



Value-Based Pricing for Restaurants

Make Pricing Your Ally: How to Put Value
Back on the Menu

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Nothing ruins great food more than bad pricing decisions.

That maxim is particularly true along the ultracompetitive spectrum of restaurants from quick service (QSR) to family and casual dining. You have invested heavily in developing your unique brand of food taste and quality, established an in-store presence attractive to your target segments, and anchored it with a compelling brand image. That is the visceral, perception-driven side of the value equation. But the “money” side of value equation – driven by pricing – is a challenge more vexing in restaurants than in almost any other industry.

The money side is murky and messy, but the real concern is that pricing is preventing restaurants from realizing their full potential. Even in the best case, pricing seems like a complex nemesis whose easy answers are risky and whose hard answers require too much time and effort for an uncertain reward.

It doesn't have to be that way.

It's time for restaurants to make pricing their ally, not their nemesis. The power and peace of mind that comes from balancing both sides of the value equation have a huge financial upside in terms of improved profits, without sacrificing the integrity of the menu and the reputation you have worked so hard to establish. This is especially true in an industry which typically operates at net profit margins in the range of 10-15%. Weaving together a great menu which balances value and price means threading the needle on six challenges that all restaurants along that spectrum face:

1. Optimizing Guest Count vs. Average Check

The simplest calculation of revenue is average check size and guest count. The simplest and prevailing logic in the business tells us that higher prices can reduce traffic, while lower prices and frequent promotions (discounts, value menus, etc.) can drive higher traffic, especially at a time where overall traffic in the industry is flat¹. But a restaurant which is packed from open to close may not be generating the amount of revenue it can and should. How do you find the right balance between ticket size and guest count?

2. Minimum Wage

Margins are sensitive enough in the restaurant business without the cumulative effects of all the pressures they face. Competitors' moves and the allure of higher traffic put downward pressure on prices, while federal, state, and in some cases local governments are setting higher minimum wages. How do you reconcile downward price pressure with higher costs?

3. Power of POS data

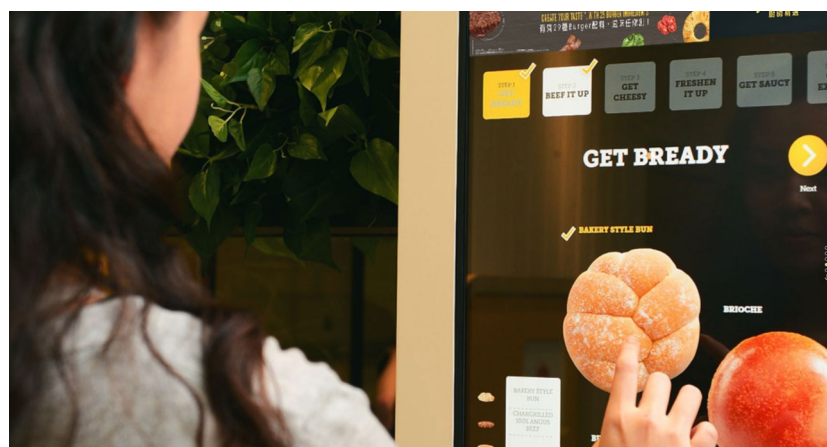
Restaurants collect a tremendous amount of rich data through their POS systems.

1. Maze, Jonathan. "Black Box: Same-Store Sales Flat in November." *Restaurant Business*, 07 Dec. 2017, www.restaurantbusinessonline.com/financing/black-box-same-store-sales-flat-november. Accessed 11 May 2018.

The potential to recognize patterns, make dynamic adjustments to menus, and predict traffic and ordering patterns is just as tremendous. But until you find a way to analyze and interpret the data reliably, and turn those analyses into action, the potential remains just that: potential. How do you leverage your very rich transaction data without becoming a slave to algorithms or black boxes, or so myopic that you lose sight of what drives your customers to your restaurant?

