iNFORM
Business Services Limited

“Pricing for profit"

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“Pricing for profit"

INTRODUCTION

This brief paper supplements a presentation to the BUSINESS^{2000} group on the subject of "Pricing for Profit" many years ago – this is a slightly edited version that is still relevant in 2015.

The BUSINESS^{2000} group comprised mainly business owners who wanted guidance and ideas of practical application to themselves.

The theory of pricing can be studied in any standard economics, business or accounting text book. Our purpose here is to outline some of the practical issues as they affect the owner controlled business. We also share some of the instances where clients (of my former chartered accountancy firm), over the years, have applied pricing techniques successfully.

All the illustrations have been modified sufficiently to ensure that individual client cases cannot be identified.

The underlying assumption is that business owners want to be more profitable. So here we are concerned with profit making.

It is also assumed that most readers work hard and are good at what they do. However, being so close to our day to day businesses we sometimes need to stand back.

We hope that this article might provoke a fresh look at some of the fundamental issues that relate to Pricing and Profitability.

What is "PROFIT"

Profit for our purposes can be expressed as a simple equation. It is:

- The number of products or services sold ***times***
- the selling price of each product/service
- ***less*** the direct cost of each product/service
- ***less*** the overhead costs.

In business there are many things you just cannot forecast accurately ….

and unfortunately two of them are in this equation. For most businesses the unknowns are the "number" sold and the "price" people will be prepared to pay for them.

Intuition, trial and error, observation, psychology, kidology and a little bit of maths all combine to help us come up with some "best guesses" - but that is all they are. Creative thinking - a willingness to abandon conventional wisdom - and a touch of gambling spirit are all required.

We hope to give some ideas about how to become better at "guessing" in the business context. And we will be looking at some examples where those guesses have "come off".

So here goes.

Let's first have a detailed look at the influence of the selling price upon the NET PROFIT of the average business.

Using the "formula" for profit at the head of this article it is obvious that the profit will be affected by

- Selling price
- Volume of sales
- Cost of production or procurement and
- Overheads.

To keep things simple we are making another assumption – that a typical business's accounts might look like this:

	% of sales
Sales	100%
Cost of sales (Direct)	70%
Gross margin/profit	30%
Overheads	20%
Net profit	10%

(If you are selling your own time the "cost of sales" should include an equivalent amount you would have to pay someone to deliver the services you do.)

Prices and Profit

In almost all circumstances, an increase in selling price - if (and a big elastic "if" it is) - if it does not result in lower volume of sales - will result in the greatest relative benefit upon the final net profit.

Double your profit

A "typical" business might achieve a **net profit** of around 10% of total sales revenue.

If the selling price is increased by 10% the profit doubles!

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Or triple it!

If the **direct costs** (cost of sales) are reduced by 10% and the **overheads** are reduced by 10% and the **selling price** increased by 10% (without triggering any extra costs) then you end up with a net profit of just under 3 times the original figure - WOW!!

OK - just double it

If all the increases are just 5% the profit doubles - WOW again – ALMOST TWICE THE PROFIT FOR ONLY 5 PERCENT!

All of which is staggeringly simplistic and perhaps, unlikely to be achievable in many business situations - but it will be achievable in some.

It is worth every business owner examining their own figures to see what can be achieved.

Prices and strategy

Price setting cannot be considered separately from the whole question of the business objectives.

Most commonly the broad strategic objective of a business will be the earning of a profit that is "satisfactory" to the owner, to compensate for the time, effort, risk and capital put into the venture. One person's “satisfactory” might be 10 where another's might be 100. Decide what YOU want to achieve.

In our experience many people are not aware of the high levels of profit that can be achieved by businesses and sometimes set their sights too low.

We would guess that most readers want to increase their net profit while maintaining business stability and sustainable growth.

The Squash Club

But … consider the case of the Squash Club some years ago (during the “squash boom”) which had a waiting list of 1,200 prospective members and which was bought by what one person called, "city types".

You might think that here is an ideal case for expansion. They could build additional courts, perhaps improve social facilities – do things to increase the paying membership and ultimately profits.

Well:

What actually happened was that they simply doubled the membership fee. A lot of members left but, with the queue waiting to join, they had no trouble in filling the "gaps". The owners then sold the club at a premium price based on the vastly increased profitability.

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They had clearly focused on their main objective which was to increase the net profit to enhance the value of the business so that they could sell and make a short term capital gain.

