

MENU PRICING

Menu pricing is important. Pricing is arguably the single most important process that will affect a restaurant's profitability. Let's think about what Sales (or Revenue) is for at restaurant:

$$\text{Sales} = \text{Quantity Sold} * \text{Price} \quad (1a)$$

$$\text{Sales} = \text{Covers} * \text{Average Check} \quad (1b)$$

Where Covers refers to the number of guests served, and Average Check refers to the average spend of a single guest. How much the average guest spends, is primarily a function of how much you charge (the price!). Sales must cover all costs, *and then some* (aka, profit). A discussion of how you affect or control cover counts is largely a function of marketing and operations, but notice that Covers and Average Check is a multiplication – so whatever Average Check (or pricing) decision you make, will be multiplied and magnified by the volume of business conducted. If an operation does not price correctly, the pricing mistake is multiplied and compounded with every guest that comes through the door. Small mis-judgments in pricing add up to big consequences in an operation's ability to cover longer-term costs, fixed costs, and the ability to generate a profit.

Okay, so pricing is important. But what exactly is pricing? Pricing is the process of assigning a dollar amount charged to the guest for a good/service/experience/product. Price is what the operation charges, and it can be viewed as the cost to the customer. Do not confuse 'cost to the customer' with the operation's cost.

Great. So how should the smart manager determine what to charge a guest for an item? Well, pricing is a process, and requires consideration of multiple factors:

- Financial factors
 - The cost of the item
 - Ingredients (direct and indirect), labor (direct and indirect)
 - Overhead
 - Capital planning
 - Required rate return / profitability
- The competition
- Psychological factors (consumer behavior)
- Market positioning, image, brand
- Operational factors
 - FOH capacity; BOH capacity
 - Mixed motives

From the list above, it's clear there are a lot of priority to juggle when honing in on a single price for any given menu item. When judging whether to have a higher or lower price, just keep in the back of your mind that *in general*: The higher the price, the lower the demand; the lower the price, the higher the demand. As you refine an item's price, use the +/-/? (below) as boundaries of whether your prices might be too high or too low. Let's think about the positives and negatives (+ / - / ?) of setting a higher or lower price for each of the factors listed:

Factor	If We Charge a <u>Higher</u> Price	If We Charge a <u>Lower</u> Price
Financial	+ More likely to cover costs + Ability to use better ingredients + Higher contribution margin – Likely less demand	– Less able to cover costs – Might use lower quality components – Lower contribution margin + Likely more demand
Competition	? Looks classier/more high-end – Looks too expensive	+ Better value relative to competition – Price war / spiral?
Psychology (CB)	?/+ Viewed as higher end • Changes expectations	+ Good value
Brand/Positioning	+ Ability to use better ingredients + Likely more demand	+ 'Good Value for Money' – Likely less demand
Operations	?/+ Likely less demand	?/- Likely more demand

Steps to Pricing

As a caveat – pricing is an iterative process that is both an art and a science. It is a science in that quantitative inputs, calculations and models can (and often are!) used to determine a price. Pricing is also an art in that qualitative, or very-difficult-to-measure factors such as image, consumer psychology, and competitive response must also be considered when pricing. But since the process has to start somewhere, we start with clear, internal factors that we can control:

- Step 1. Calculate a base price using a target food cost percentage
- Step 2. For any given menu category, adjust pricing to narrow contribution margin variability within a menu category.
- Step 3. Compare pricing ranges to competition
- Step 4. Fine tune pricing strategy against:
 - a. Competitors
 - b. Operational and management motives
 Using.....
 - Raw price shifts
 - Psychological cues
 - Endings; decoys, bundles.
 - Demand models
- Step 5. Collect and analyze data, and evaluate effect of pricing strategy.
- Step 6. Change/update pricing strategy: Leather, rinse, repeat.