4. The Millennial Revolution

The growing presence and buying power of Millennials has shifted the market away from standardization. Custom-built items have become the new normal in the industry. Even chains known for their excellence in standardization (such as McDonald's) have introduced "Create-Your-Taste" offers (Picture 1). Instead of embracing the standardization and consistency which defined their parents' and grandparents' restaurant experiences, Millennials have grown up accustomed to getting what they want, how they want it, and when they want it. In light of guests' desire for more control, how do you balance the increasing demands for customization with powerful value drivers such as consistency? How do you price your custom items relative to your standard ones?



Picture 1: McDonald's "Create-Your-Taste" kiosk.²

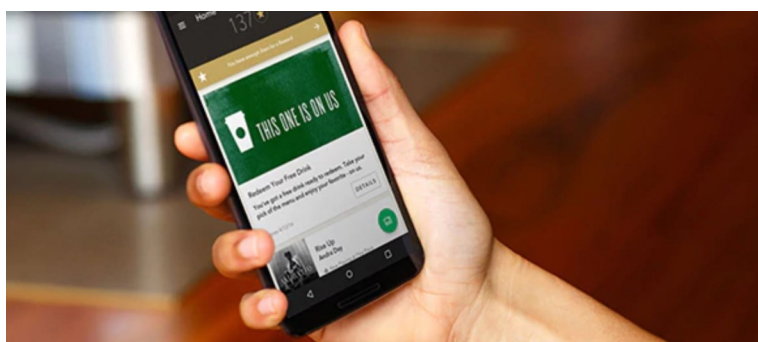
2. McDonalds. *McDonald's Create Your Taste Home Page*, 2018, www.mcdonalds.com.hk/en/create-your-taste.html. Accessed 11 May 2018.

5. Rampant Promotions

More players and more categories (e.g. the growth of fast casual) mean more competitive pressures, which have triggered an almost knee-jerk reaction from restaurants: discounts, coupons, promotions, just about anything to keep guests walking in the door. The truth is that over-promoting is like an addiction which undermines your restaurant's health, i.e. your brand and your bottom line. Resisting that temptation is a key success factor in today's restaurant environment. It boils down to this question: How do you know when to be proactive and when to be reactive regarding promotions?

6. Apps, not Appetizers

No business has escaped the overwhelming technological advancements of the last decade. These advancements create vast new opportunities for restaurants, such as delivery services, loyalty programs, and mobile ordering through apps. Mobile apps bring two clear advantages. First, they extend the reach of your kitchen and brand. No longer must restaurants rely solely on foot or drive-through traffic, reservation counts, and tables turned to generate their profits. Second, mobile apps collect a vast amount of data (e.g. geolocation, delivery fee pricing, ad and offer responsiveness) well beyond what the restaurant can collect at point of sale. Just look to the successes of Starbucks (Picture 2) and McDonald's.



Picture 2: Starbucks app for iPhone³

3. Starbucks. *Starbucks® App for iPhone® and Android™*, 2018, www.starbucks.com/coffeehouse/mobile-apps. Accessed 11 May 2018.

How do you capitalize on those opportunities to create a new relationship with guests by crafting a superior guest experience and by capitalizing on the new pricing opportunities these technologies bring?

Determining The Maturity of Pricing

The good news – and the huge opportunity – is that restaurants can put a pricing strategy and pricing processes in place which offers the guidance, if not definitive answers, to create and preserve an equilibrium between value and price. That powerful and valuable equilibrium comes from understanding where you currently stand relative to each of the six challenges above, then defining, prioritizing, and executing the steps to address them. But how do you establish that baseline, decide where to begin, and determine how to balance expectations between investment and outcomes? After all, significant price and menu changes are expensive and risk alienating guests.

It all starts with knowing your current level of pricing process maturity and determining the realistic and the aspirational levels to aim for. The World Class Pricing™ system (see Figure 1) comprises five levels. Where a restaurant starts and where it ends up in terms of pricing depends on its maturity level, which we assess using that progression.

Roughly 70% of all restaurant chains fall into either Level 1 or Level 2. This illustrates the nature of the opportunities for restaurants. Rather than needing to catch up to peers, they have a chance to carve out a clear advantage, both commercially and financially, when they make pricing their ally.

The levels differ in terms of the intensity of the challenges, their root causes, and the steps a restaurant needs to take in order to reach the next level and aspire to progress further.