If you are lucky to have a high demand for your products/services then it is worth considering alternative ways of exploiting the situation.

Another case concerned a business where the owners were coming up to retirement age. In their particular sector, businesses were valued not so much by the profit they achieved but by the number of "live accounts" they had.

In the run up to selling the company the owners fixed their prices at very competitive levels in order to increase the number of accounts - even at the expense of the margin of profit. This worked and they were very satisfied with the deal they achieved.

Objectives again

So, having decided what your key business objectives are, what are the main factors which affect pricing policy?

Let's start with the Market place competition.

Depending upon what sort of business you are in, it can be difficult to establish exactly what the competition is really charging for their products and services, but generally one will have a good idea of "the going rates".

Customers (bless 'em) will generally fall back upon "price" as one of the key criteria in the purchase decision making process - though research indicates that quality, service and other factors can figure higher up the scale.

Well, for attracting "new" customers let's start with the assumption that the price has to appear to be "competitive".

The competition

Consider first of all whether you can offer your products or services in such a way that they cannot be directly compared with the competition.

This is a common ploy in areas such as mobile telephones, utilities and financial services.

Should you be paranoid about the low prices of competitors? Your customers are not going to be perfectly informed about all the prices of the competition. And if your sums show that you cannot come down to the competitors' price consider whether the competitor is actually a fool and working at an unsustainable loss.

Does this sound far-fetched? Speak to insolvency practitioners about business failures – they will tell you that whilst some are due to uncontrollable outside forces such as the economic recessions - many are caused by financial ineptitude (which is a less offensive word than stupidity).

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An example which might give a bit of confidence to some:

The painters brush with reality

Many years ago, a commercial painting company went to the wall just when it was half way through one of the biggest factory painting contracts it had ever landed. It transpired that this customer had accepted the company's tender price (which was way below that of the next lowest tender) knowing that it was "impossible" to do the job at that price but reckoning that if the painters got half way through the work and a new contractor had to come in, it would still be cheaper than accepting the next higher tender. And they had built in performance clauses so they would not have to pay if the job was not completed!

This may be regarded with some distaste - after all it is the cynical exploitation of the naiveté of a supplier - but there is no law against it.

So, it may be that the competitor that you cannot beat on price, may soon disappear.

Next, if you have to compete on price, look again at your products and services to see whether they can be "re-designed" to achieve cost savings.

The starting point in this exercise is to revisit the fundamental and core touchstone of all business - Defining what the customer wants.

Are there unnecessary features - cheaper materials - cheaper packaging - features that can be sold as add-ons instead of incorporated?

Airlines are a good example of tailoring the basic service of "personnel transportation" so that you can fly the same distance - in much the same time and sometimes on the same plane but have a choice of whether to pay £100 or £600 for the flight - the difference in price being accounted for by often fairly minor (and psychological, about which more later) variations in service, comfort and status.

A good read with some well-known examples is “Blue Ocean Strategy”.

"Designing" to a price

A local law firm used to offer a (relatively) modest standard tariff of services on a "you get and pay for “standard” service" basis but knowing that often one thing leads to another and a client will often choose to "buy" additional "bespoke" advice.

If this sounds as if we are straying into "marketing" territory - well of course we are. The straight jacketing of the business "disciplines" has to be thrown out of the window. For many small businesses the owner combines all the functions anyway - but when setting price levels never take the accountant's advice in isolation from a consideration of the real business environment in which you have to work.

Price and demand

Now let's look at the big "if" referred to before. Judging the effect on business volume of a price change - either up or down - is very difficult.

You will be familiar with what economists call "elasticity of demand" - which is simply "how far can you push the market on price before the demand for your product goes up or down?".

But ask yourself the question - how do you know that your present price is the "optimum" price which will produce the greatest profit from the market?

Lower sales at higher margins might produce a greater profit - or higher sales at lower prices might.

For an established business this really is one of the most interesting aspects of decision making.

Attracting by price

Market research might help to establish the reaction to a price change - but for the smaller business this is both potentially expensive and common sense suggests that the outcome may not be reliable.

For "minor" price increases of up to 15% we would suggest that there is a case for a "suck it and see" strategy.

Our experience shows that an objective "outsider" opinion can help overcome an understandable timidity to "upset customers".

A case in point: Before the recession a client company was doing very well and the directors were happy with the profit. During a recession in the 90s they set their objective as keeping the turnover level up - and being good at their job, they achieved this. However all the costs - including the wages of a staff of 8 - had carried on going up. The book-keeping was OK but no "accounting" was being done and the reserves of cash - which had kept them going - were suddenly exhausted. They had been making small losses over a period without realising it.

