Marketing Instincts

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The low hanging fruits in your pricing system

Over the last 14 years, as a consultant to management, I have successfully completed over 200 consulting assignments for mid-size private Canadian companies. Clients included manufacturers, distributors, business services providers and high-tech companies. These assignments included preparing strategic and marketing plans, turn-around missions, succession plans, executive coaching and helping set up advisory boards.

These assignments gave me an incredible exposure and insight into what makes for running a successful business. While I had personally lead in my first career at Dun & Bradstreet, four major turn-around missions that took me to manage companies in Italy, Brazil, France and Canada; the consulting experience was by far more insightful. At D & B I had the backing of a large corporation with many resources and capital. I was sent to under-performing business units with the authority and the "blessing" of the head office. Local management knew their business unit was in trouble and that this "new guy" was here to help turn-around their misfortunes. But in my consulting assignments, there were no such luxuries. Clients expected me to diagnose the situation rapidly, identify the problems and then recommend instant actions that were immediately effective.

The expectations of a "magic wand" philosophy taught me to look for **short term solutions** that could produce almost immediate positive results so that more time could be taken to analyze further the real roots of the problems and recommend more long-term solutions. In other words, I was looking for "gold" and there was an urgency to find it fast.

Unquestionably, managers knew what was wrong in the vast majority of cases. Unfortunately, there was usually no agreement on the solutions, or better said, no focus: No set of objectives. No specific plans. No defined milestones. Good intentions. Lots of hard work and many sleepless nights lost because the issues were blurred and the solutions diluted.

This situation made my search for gold easier as I would usually identify a handful of actions that needed to be addressed immediately and convinced senior management of the real priorities, and offered a "road map". By God's grace, I did find gold almost all the times in my first days of diagnosis and fact finding. Invariably, the **pricing system** was often an area where I found an abundance of what I will call "low hanging fruits", the subject of this issue of Marketing Instincts.

Better control over price means better control over profitability

For example, let's assume you are a distributor and buy an item for $75 and sell it for $100 making a 25% gross margin; ($100 selling price minus $75 cost of goods = $25 Gross profit or 25% gross margin).

If $22 dollars go towards your overhead, you are then left with 3% of pre-tax profit. ($25 Gross Profit minus $22 overhead cost = $3 pretax profit or a profit margin of 3%)

A $1 price increase (1%) means selling at $101 while the cost of goods remains unchanged at $75. This increases the gross margin to $26 and your pre-tax profit now becomes 4%. This increase is **more than a 30% increase to your bottom-line**. **In this example a <u>1% price increase to the selling price resulted in a 30% increase in profitability!</u>**

Do your own numbers and find out what the effect of 1 to 5% increase would have on your pre-tax profit. You will be surprised!

Whenever I bring a price increase as a potential subject to the table, management invariably tells me that the market forces usually set the price and it would be almost impossible to increase the price! This would be suicidal! Yet time and time again, I always find many angles to increase the price. Here is a short list you may want to review for what could be applicable to your business:

Mark-up formula is general

Most companies arrive at a mark-up percentage or a mark-up multiplier by item sold or category of items. For example, a company would multiply the cost of purchasing by X1.4 or X1.5 and so on to arrive at the selling price. An item purchased at $10 would then be sold for $14 or $15 and so on. While this formula may have been good when the company had a limited number of items, it is probably too simplistic as the company has added on many items to its line of products and/or expanded beyond its usual original line of products.

Look at your inventory of items and break it down into categories and then in sub categories; and review your mark-up for every item. In reviewing your prices you should consider many factors: the item cost, the estimated turns of the item (turns per year or inventory turn-over), customer behavior, the competitive climate and your own gross profit objective. This simple analysis may identify pockets of opportunities for increased prices, i.e. Category A is marked-up at X1.5, Category B at X1.6 and Category C at X1.7 and so on. Exceptions within a category may also be made if you have exclusive items and/or hard to compare items (with the competition) and so on.

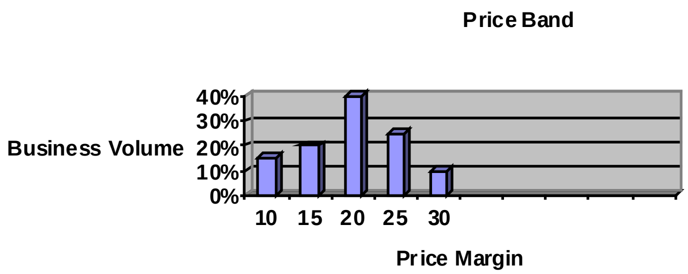
Discounts

Almost all companies offer discounts in one form or another. Discounts tied to volume of purchases, type of products, type of customers, geography etc. The list is long. While discounts are an effective tool to win new business, they can be a double-edged sword and cut deeply into your profit if they are not well thought out and implemented carefully and intelligently.