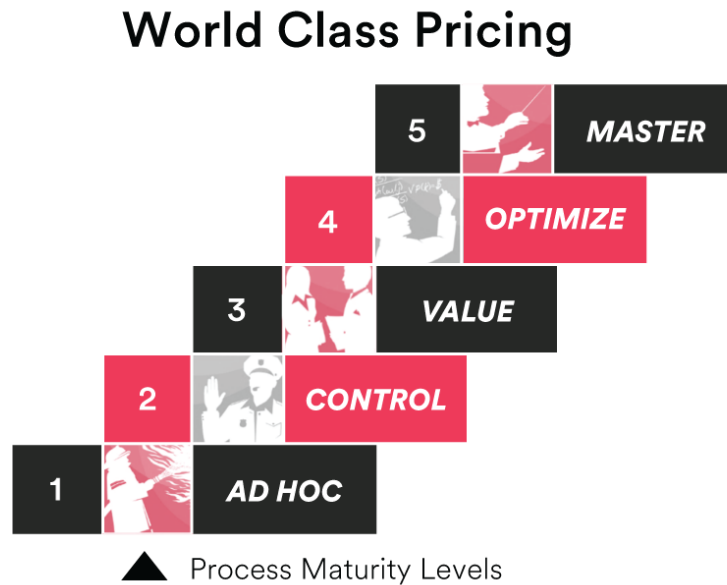


Figure 1: The World Class Pricing™ of Pricing Solutions takes a company step-by-step toward optimization and ultimately to mastery in terms of pricing

Level 1: Lack of Strong Controls

Restaurants at Level 1 show the weakest controls over the discounting addiction. They rely too heavily on promotions, and they are slow to weed out the unprofitable stores which contribute to the vicious cycle of promotions. But the lack of controls extends beyond discounting and promotional behavior.

Level 1 restaurants use simple rules of thumb instead of grappling with the six challenges. They make across-the-board price increases (say, 3% on everything) instead of targeted ones. They suffer from menu proliferation (“more is better”) instead of focusing on balance. They also use costs as the basis for their price setting (cost-plus method) rather than using value as the basis.



The response of one restaurant chain in the face of minimum wage and food cost increases shows the risks of being at Level 1. The company implemented a large, across-the-board price increase to offset these costs. But this price increase bore no relation to the underlying value in its menu. The result was a lower guest count compounded by lower volumes or tickets from the guests who did come. The restaurant fell short of its financial goals. What could the restaurant have done differently?

The solution lies in adopting the practices from Level 2. It starts with revisiting the core value proposition and reinforcing what the brand truly stands for. The chain needs to put controls in place that limit the extent and frequency of promotions and close its unprofitable stores. Finally, the chain needs to pull back from a “more is better” philosophy and ensure that the menu closely reflects the core value proposition. In most cases, this leads to a simpler menu.

Level 2: Controls Are in Place, but Value Is Left Untapped and Underutilized

Putting controls in place and reaching Level 2 is an important achievement, but the journey is only beginning. Despite a clearer pricing process and more controls on promotions, Level 2 restaurants still behave similarly to Level 1 restaurants in some aspects, albeit to a lesser degree.

One of the key similarities is the continued reliance on simple rules of thumb. While they manage their promotions better, they still take more of a “one-size-fits-all” approach rather than targeting specific segments. They also risk sliding back into the old behavior of heavy promotions if guest count declines, despite their controls. In the process of identifying and closing unprofitable stores, they may have developed store tiers, which is an important step away from using rules of thumb to set chain-wide prices.



Challenges:

- Cost-Based Pricing
- ‘Vanilla-Based’ Price Increases (e.g. 3% across the board)

But even in that case, they are prone to use costs to define the store tiers, rather than using value, which is a better metric but which can be harder to define. Perhaps most critically, they still make price increases based more on costs than value. Figure 2 illustrates how a restaurant can knock its price-value relationship out of balance when it uses costs instead of value as the basis for a price increase.

