easily into separate groups. The basic idea is that hotel managers will have different marketing plans for the different types of customers. Hoteliers would like to be able to sell these segments rooms that best fit their needs. In the case of pleasure travelers, lower-priced rooms that must be booked a certain length of time ahead may be most appropriate. With business travelers, higher-priced rooms that have no time penalty may work best.

Perishable inventory.

Clearly, hotel rooms are a perishable inventory item. If the room is not sold one night, that room-night is lost forever, and the hotel manager cannot put it into inventory for use at some other time. Airlines and rental-car firms face similar problems.

WHERE DOES YIELD MANAGEMENT WORK?

Product sold in advance.

Some transient hotels sell most of their rooms a few days in advance, but in some situations, reservations are made well in advance of the day desired. In the case of group sales, reservations may be made several years in advance. When the product is sold in advance, the manager is faced with uncertainty. Should a group that wants to pay a low rate be accepted, or should the manager wait to see if higher-paying customers will appear? How many super-saver rooms should be sold? Might someone who would pay a higher rate want to reserve those same rooms? With a good yield management system, these types of questions can be answered.

Fluctuating demand.

Hotels face widely fluctuating demand patterns. Demand varies by season of the year, by day of the month, and by time of the week. Yield management can be used to help temper some of the demand fluctuations by helping to increase occupancy during slow times (by decreasing price) and by increasing revenue during busy times (by increasing price). If a manager knows when demand peaks and valleys are going to occur, he or she will be better able to plan for them.

WHERE DOES YIELD MANAGEMENT WORK?

Low marginal sales costs.

Once a certain number of rooms are sold, it does not cost much more to sell another room. The hotel and staff are already in place, and one more room does not make much of a difference in terms of cost.

High marginal production costs.

Conversely, hotels face high marginal production costs. For example, if a property is full and a customer wants a room, another room cannot easily be added onto the property because of the large fixed cost. Hotels add capacity only in large chunks and only after demand patterns have been carefully studied.

PROFIT MARGIN

PROFIT MARGIN

Businesses and individuals across the globe perform for-profit economic activities with an aim to generate profits. However, absolute numbers - like $X million worth of gross sales, $Y thousand business expenses or $Z earnings - fail to provide a clear and realistic picture of a business' profitability and performance. Several different quantitative measures are used to compute the gains (or losses) a business generates, which make it easier to assess the performance of a business over different time periods, or compare it against competitors.

Profit margin is one of the commonly used profitability ratios to gauge profitability of a business activity. It represents how much percentage of sales has turned into profits. Simply put, the percentage figure indicates how many cents of profit the business has generated for each dollar of sale. For instance, if a business reports that it achieved 35 percent profit margin during the last quarter, it means that it had a net income of $0.35 for each dollar of sales generated.

PROFIT MARGIN

Profit Margin = Net Profits (or Income) / Net Sales (or Revenue)

= (Net Sales - Expenses) / Net Sales

= 1- (Expenses / Net Sales)

Taking a simple example, if a business realized net sales worth $100,000 in the previous quarter and spent a total of $80,000 towards various expenses, then

Profit Margin = 1 - ($80,000 / $100,000)

= 1- 0.8

= 0.2 or 20%

It indicates that over the quarter, the business managed to generate profits worth 20 cents for every dollar worth of sale. Let's consider this example as the base case for future comparisons that follow.

MARGINAL COST

MARGINAL COST

Marginal cost is the increase or decrease in the total cost a business will incur by producing one more unit of a product or serving one more customer. If you plot marginal costs on a graph, you will usually see a U-shaped curve where costs start high but go down as production increases, but then rise again after some point. For example, in most manufacturing endeavors, the marginal costs of production decreases as the volume of output increases because of economies of scale. Costs are lower because you can take advantage of discounts for bulk purchases of raw materials, make full use of machinery, and engage specialized labor.

However, production will reach a point where diseconomies of scale will enter the picture and marginal costs will begin to rise again. Costs may rise because you have to hire more management, buy more equipment, or because you have tapped out your local source of raw materials, causing you to spend more money to obtain the resources.