The one success was keeping the customer base - and they were very hesitant when we said that increasing their charges was the only option they had.

We eventually all agreed that the standard "man hour" charge in those days of £14 would be increased to £16. Our view was that an average invoice to customers of about £72 included materials of about £30 and the labour increase would mean this would only increase to £78. We doubted that customers would "notice" and, given the quality of the service, would almost certainly not go elsewhere for such a small overall increase.

Finding the Break Point

You have probably already seen where this is going - even at 50% efficiency - the 8 employees were each contributing an additional £40 per week towards profit - £320 altogether - and, of course, productivity was better than 50%.

The price increase was one of a number of fine tuning changes to the business. In the event, the clients believe that they lost no customers - and the financial recovery was dramatic.

The Retailer's Story

Another example of judging whether the customer base will "stand" an increase in prices, is illustrated by the case of the retail shop in one of the MK local centres many years ago. The proprietor sold a "necessary" product, at a budget price, his shop was always busy and he worked very hard - but was only scraping a living.

To the suggestion that he might put up his prices to the level of shops in the City Centre he was adamant that this would "destroy the trade" and that his customers would go to the Centre instead of shopping locally.

We asked him just three questions -

- Are your customers happy with what you supply? - ***Yes, very***
- Why do they shop with you aside from the price? - ***I'm convenient***
- If you were a customer would you shop in the Centre, not to save money - but to pay just the same? - ***No***

We persuaded him to raise his prices for just a week on the basis that he could reverse the situation and limit the damage if this proved to be a mistake. Well it wasn't and he didn't have to - and enjoyed the benefits, at last, for his considerable skill and effort.

We know what it "costs" but what is it "worth"?

The little "market survey" we conducted at the outset of the presentation to BUSINESS***2000*** was designed to illustrate that for some purchases there is a very wide difference in price expectancy caused by differing perceptions of value.

We split the audience into two groups. To one we gave each person a list of three branded items – to the other we gave a list of the same items but without the brand name (from memory they were “Aquascutum umbrella” and “Umbrella”; “An hour of a City lawyer” and “An hour of a lawyer”; “A can of Heinz baked beans” and “a can of baked beans”).

Each person gave their estimate of how much each of the items would cost to buy.

Whilst by no means “scientific” the outcome was that for each branded item the “average” price assigned by the audience was 30% higher than that for the unbranded. Quite remarkable and a pointer to perceived values.

It is worthwhile looking at one's products and services to see if there is any way that value - or perceived value - can be added to it.

Some ways of doing this include "prestige" packaging - for instance this might include an attractive and useful item such as a decorative tin or wooden box. If the perceived value can be enhanced to command a price higher than the cost of the box, then there will be profit added as well as value. The problem is to know whether the potential customers for the "unadulterated" version of the product will still buy at the higher price or whether one is replacing one customer sector with another.

Marketing techniques such as developing exotic brand names can achieve similar results - everyone knows that Häagan Dazs is a made up name and for a clever psychological reason it automatically commands a higher status than "Lyon's Maid". In this specific case it is likely that the objective was to "position" the product to appeal to a particular market sector - which is probably different from and separate from the "choc ice" buyers.

Another common technique is used by the electrical goods industry which supplies "peace of mind" along with the Hi Fi - by selling product maintenance insurance. We understand that a large part of Dixons profits were derived from this (*this may not be the case now)*.

In today's business environment it is dangerous to link the concept of "quality" with that of higher prices.

To take an example - the software producers, Intuit Inc., offer a book- keeping system called "QuickBooks". This was sold for £100 (1996) but had features that many systems at that time costing 5 or 10 times as much did not have. *(This is now one of the world leading suppliers of small business software)*

The pricing strategy had evidently been fixed to get the product into the market place at a very accessible - or irresistible price. The software company has in the past, and is likely in the future, to produce upgrades and new products. It is now well placed to achieve substantial sales to a satisfied and large user base but with relatively low marketing costs.

Is this principle one that can be applied in the case of a smaller business? Well, it requires a first class "sector beating" product or service - and it also does need skilful market research - otherwise it becomes simply a gamble.

The Wholesaler’s Story

An actual instance where lower prices did produce profits (eventually) is the case, some years ago, of a client company, who operated in a "crowded" market place. Goods and quality of service were much the same as competitors’ and they decided that the only way to build market share was to compete on price.