The diagonal blue line indicates the threshold where price and perceived value are in equilibrium. By raising the price significantly above that line, but keeping the product quality the same, the chain puts its coffee's price-value relationship not only at a disadvantage relative to the notional equilibrium, but more importantly relative to its two primary competitors. The chain used rising costs as the justification for the price increase, but Figure 2 explains why making such a move is harmful both financially and in terms of competitiveness and brand image.

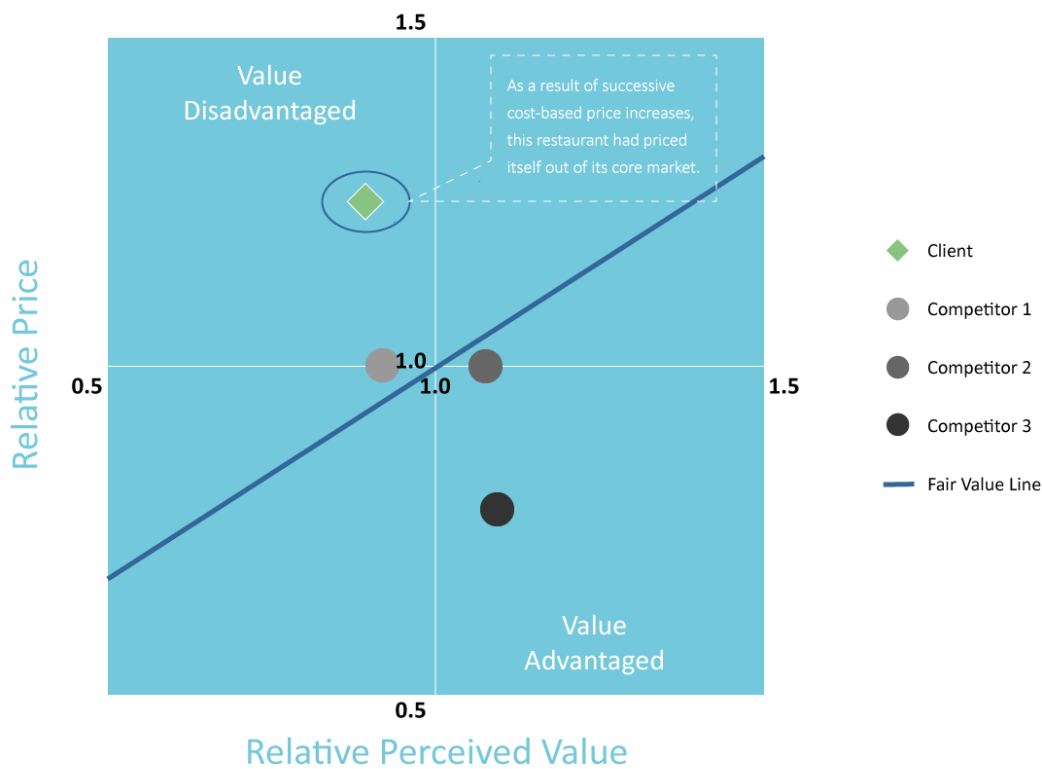


Figure 2: Price value map for coffee, core customer segment. A cost-based price increase for coffee puts this restaurant, and its core segment, at a value disadvantage

The solution, and the source of future improvement, centers around one vitally important word: value. One could say that the biggest difference between restaurant chains at Level 2 and the more value-focused ones at

Level 3 is that they have the desire, the capabilities, and the commitment to create analyses like the one in Figure 2, and then interpret them and act on them. In other words, they start using value – both in the visceral and the quantitative sense – as their guiding principle for menu and pricing decisions, rather than costs or short-term competitive pressures. When they make this shift in focus, they start to segment their customers and redefine their store tiers based on value. They are also in a position to redesign their menu around key price points.

Level 3: Add Value-Based Pricing to Your Strong Controls

The emphasis at Level 3 switches from outright improvement to enhancement, because restaurants start capitalizing on their firmer grasp of customer and competitive dynamics. They know their customers very well by conducting regular research to augment their own POS data. This helps them gain a deeper understanding of the value drivers in the markets, and how they perform relative to the competition. Our own research has found that food quality is the top value driver, ahead of price, regardless of where the restaurant competes along the industry spectrum from QSR to casual.