MARGINAL COST

The formula for marginal costs can be expressed as follows:

- **Marginal Cost = Change in costs / Change in quantity**

For the more algebraically inclined, marginal cost can be also be expressed by this equation:

$$\text{Marginal Cost (MC)} = \frac{\Delta TC}{\Delta Q}$$

Where

Δ =	Change
TC =	Total Cost
Q =	Quantity

Application

Let's apply what we've learned. It costs $250,000 to produce 5,000 items and $340,000 to produce 6,500. You have set the price for each item at $75. Should you increase production from 5,000 to 6,500 items?

Marginal Cost = Change in costs / Change in quantity

Marginal Cost = ($340,000 - $250,000) / (6,500 - 5,000)

Marginal Cost = $90,000 / 1,500

Marginal Cost = $60

$75>$60

Since the marginal cost is less than the price you charge per item, you can expand production.

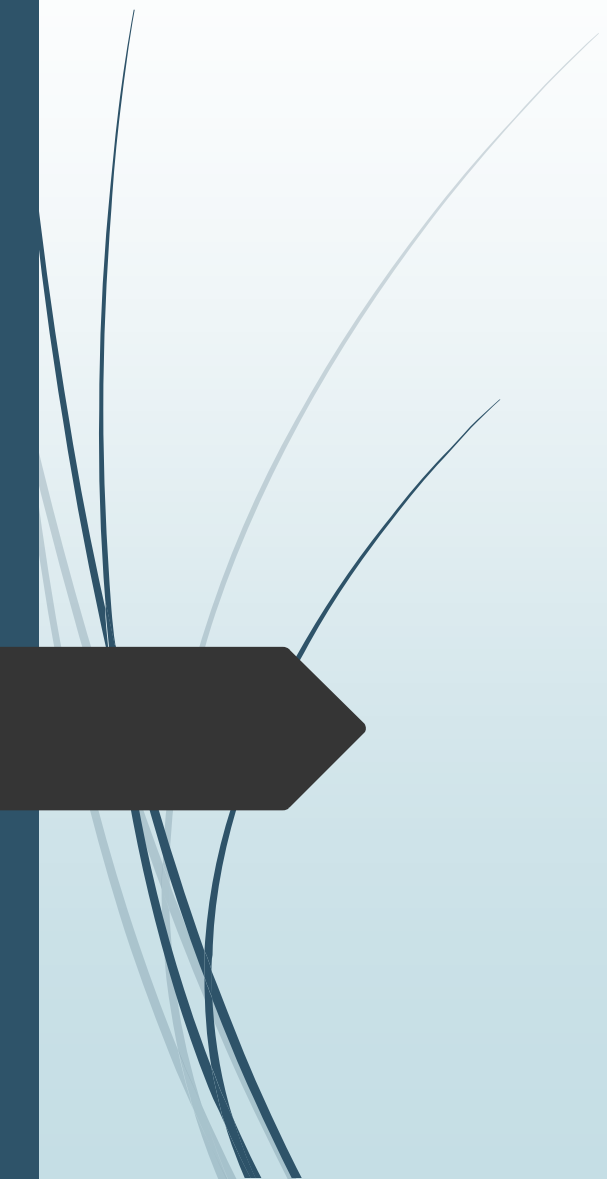
MARGINAL COST

What is “Change in Costs”?

At each level of production and during each time period, costs of production may increase or decrease, especially when the need arises to produce more or less volume of output. If manufacturing additional units requires hiring one or two workers and increases the purchase cost of raw materials, then a change in the overall production cost will result. To determine the change in costs, simply deduct the production costs incurred at during the first output run from the production costs in the next batch when output has increased.

What is “Change in Quantity”?

Since it’s inevitable that the volume of output will increase or decrease with each level of production. Thus, the quantities involved are significant enough to evaluate the changes made. An increase or decrease in the volume of goods produced translates to costs of goods manufactured (COGM); therefore, it is important to know the difference. To determine the changes in quantity, the number of goods made in the first production run is deducted from the volume of output made in the following production run.



UNDERSTANDING VARIABLE COST AND FIXED COST

Variable Cost vs. Fixed Cost: An Overview

In economics, variable costs and fixed costs are the two main costs a company has when producing goods and services. A variable cost varies with the amount produced, while a fixed cost remains the same no matter how much output a company produces.