Analyze your discount policy frequently and make sure the policy is achieving your objectives. Similarly, track how your sales force is using discounts to win new business making sure that discounts are not given as a normal routine but used effectively to win business from your competitors. Are your sales people using discounts wisely or are they giving discounts to all customers?

Price band analysis

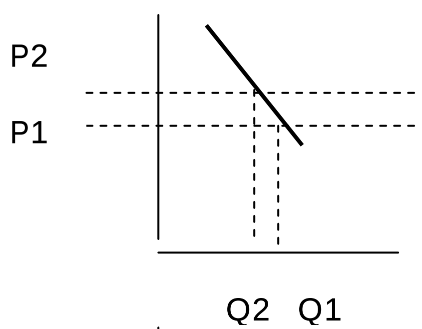
This analysis is designed to create a graphic picture of all your pricing activity during a specific period of time. Analyzing the results and taking actions based on the results can add few points to your gross margin. The vertical axis represents the percentage of business sold at the particular margin listed on the horizontal axis. In our example 15% of the business sold during the specific period was sold at 10% margin, 20% at 15%, 40% at 20% margin and so on.



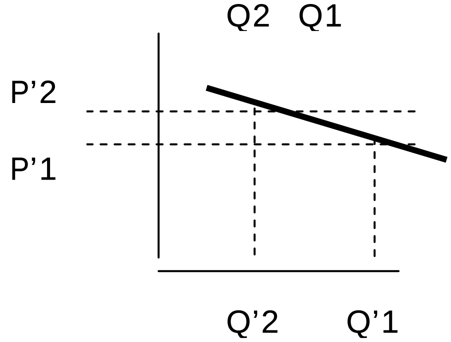
This analysis tells us that (a) 75% of the volume was sold at a margin of 20 to 30% while 25% of the volume was sold at a margin of 10 to 15% and (b) that the price band is quite large between a margin of 10% and one of 30%. You may want to analyze the 25% volume sold at a low margin to see if you can improve the selling price. You may also want to put a forward strategy to narrow that large price band you have.

Elasticity of demand

The golden economic rule of supply and demand says that demand will increase if price drops and demand will drop when price increases. That is true for most products but there are also markets that have low elasticity of demand i.e. demand fluctuates little with the movement of price. This is particularly applicable for prestige products or innovative and unique products. Check the elasticity of your product or service, you may find possibilities of price increases. Here are two figures showing elastic and inelastic demand:



(A) Inelastic demand



(B) Elastic demand

Bundling and unbundling

As companies grow, bundling of products may have occurred and prices are no more given for each component or item but for the whole. Then a customer comes along and asks for the price of an individual item and during the process, you may end up loosing few pricing points. You may want to review the effect that bundling and unbundling of product(s) has on your prices.

Does your product include a large portion of service? Should you price the product in a way that bundles the physical product with the service or do you price the product separately from the service part? Do you price your product including the transportation cost or do you price it excluding the transportation?

<u>Remember that PRICE is the only element in the marketing mix that produces revenue; the other elements represent costs.</u> Yet, my experience clearly indicates that the vast majority of medium size businesses do not handle pricing in an optimum manner.

The most common mistakes are: pricing is too cost oriented; price is not revised often enough to capitalize on market changes (I call them market opportunities); prices are set independently of the rest of the marketing strategy or package.

Here are 6 key steps you should consider in setting your prices:

1) Price objective
2) Estimate demand
3) Estimate costs
4) Analyze competitors pricing
5) Consider price as and intrinsic element of your marketing strategy
6) Choose your pricing formula and tactic

Profit is not a dirty word and while you do not want to extort your customers, you want to identify pricing opportunities and then take actions to harvest these opportunities to optimize your profit.

Finally the word **PRICE** has many names as my research has identified: we pay **RENT** for an apartment, a **FARE** for a subway ride, a doctor **FEE**, a **TUITION** for education, **INTEREST** on the money we borrow, a **PREMIUM** for insurance, a lawyer **RETAINER**, a lecturer charges **HONORARIUM**, a **TOLL** on Highway 407, a **WAGE** for a worker and a **SALARY** for the manager, a **COMMISSION** for the sales person and **DUES** to an association…I guess price must be an important subject!

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