The graphic consists of three main elements: a black square with the white number '3', a red silhouette of a person's head and shoulders, and a black square with the white word 'VALUE' in all caps.

Challenges:

- Competitive Benchmarking
- Store Tiering
- Deep Knowledge of Customer

This extensive knowledge base, combined with an understanding of value vs. cost, enables restaurants to make pricing decisions which are more tightly aligned to their core value proposition.

Restaurants at Level 3 undertake smart redesigns of their menu, building around key customer segments and key price points, such as breakfast deals at \$5 and lunch deals at \$10. These prices do not come from thin air. In our price expectations research, we use “fair price/think twice” questions to uncover customers’ price thresholds. This research has repeatedly shown that \$10 is a key price threshold for lunch. In the spirit of the control and discipline they fostered at Level 2, many chains at Level 3 reinforce these key menu price points but by offering discounts only to key segments of the market.

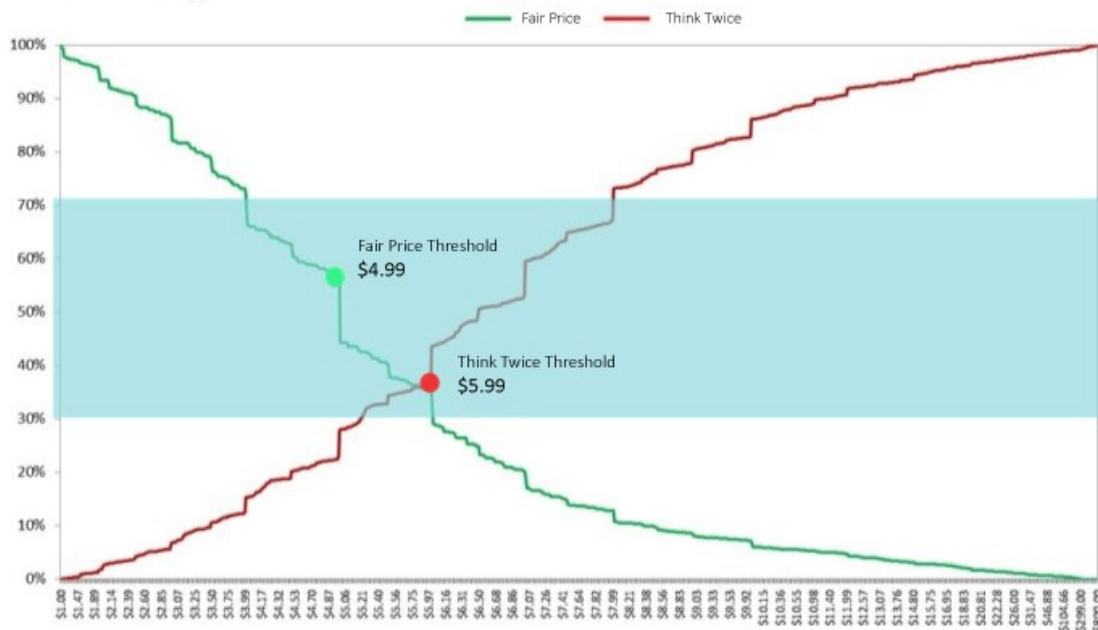


Figure 3: Example of “Fair Price / Think Twice” analysis for breakfast

A more comprehensive, value-based pricing approach also extends to the determination of store tiers. Instead of treating all stores the same, or focusing on a few simple metrics, the restaurant group takes all 4 C’s (customer, costs, competition, and conditions) into account in order to maximize value across the group. When we analyze individual restaurants across an entire system, we generally find less price sensitivity in areas where there are many travelers (customers), few nearby competitors

(competition), high wages (costs), and high household income (conditions). This combination creates a set of pricing opportunities not present at stores where, for example, competition is much more intense and local purchasing power is lower.