Step 1 – Base Price on Target Food Cost

$$\text{BaselinePrice} * \text{FoodCost \%} = \$\text{ItemIngredientCost} \quad (2a)$$

$$\text{BaselinePrice} * \text{FoodCost \%} = (\$ \text{IngredientCost} + \$ \text{QFactor}) \quad (2b)$$

$$\text{BaselinePrice} = \frac{\$ \text{IngredientCost} + \$ \text{QFactor}}{\text{FoodCost \%}} \quad (2c)$$

Where FoodCost% is given, and \$QFactor is the item's allocated portion of all random, too-difficult-to-measure ingredients and accoutrements associated with a meal. Practices in applying QFactors vary across operation, and may be expressed as a single dollar amount or percentage per menu item, per entrée only; or as different dollar amount percentages based on different menu categories. For the purposes of simplification, you can assume that a simple QFactor for the Vista Room dining room can be calculated as:

$$\$ \text{QFactor} / \text{Entree} = \frac{\text{Total Food Cost of Ingredients Not Uniquely Attributable to a Menu Item for a Given Period}}{\text{Number of Entrees Served for the Period}} \quad (3)$$

The numerator is generally comprised of little, random items that may be held in par, difficult to find historical pricing for, or are of measurements too small to really cost for in a recipe (for example a recipe quantity amount of 'TT' or 'To Taste;'). Salt, pepper, general-use spices, shared paper goods (napkins, stir sticks, sugar packets, random plate garnishes....etc) are the types of items that get rolled into a general QFactor calculation.

Step 1 (Variation) – Base Price on Target Cost Metrics

Operations that have their processes together tend to extend pricing to quantitatively cover more costs than just food costs. More precise costing methods calculate a baseline price off of a custom, more relevant and comprehensive cost target that might include labor, overhead....and maybe even a desired profit component.

$$\text{BaselinePrice} * \text{QtySold}_{\text{Expected}} = \text{AllItemIngredientCosts} + \text{AllocationLabor} + \text{AllocationOfOverhead} + \text{AllocationOfTotalExpectedProfits} \quad (4a)$$

$$\text{BaselinePrice} * \text{QtySold}_{\text{Expected}} = \text{QtySold}_{\text{Expected}} * \$ \text{ItemIngredientCost} + \$ \text{QFactor} + \$ \text{Labor} + \$ \text{OH Allocation} + \$ \text{ExpectedProfits} \quad (4b)$$

$$\text{BaselinePrice} = \text{\$ItemIngredientCost} + \frac{\text{\$QFactor} + \text{\$Labor} + \text{\$OH Allocation} + \text{\$ExpectedProfits}}{\text{QtySold}_{\text{Expected}}} \quad (4c)$$

How should you allocate:

- Labor – Direct and Indirect
- Overhead (OH) - Direct and Indirect – Weighted average allocation across all entrees.
- Expected Profits – Weighted average allocation across all items

There are many ways to allocate, and different operations allocate in different ways, depending on the amount of time, resources, and effort they dedicate to their pricing strategy.

Step 2 – Adjust Prices to Align Contribution Margins

In the very short term, each item sold just has to cover its own variable cost...generally its food cost. As such, the quick and dirty metric generally used to determine an item's financial viability is contribution margin – how many dollars does the item contribute to the margins of the business?

$$\text{\$ContributionMargin} = \text{\$Price} - \text{\$ItemIngredientCost} \quad (5a)$$

$$\%ContributionMargin = \frac{\text{\$Price} - \text{\$ItemIngredientCost}}{\text{\$Price}} \quad \text{or} \quad 1 - \left[\frac{\text{\$ItemIngredientCost}}{\text{\$Price}} \right] \quad (5b)$$

The main idea behind contribution margin-based pricing is to price a menu category where management would be financially indifferent to whichever item is sold – no matter which item in the category is sold, the item sold would contribute the same amount to covering costs and profitability as any other item. For example:

Mixed Motives and Contribution Margin Example			
	Steak	Lobster	Pasta
+ Price	\$ 19.00	\$ 22.00	\$ 15.50
- Total Food Cost	7.00	11.00	5.00
= Contribution Margin	\$ 12.00	\$ 11.00	\$ 10.50
Food Cost %	36.8%	50.0%	32.3%
Tip (@20%)	\$ 3.80	\$ 4.40	\$ 3.10

UNIFORM SYSTEM OF ACCOUNTS – RESTAURANT INDUSTRY

The Profit & Loss or Income Statement

Restaurants and food and beverage (F&B) operations are almost always for-profit operations. In rare instances, the operation is meant to operate at breakeven (eg the Vista Room, not-for-profit organizations, charities, etc.), or are run as cost centers for some other operational purposes (eg many corporate cafeterias designed to keep employees on campus or to build camaraderie). Whatever the (not-for) profit motive, *all* F&B operations must monitor and closely manage its *Profit & Loss* or *Income Statement*. ‘P&L’ and ‘Income Statement’ are used interchangeable in industry. For the food and beverage industry, the standard format used to present the P&L is in the *Uniform System of Accounts for Restaurants* (USAR). USAR is a set of guidelines put forth by the National Restaurant Association that accounts use to better present information to management. The figure below shows the standard presentation of the USAR Income Statement according to the 8th and 7th editions of the standard:

Uniform System of Accounts for Restaurants 8th ed – Income Statement Format			
Statement of Income for the Period Ended			
	[Insert Date]		
	\$	%	
Sales			
Food	\$ 750,000	75.0%	
Beverage	225,000	22.5%	
Merchandise & Other	25,000	2.5%	
Total Sales	<u>1,000,000</u>	<u>100.0%</u>	
Cost of Sales			
Food	217,500	29.0%	
Beverage	49,500	22.0%	
Merchandise & Other	3,750	15.0%	
Total Cost of Sales	<u>270,750</u>	<u>27.1%</u>	
Labor			
Management	90,000	9.0%	
Staff	165,000	16.5%	
Employee Benefits	58,650	5.9%	
Total Labor	<u>313,650</u>	<u>31.4%</u>	
Prime Cost	584,400	58.4%	
Other Controllable Expenses			
Direct Operating Expenses	60,000	6.0%	
Music & Entertainment	600	0.1%	
Marketing	25,000	2.5%	
Utilities	48,000	4.8%	
General & Administrative Expenses	50,000	5.0%	
Repairs & Maintenance	30,000	3.0%	
Total Other Controllable Expenses	<u>213,600</u>	<u>21.4%</u>	
Controllable Income	202,000	20.2%	
Non-Controllable Expenses			
Occupancy Costs	72,000	7.2%	
Equipment Leases	6,000	0.6%	
Depreciation & Amortization	15,000	1.5%	
Total Non-Controllable Expenses	<u>93,000</u>	<u>9.3%</u>	
Operating Income	109,000	10.9%	
Corporate Overhead	2,500	0.3%	
Interest Expense	1,000	0.1%	
Other (Income)/Expense	1,250	0.1%	
Income before Income Taxes	<u>\$ 104,250</u>	<u>10.4%</u>	

What goes into each line item is strictly defined by USAR guidelines. For example, USAR defines what should be considered as a *Marketing* expense, and what should go into *General & Administrative*. Appendix A and B of the *Uniform Systems of Accounts for Restaurants* should be used as reference – you can look up what is in each line item in Appendix A, and you can look up which category any particular expense should be classified in with Appendix B.

- Dollar amounts are in one column, and a common-sized version (presented as percentages of *Total Sales*)
 - **Except!!!** – Cost of Goods Sold lines are shown as a percentage of their respective sales lines, not as a percentage of total sales.
- *Costs of Goods Sold* are separated out into the same individual lines that Sales is separated out into.
- In the 8th edition, all labor costs are listed and totaled immediately after *Total Cost of Goods Sold*.
- The P&L stops at the *Income or Earnings Before Income Taxes* (EBIT) line, and does not include *Income Taxes* or *Net Income*.

The first step to interpreting the income statement is to organize the income statement into a standard form.

A – Compare the operation's performance to the performance of other operations

1. Put the P&L to be formatted into the correct USAR format.
2. Common-size the P&L at a percent of *total* sales. **Except!!!** – Individual cost of goods sold lines are shown as a percentage of their respective sales lines, not of *Total Sales*. Only the *Total Cost of Goods Sold* line is shown as a percentage of *Total Sales*.
3. Find a comparable operation to compare your operation to. Comparables should be chosen based on a mix of factors:
 - a. **Size of operations** – expenses related to the building, utilities, rent, should be similar for similar sized operations
 - b. **Level of service** – a full or limited service concept; complicated or simple service; level of expertise of staff (BOH and FOH) – similar service levels will have similar labor and benefits expenses.
 - c. **Food concept** - cuisine, ingredient types, average check, complexity of items served, level of food preparation – similar food concepts will have similar direct operating expenses, and cost of goods sold.
 - d. **Age of operation** – how long as the business been around; age of building; lease type – operations of the same age will have similar Depreciation & Amortization, Repairs and Maintenance Expenses.
 - e. **Location of concept** – Metropolitan Area (MSA); Urban/Suburban/Rural designation; neighborhood. Businesses in similar MSAs and areas will have similar occupancy costs.
 - i. One big thing to watch out for though, is whether the operation owns or leases its building. All other things equal, the business that owns its real estate will have higher Depreciation & Amortization, and lower Occupancy Costs than the business that leases.
4. Compare your operation's common-size financial statement to that of the competitive set.
 - a. Which of your operation's line items are very different than the competitive set? Why do those line items differ? If so, explain the source of the difference. If not, do some digging!
 - b. Compare your operation's line items to industry standards/benchmarks. Does the operation differ a lot compared to the industry? If so, explain the operational reason(s) for the differences.
 - i. Prime Cost should be between 40%-65%
 - ii. Food Cost should be between 23%-35% of sales.
 - iii. Staff Wages are about 15%-22% of sales for full-service establishments, and 13%-20% for limited service establishments. These rates are higher in municipalities with high minimum wage requires, and for union shops.
 - iv. Occupancy costs should be 8%-10% of sales, though this may be as high as ~20% for high-traffic, major metropolitan areas.