VARIABLE COST

A variable cost is a company's cost that is associated with the amount of goods or services it produces. A company's variable cost increases and decreases with its production volume. When production volume goes up, the variable costs will increase. On the other hand, if the volume goes down, so too will the variable costs.

Variable costs are generally different between industries. Therefore it's not useful to compare the variable costs between a car manufacturer and an appliance manufacturer because their product output isn't comparable.

Variable costs can be calculated by multiplying the quantity of output by the variable cost per unit of output. So, suppose company ABC produces ceramic mugs for a cost of $2 a mug. If the company produces 500 units, its variable cost will be $1,000. However, if the company does not produce any units, it will not have any variable cost for producing the mugs. Similarly, if the company produces 1000 units, the cost will rise to $2,000. This calculation is simple and obviously does not take into account any other costs such as labor or raw materials.

Examples of variable costs include labor costs, utility costs, commissions, and the cost of raw materials that are used in production.

FIXED COST

A fixed cost is the other cost incurred by businesses and corporations. Unlike the variable cost, a company's fixed cost does not vary with the volume of production. It remains the same even if no goods or services are produced, and therefore, cannot be avoided.

Using the same example above, suppose company ABC has a fixed cost of $10,000 per month for the rent of the machine it uses to produce mugs. If the company does not produce any mugs for the month, it would still have to pay $10,000 for the cost of renting the machine. On the other hand, if it produces one million mugs, its fixed cost remains the same. The variable costs change from zero to $2 million in this example.

The more fixed costs a company has, the more revenue a company needs in order to break even, which means it needs to work harder to produce and sell its products. That's because these costs occur regularly and rarely change.

The most common examples of fixed costs include lease and rent payments, utilities, insurance, certain salaries, and interest payments.

VARIABLE & FIXED COSTS: KEY TAKEAWAYS

- Companies incur two types of costs: variable costs and fixed costs.
- Variable costs vary based on the amount of output, while fixed costs are the same regardless of production output.
- Examples of variable costs include labor and the cost of raw materials, while fixed costs may include lease and rental payments, insurance, and interest payments.

MARK-UP & MARK-DOWN PRICING

MARK-UP

Markup refers to the difference between the selling price of a good or service and its cost. It is expressed as a percentage above the cost. In other words, it is the added price over the total cost of the good or service that provides the seller with a profit.

MARK-DOWN

A markdown is a devaluation of a product based upon its inability to be sold at the original planned selling price. An example of a markdown would be if you had a sweater for sale that was originally priced at $100 and after one month of slow sales, you decide to markdown the sweater to 20% off, making it $80 at retail. Although you just lost $20 of your intended markup on that sweater, you are also inviting more people to purchase it at a price they may prefer than the original $100. Since the sweater had not been selling well at $100, offering a nice, markdowned price can often result in sales that would not happen otherwise.

Markup Percentage Formula

The formula for calculating markup percentage can be expressed as:

$$\text{Markup Percentage} = \frac{\text{Sales Price} - \text{Unit Cost}}{\text{Unit Cost}} \times 100$$

For example, if a product costs $10 and the selling price is $15, the markup percentage would be ($15 – $10) / $10 = 0.50 x 100 = 50%.

Pros & Cons of Markup & Markdown Sale Prices

Pros & Cons of Markup & Markdown Sale Prices

- **MARKETING**

Marking up the price of your goods before putting them on sale increases the percentage customers save, which can influence them to buy. Say a store currently has 50 sweaters in last year's style gathering dust in the stockroom and drawing little interest at a $40 price point. Reducing the price to $30 may increase sales slightly, but a 25 percent off tag might not be enough to get people to stop and look. Increasing the list price to $60 before cutting it to $30 offers a more impressive 50 percent discount. If few or no sales would occur at the higher figure anyway, there's little risk in that maneuver, and the larger perceived discount may help draw consumer interest.