The more rigorous and quantitative the store-tiering analysis is along the 4 C's, the greater the chances the restaurant can isolate and seize specific pricing opportunities. An analysis we performed for a restaurant chain with over 900 stores revealed that most locations with no key competitors located within 1,000 feet could increase prices without losing volume. The extent of the changes varied from store to store based on the other C's, but this one change alone was responsible for over \$5 million in additional revenue. What made this incremental revenue possible was the underlying analysis involving thousands of data points and millions of interrelationships.

One risk that restaurants at Level 3 face comes as they make the transition to value-based pricing. The intensive focus on this new pricing approach cannot come at the expense of the discipline and controls the company has implemented to improve its revenue and profit situation in the first place. Value-based pricing should in fact build upon this discipline and control.

Level 4: Optimize Your Value-Based Prices

Restaurants at Level 4 have implemented value-based pricing, but their journey is far from over. Thanks to market dynamics as well as ongoing improvements in capabilities, technology, and data, these chains now face the challenge of optimizing their menu prices.

Optimization not only preserves the gains from previous levels, but also yields additional incremental profit improvement.

Menu optimization is an iterative, ongoing process which requires a considerable amount of data and analysis. The process starts with identifying price elasticities at the category level, or ideally at the item level. By knowing how sensitive the volume of each menu item is to changes in price (both small and large), the restaurant can develop a predictive model which shows how revenue, guest count, profits, and other key metrics move as prices change. Just as important are the interrelationships between menu items and price changes, i.e. the substitution effects and the basket effects. The model, in turn, allows the chain to make decisions on optimal prices for each menu item and bundle.

**Challenges:**

- Predictive and Prescriptive Modeling
- In-Store Testing
- Survey Testing (Menu-Based Conjoint)

Getting accurate estimates of price elasticities allows restaurants to identify the extent of their pricing latitude across the menu. The analyses reveal areas where the restaurant can raise prices comfortably, where changing prices would be risky, and even where lower prices would be advantageous. Generally speaking, there are many menu items that are price-inelastic, meaning an increase in prices results in only small decline in volume. Higher prices are therefore worth considering. Conversely, some products are consistently price elastic. For example, beverages – regardless of whether they are soft drinks or alcohol, hot or cold – are more sensitive to price changes than food items are. In fact, they are sensitive not only to changes in their own price, but also changes to food items' prices.

One restaurant learned that latter point the hard way with its breakfast menu. Its aggressive price increases on breakfast sandwiches inadvertently its coffee sales, as guests continued to buy the sandwiches but stopped buying coffee in order to keep their total ticket constant.

Three kinds of analyses provide the necessary insights for menu optimization.

Leveraging POS (and App) Data

POS data – supplemented by App data if available – is a unique, renewable resource. It is continually refreshed and increased with each guest purchase, it is visible only to the system which collects it, and it incurs no third-party acquisition costs. Once again, the analyses based on this data must capture both the direct and indirect effects of potential price changes. Calculating the direct price elasticity, i.e. the impact of an item's price change on its own volume, is the easier part. More difficult, but just as essential, is the measurement of the substitution and the basket effects.

The substitution effect occurs when a price increase on one item prompts guests to shift their consumption to other menu items they perceive as better value for money. The basket effect occurs when a price change in one item affects the volume of a complementary item (such as sides or beverages).

