

## The Lodging Industry Market Structure - by Manmohan Shetty

2008-04-29

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The market structure of lodging industry is 'Monopolistic competition' - market structures in which there are many firms selling differentiated products, there are few barriers to entry.

A monopolistically competitive firm acts like a monopolist which means that the firm is able to influence the market price of its product by altering the kind of the product being offered.

Unlike in perfect competition, monopolistically competitive firms have products that are not perfect substitutes. As such a Holiday Inn Express product, which is different (or at least perceived to be different) from all other brands' product like Days Inn is available from a single producer.

Consumers have a clearly defined preferences and sellers attempt to differentiate their products from those of their competitors, the goods and services are heterogeneous. In the short-run, the monopolistically competitive hotel can exploit the heterogeneity of its brand so as to reap positive economic profit, this is a rate of return greater than the rate required to compensate debt and equity holders for the risk of investing in the hotel.

The lodging industry being a monopolistic competitive market has the following characteristics:

Many sellers

Differentiated products

Multiple dimensions of competition

Easy entry of new firms in the long run.

The characteristics are almost exactly same as in perfect competition, with the exception of heterogeneous products and that monopolistic competition involves a great deal of non-price competition (based on subtle product differentiation). This gives the hotel a certain amount of influence over the market, it can raise prices without losing all the customers, owing to brand loyalty.

Many sellers, today in the market we have different types of hotels like Days Inn, Hampton Inn, Holiday Inn Express, Baymont Inn and so on. When there are many hotels, getting them to act as one is difficult, monopolistically competitive hotels are assumed to act independently.

Since the products in monopolistically competitive markets are heterogeneous they are differentiated slightly, the product may not really be different although in trying to be a monopolist by advertising the fact the good is different it can convince people. Monopoly is fleeting, to fit the monopolistically competitive model, the hotels must make their decisions as if they had no effect on other hotels.

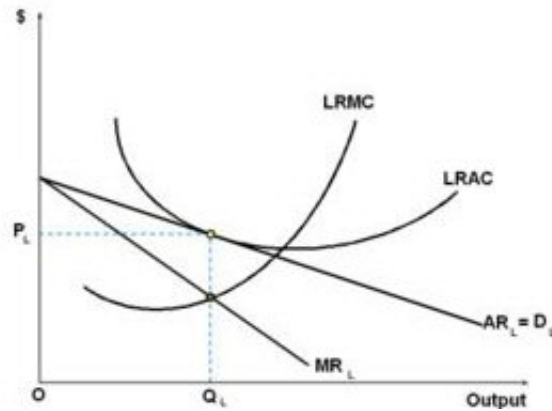
Multiple dimensions of competition make it much harder to analyze a specific industry, but the alternative methods of competition follow the same two general decision rules as price competition:

Compare marginal costs and marginal benefits

Change that dimension of competition until marginal costs equal marginal benefits

The last characteristic of a monopolistically competitive market must meet is that, long run barriers of entry must be relatively easy, there must be no significant entry barriers.

The implications of this market structure on pricing are explained as follows. In the long run equilibrium, a perfect competitor makes only a normal profit. The normal profit will attract new entrants, which would make some of the existing lodging establishment customers to defect, and its portion of the market demand curve for the existing lodging establishment would decrease. The existing lodging firm would try to protect its profits by increasing its expenditure on product differentiation and advertising to offset that entry of a new lodging establishment. These additional expenditures would shift its average total cost curve up and would continue till its profits disappeared and the new demand curve is tangent to the new average total cost curve. A monopolistically competitive firm can make no long run economic profit.



### Long-run equilibrium of the firm under monopolistic competition

The lodging industry has also some unique characteristics different from the manufacturing sector that plays a role in pricing decisions. Unlike manufacturing facilities that can expand production/supply when demand increases, hotels have a set number of rooms (in the short term), and hence supply is capped (atleast in the short run). The second unique characteristic, lodging supply is perishable. Hotel stays cannot be inventoried for future use once an opportunity to rent a room has passed. Conversely tangible goods have a shelf life that is considerably longer, and can be sold at a later date. The third unique feature is that hotels have a substantial start-up capital requirement. Lastly, lodging operations encompass more complex production methods which are characterized as labor intensive, with intangible products, inseparable production and consumption functions, multiple locations, and variable levels of service quality and these service systems are less efficient than conventional industrial production methods, and hence has an impact on overall financial performance.

The concern of perishability of lodging supply creates a sense of urgency regarding the execution of various marketing or yield management functions which reflects on pricing decisions. In order to understand the pricing, the hotel has to understand about sunk costs and subsidies, since hotels involve start up capital there is already sunk costs involved in operation. Standard & Poor, Lodging & Gaming Industry Survey states hotels typically seek to maximize revenues, profits and cash flow by finding optimal relationship between occupancy and room rates. Hence if the lodging establishment remains anchored with a fixed price it will forgo the opportunity cost of renting the rooms and will have to subsidize the empty rooms with the revenue collected from the rooms rented, thus reducing total profit.

The application of variable pricing and price discrimination is widely applied in the lodging industry to maximize revenue and profits since whatever distinguishing characteristic that enables one hotel to reap monopoly profits will be duplicated by competing firms. The competition will drive price down and, in the long run, the monopolistically competitive firm will make zero economic profit.

The non - price strategies to maintain or increase revenue for lodging products would be 'Barriers to Entry'. The economic theory behind barriers of entry postulates that in every market various structural constraints can impose disadvantages to entrants relative to incumbents. That is, the presence of barriers to entry result in fewer entries and there allows incumbent lodging products to enjoy above average profitability.

Barriers of entry can be classified as structural or behavioral. Structural barriers can be due to environmental factors and behavioral can be termed as controllable factors. Structural barriers include factors such as government approvals, capital requirements, technology levels and industry requirements. Behavioral barriers are mainly purposeful acts carried out by incumbent firms to prevent entry of potential competitors, the strategies could include such issues as patents, price undercutting, lobbying, lawsuits, product proliferation, exclusivity agreements with suppliers and distributors.

The presence of high entry barriers inhibit competition from entering the market, increase and incumbent lodging products rate of growth, improves the lodging products market share, and increase the incumbent lodging firm's profits by allowing them to charge higher prices or achieve greater asset efficiencies.

If the lodging firm has to remain competitive in this market structure, it will have to differentiate itself by making use of its existing and most expensive resource labor, more productive, lets take the example of Fairfield Inn a lodging product by Marriott which can be used by individual lodging firms to succeed. In 1987 Marriott launched Fairfield Inn into the economy limited-service motel industry, a sector saturated with excess rooms and with low 55% occupancy rates. Marriott wanted to gain market share quickly by creating an enhanced service focus - a focus somewhat foreign to this segment of the industry. Marriott was faced with higher break-even costs than its competitors and a requirement for much higher occupancy levels.

Marriott implemented this focus with the support of very selective hiring - an approach used by Southwest Airlines, and a new customer feedback mechanism for evaluating staff and unit performance. The guests would rate three aspects of service: cleanliness, friendliness, and efficiency. The three individual scores were aggregated to give an overall guest score, the scores were publicized across the firms to allow for easy comparison and monetary incentives were tied to the performance at individual lodging properties. Thus there was considerable motivation for all unit members to investigate opportunities and effect improvements.

Fairfield Inn won awards for the best hotel in segment only two years after opening. It has continued to win awards over the last decade. This has translated into more growth of Fairfield Inns' in secondary and tertiary market segments of the lodging industry.

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This article comes from Hotel News Resource

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