- **EXPECTATIONS**

Marking up prices only to put the products on sale at a more reasonable figure might be manipulation, but it also tends to work even if the customer realizes the tactic. Because customers enjoy the perception of the discount, failing to play the markup-markdown game can cause a retailer to lose business. J.C. Penney, for example, notoriously had to resume the strategy in 2013 after abandoning it briefly because switching to a true everyday low price model was so detrimental to the bottom line. Promising that every customer would always get a fair deal with no promotions may have seemed like a reasonable idea, but after a reported 25 percent drop in sales over the next fiscal year, the CEO lost his job and the company abandoned the strategy.

Pros & Cons of Markup & Markdown Sale Prices

- **CHALLENGES**

The markup-markdown strategy isn't as easy as it sounds. Determining which merchandise should be discounted and the percentage off it takes to move slow-moving items requires an analytic study of your sales data, not just a guess of which numbers will move the needle. Discounting shoes might move them out the door faster, but if your customers would otherwise pay a higher price, that strategy may be counterproductive.

- **CUSTOMER TRAINING**

Constant discounting trains your customers that your everyday prices are too expensive and that they should wait until a sale to buy. Essentially, it commits your business to constantly advertise sales and price reductions, or customers will look for competitors who do so. Studies have shown that customers, familiar with the markup-markdown strategy, effectively "discount the discounts," by assuming the real savings are less than advertised. The promotion threshold, or the amount of discount that convinces customers to change their preferences, depends on the product, but the "discount on discounts" is higher for store brands. In other words, these must have a higher discount, or consumers won't believe they are getting a good deal.

Managing Currency Exchange Risks in the International Travel Industry

Managing Currency Exchange Risks in the International Travel Industry

Potential Benefits from Shifting Foreign Exchange Rates

Changing foreign exchange rates can sometimes benefit travel companies. For example, consider a travel company whose business is based on providing local tours or other services to tourists flying in from abroad. All else equal, if this company's local currency has depreciated against its foreign visitors' currency, its prices will drop, potentially attracting more foreign customers.

However, many factors go into consumer decisions about international travel. Sometimes it takes time for shifting foreign exchange rates to change a destination's reputation for value. Therefore, a weaker local currency doesn't necessarily translate into more visitors immediately -- nor, conversely, does a stronger currency instantly empty out the hotels.

In 2011, Tourism Australia found that inbound travelers varied widely in their reaction to an Australian dollar then trading at an extremely high price. Travelers from Singapore, Korea, and Hong Kong changed behavior more than Canadians did; vacationers were more influenced than business travelers; "baby boomers" were more responsive than younger travelers. Overall, travelers kept coming, but some cut back on expenditures after arriving.3 Something similar appeared to happen in the Orlando, Florida area as Brazilian tourists struggled with the decline of the Brazilian real against the U.S. dollar a few years ago: they still came, but some purchased fewer souvenirs or stayed in lower-cost venues.

Managing Currency Exchange Risks in the International Travel Industry

Downside Currency Risks of Selling Foreign Travel

In one respect, however, international travel providers are at immediate and serious risk from shifting currency markets. Consider a company selling foreign tours, flights, lodging, or cruises to local customers planning future vacations. Typically, the company must set its prices for these services quite early: occasionally, as much as 18 months in advance.

If the company's home currency drops between a customer's advance payment and the date when foreign suppliers must be paid, the company could easily find itself paying unexpectedly high costs -- wiping out profit, creating a loss, or requiring the company to take the undesirable step of asking customers for more money.

That's the situation the U.K.'s Jasmine Holidays found itself in when the British pound dropped in the days after the European Union referendum. According to The Telegraph, it surcharged customers by up to 185 pounds (about $240) per person, while offering them a corresponding discount off any future trips.

US tour provider Jean-Paul Tennant of Geographic Expeditions faced a similar challenge years earlier. As he told the New York Times he had booked a tour of northern India for eight clients. Then, the Indian rupee soared against the dollar, and his Indian supplier demanded $1,500 more per person.

Q&A

- What is Yield Management?
- What is the formula for finding the Profit Margin?
- What is Marginal Cost?
- What is the formula for finding the Marginal Cost?
- What is Mark-Up and Mark-Down Pricing?
- What are some pros and cons od Mark-Up and Mark-Down Pricing?