Pricing Action: Increase the price of Burger

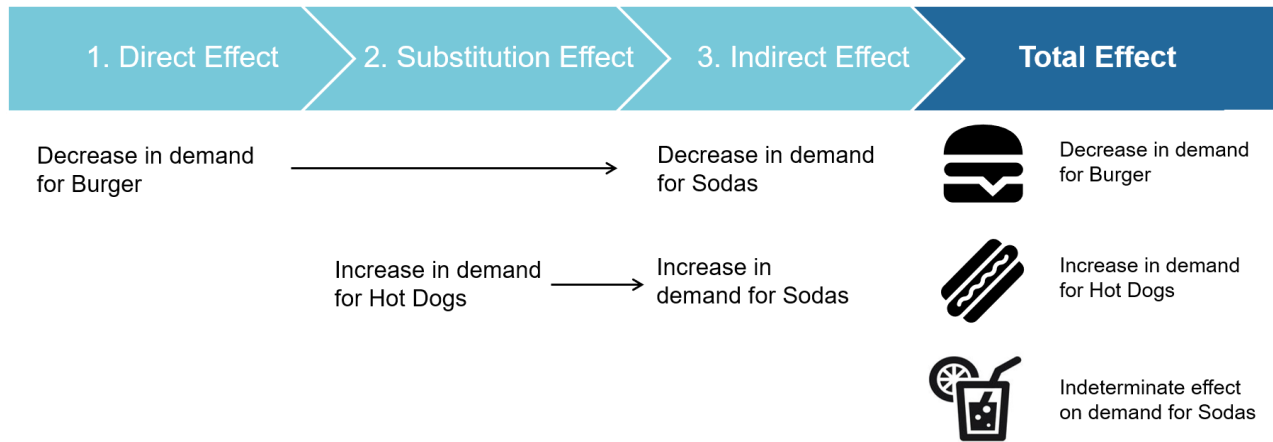


Figure 4: Measuring the total impact of a price increase on the business by analyzing direct, substitution and indirect effects.

Testing (In Store)

This method is well suited for getting direct feedback from guests while minimizing the financial and commercial risks. By limiting the test to a small number of locations and/or items, and by keeping the test period short, the restaurant gains valuable insights into how guests will respond to menu and price changes, but without exposing the entire system's guests (and its competitors) to the changes under consideration. These tests generally run for 1-2 months in order to give guests multiple interactions with the changes. One chain (see Figure 2) ultimately used this approach to redesign its high-priced coffee offer, a move which drove millions of dollars in revenue and profit improvement. The method is widely used to test the effects and performance of new products. But we feel the method is underutilized as a means to test price changes, in part because of restaurants' reluctance to test prices in market.

Testing (Online Surveys)

This approach is especially appealing when the changes under consideration are too bold or risky for an in-store test.

The best practice for these surveys is Menu-Based Conjoint (MBC). This method allows pricing departments to conduct controlled randomized experiments with prices and collect valuable data from the respondents. This method also has an advantage which both POS data and in-store testing lack: the ability to capture non-customers as well as a sufficient numbers of light users, who may be inclined to visit more and consume more if the price-value relationship or menu composition changed. Surveys offer a means to gather information from both of those groups and also understand the reasons behind their current behavior.

MBC is not only a powerful analytical method, but a confidence builder as well. When a QSR chain wanted to redesign its value menu and push some low-price items beyond the critical thresholds of \$1 and \$2, we conducted an MBC which helped them gain the confidence and knowledge needed to successfully implement the changes such that they improved business performance.

Level 5: Pricing Mastery over Time

Level 5 companies have typically honed their skills at Level 4, have superior profitability to their industry peers and the CEO sees pricing as a source of competitive advantage. Their pricing processes are optimized machines which are “well oiled” with a constant inflow of valuable data. Level 5 companies have completely integrated pricing into their business. The pricing function, often led formally by a Chief Pricing Officer, reporting into the C-Suite. Given the dynamic nature of the restaurant industry there are very few companies that can claim to be Level 5.



Challenges:

- At Least 3 years at Level 4
- Pricing Fully Intergrated into Busienss Strategy

Conclusion

When we build a high impact pricing strategy for a restaurant business, the goal is to optimize overall long-term profitability. As a restaurant makes the upward progression from Level to Level, it becomes better and more confident in addressing the six challenges which make pricing in the restaurant industry so difficult. It also abandons one-size-fits-all thinking, simple rules of thumb, and reactive tactics, in favor of a data-driven approach which provides insights at the individual store, menu item, and in some cases even guest level. The right pricing strategy, backed with the right model, increases overall returns by improving the complex interplay between guest count, menu design, and ticket size.

About Iris Pricing Solutions

At Iris Pricing Solutions, it is our mission to dramatically improve client's profitability and market share through improved pricing. We have grown to become one of the world's leading pricing consultancies with offices in North America, Europe, the United Kingdom, Asia Pacific and Latin America.

We focus on all of pricing, and only pricing!

Pricing Solutions specializes in four core

services:

Pricing Strategy

Pricing Analytics

Pricing Research

Pricing Training

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