They had a distribution unit. The two partners and three staff were highly committed to hard work and endeavour. The business started on a shoestring and though the customer base expanded rapidly - attracted by competitively low prices - it was clear that a loss was being incurred.

Should they increase their prices like the retailer? On analysis it seemed that if the on-take of business continued at the same rate the business would reach "break-even point" - that is cover their costs - in a further 8 or 9 months.

But, vitally, after that point had been reached, any increase in sales would - in their case - feed additional profit almost straight to the net profit line. (They had ample capacity within the existing business costs to cope with a lot more business without the need to increase premises or staff.)

Like a lot of business plans (or most business plans?!) it looked like a case of "jam tomorrow" - but we were convinced that the odds were on the side of the clients achieving their goal.

The bank was not convinced. There were trials, tribulations and a change of bankers which held up progress by several months - but in the end the projected pattern of business - and profits - substantial profits - materialised.

There is no Magic Formula

A lot of businesses are required to quote for their work on an order by order basis. In our experience many such businesses use a fixed formula to work out their prices - sometimes called "on cost" or "standard" costing.

We hate these formulas. I would guess that they are the cause of more losses and more lost contracts than any other business technique (probably!).

Among the key profit factors that need to be "guessed" is the level of productivity of a business. Generally speaking the more productive it is, the more flexibility it has to be in its pricing policy. This is because, for many concerns, the basic fixed costs - such as premises and administration - do not change significantly whether the firm is busy or slack. However, the profit contribution normally varies in line with the level of activity.

Information and more information

It is vital that such businesses have immaculate financial data systems to enable a constant detailed review of costs and work projections. By constant we mean at least weekly and ideally there should be "real time" data available to track profitability of current work and modify the financial forecast.

Without this it is impossible to achieve the "double target" of:

- pricing to get the work and
- winning the mix of work that will produce the maximum profit

We have been retained by such businesses where a fresh approach to the whole method of costing quotations has totally reformed their profitability (even after paying our fees!).

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When the price quote has been calculated using such a relatively sophisticated costing appraisal system there is still the necessity to "stand back" and consider the "value" of the work being quoted for.

Value versus Cost

An organised client computed a quote to make several hundred items for a large company.

He was thinking initially in terms of the total value of the potential contract.

However, by looking at the quote from the point of view of the "cost per item" produced, he could see this was £85. Knowing the use the customer was going to make of the products, he made an intelligent guess that they might well be regarded as worth £120 each. It turned out that on this occasion he was right and won the job - and made a "super profit". Happiness all round!

What do People Really Cost?

Finally, for those businesses that sell peoples' time, a reminder that the cost of productive time is often far more than it seems.

Calculating the proportion of unrecoverable time and monitoring against the actual performance is essential for effective profit management.

We can demonstrate how the “real” cost of staff might be calculated taking into account productive time, holidays, sickness, employer’s national insurance and pension contributions etc.. Knowing the true cost of each saleable hour an employee works can be an eye opener and critical when setting selling prices. More on this if you contact us.

Directors, owners and self-employed people who sell their own time might well apply the same exercise to themselves – substituting in the calculation a figure for what they regard as a reasonable target "salary".

We need a summary of all of that – so read on.

In conclusion

To sum up this "fly past" of some of the practical issues of “Pricing for Profit” you might wish to work through the following check list:

1. What are your profit targets?
2. What are the business objectives - short and longer term?
3. What effect would the 5% and 10% changes have on your business?
4. Are there other ways of exploiting demand by a different pricing strategy?
5. Do you need to be afraid of price competition - from all sources?
6. Can your product/service be pared down? or
7. Spruced up - with "added value"?
8. Have you guessed the effect of a complete change in pricing structure - just to see what thoughts it inspires?
9. Can you "test" a price increase?
10. Should you have multi-level pricing?
11. Are your prices too low anyway?
12. Should you consider "buying" market share through low pricing?
13. Is your standard pricing "formula" due for an overhaul?
14. Do you get the financial and sales data you need for fixing prices?
15. Do you know the real cost of the productive time of your people?
16. **Do you need help ....?**

If your profitability needs to be increased please contact me for a “no-obligation” conversation to see if we can help you do something about it.

If you pass this on to friends or other business owners I would appreciate you letting me know and happy to make contact on your referral.

Finally, I hope that something in this document has stimulated ideas that you can put into practice to improve your business.

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