B – Compare the operation's performance to its own past performance

1. Put the P&L for each year into the correct USAR format.
2. Look for trends and changes in performance from one period to the next. Do you know why percentages changed from year to the next? If so, explain. If not, find out why!

The Balance Sheet

Oddly enough, attention to forecasting financial analyses for food and beverage operations do not really concentrate too much effort on the balance sheet. Probably because restaurant capitalization is VERY different across operations – how a restaurant is funded varies wildly from one concept to another. There really is not a standard mode of capitalization – the structure differs by too many factors and makes for poor generalizations. Note, when we talk about capitalization, we’re talking about how the operations funded itself – through debt (by borrowing), equity (finding investors), through its suppliers and employees (current liabilities). Who provided the resources for the operations to get the assets that its got.

That being said, restaurants do share a few common traits on either balance sheets:

- Generally a negative working capital position – Working capital is current assets minus current liabilities. Restaurants generally run working capital negative because current liabilities are accrued quickly but paid relatively slowly, yet current assets are not really accrued.
- Restaurants generally do not have accounts receivables unless they have some other business besides just serving meals during meal time. Instances where a restaurant or F&B operation would have accounts receivables would be if the operation:
 - Offers catering, banquets or events – anything that requires invoicing and a collection period after the service has been rendered.
 - Licenses or rents out rights – for example if the operation licenses its name for use on a product.
 - Sells or distributes product wholesale or through some other distribution channel. For example, if the operation is itself a commissary and makes and sells (say...) bread and pastries in bulk to some other operation and then sends a bill for those products sold.
- A healthy F&B operation should have cash on hand to cover at least 3 months of current liabilities. So a good metric to gauge the financial health of the operation’s balance sheet is if:

$$\frac{\text{Three Months of Total Current Liabilities}}{\text{Total Cash under Current Assets}} < 1$$

- The absolute size and proportion of assets that the Property Plant & Equipment account for an F&B operation has can vary greatly depending on several factors:
 - **Ownership of real estate** versus leasing the space – if the operation owns the building and or land that they operate in, PP&E will be higher. If the operation leases the space, if the lease is a capital lease, PPE will also be higher.
 - **Own versus lease of equipment** – depends on how much of the operation’s equipment is owned versus leased (for example, delivery trucks, ice machines, storage or refrigeration).
 - **The age and useful life of the PP&E** – PP&E will depreciate, and depending on how long the PP&E has been around for, the useful value of the PP&E may not be reflected on the balance sheet. A lot of very old, traditionally built equipment is made to last decades, much longer than traditional depreciation lives.
- Inventory and the type of operation – Different types of operations will have different inventory requirements. Most notably for example, high end restaurants with developed wine programs are likely to have large wine inventories; those with bars will have large liquor inventories; steakhouses might hold inventories of their dry-ageing steaks; and charcuterie and cheese focused shops may hold inventory of curing meats and cheese.

So, given the traits discussed above, any analysis of the balance sheet should be discussed in terms of financial health, and the availability of cash to cover current liabilities. Apart from that, a discussion of why balance sheet line-item balances are relatively high or low should be framed in the context of what the operation does or does not do. For example, “the operation does own a large wine cellar, thus inventory might be high”.....”the operation does not own its real estate, so PP&E might lower...” Don’t try to compare one balance sheet to another to gauge whether the operation is performing well or not.