Let's Make Things Worse: Cutting Prices in a Down Market

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During recessions, price cutting is almost always an absolute disaster. However, when sales volume is soft, there is something close to a conditioned-response to reduce prices in an effort to "keep things going." The fact that price cutting makes the going even worse is seldom considered.

This report will address the issue of price cutting, particularly with regard to its impact on profit in difficult economic times. It will do so from two perspectives:

- **The Impact of Price Cutting on the Bottom Line**—An examination of how price cutting affects the profit structure of the firm.
- **Alternatives to Price Cutting**—A review of the opportunities for maintaining gross margin, and resulting bottom-line profit, in down times.

The Impact of Price Cutting on the Bottom Line

Exhibit 1 presents financial information for an illustrative distributor. As can be seen in the first column of numbers, the firm generates $20.0 million in sales, operates on a gross margin of 25.0% of sales and brings $500,000, or 2.5% of sales to the bottom line on a pre-tax basis. It represents comfortable performance.

Like every firm in every industry, this firm has both fixed expenses and variable expenses. Most firms like to avoid conducting this expense analysis as it is "academic" and something of no real concern to management. Actually, it is financial life and death for the firm in difficult times. Management ignores conducting the fixed/variable analysis at their peril.

Fixed expenses are overhead expenses that tend to be difficult to shed as sales fall unless some specific actions are taken. Reducing travel and employee training expenses are typical ways that fixed expenses are cut during a recession.

Variable expenses, including things like commissions, are expenses that rise and fall right along with sales volume. That is, when sales fall, these expenses will fall in proportion to the sales decline. In the exhibit, variable expenses are assumed to be 5.0% of sales.

In the next final two columns of numbers, sales have been impacted by recessionary pressures. In the second column the sales decline is 10.0%. The result is that profit is sharply reduced because of the inability to shed overhead expenses. With a 10.0% sales decline, profits fall by 80.0%.

In slower economic times there is the previously-noted tendency to lower prices in the hope that such price cutting will jump-start sales volume. The next column combines the 10.0% sales decline with a reduction in the gross margin percentage from 25.0% to 24.4%. This reduces gross margin dollars on the lower sales by 3.0%.

The assumption in this column is that the price reduction has no impact on unit sales volume. This represents a situation where demand is not influenced by price reductions—a very common event in recessions. Under this assumption the profit challenge is even greater. This has the impact of turning the profit into a loss of $28,250. In short, a bad situation becomes much worse.

In summary, price cutting is always problematic. In a recession, price cutting does little more than make things much worse. However, in a recession, every competitor seems to resort to some degree of price cutting, whether by choice of competitive coercion.

In particular, desperate firms almost always cut prices first. If a stronger competitor doesn't react, it often appears to be over-pricing. As a result, it may experience an even larger sales decline. It does not appear to leave the firm with any options other than bad choices. However, with some planning, that may not have to be the case.

Alternatives to Price Cutting

There are no perfect alternatives to price cutting in a down market; it is an inevitability. However, there are some very real ways to minimize the impact of price cutting so that profits can be maintained. There are two major tools at the firm's disposal—targeted rather than across the board price cuts and identifying margin build back opportunities.

Targeted Price Cutting—The numbers presented in the exhibit assumed that prices were cut across the board. That is, every SKU was reduced by the same 10.0%.

For most firms relatively few items items in the assortment are exceptionally price sensitive. These are the ones on which the firm absolutely must be price competitive, even if competitors are making irrational pricing decisions. Furthermore, the firm must communicate how price competitive it is. It is not enough to cut prices here, the cut must be broadcast to maintain a positive competitive position.

Unfortunately, the few SKUs that are the most price sensitive are also the ones that deliver the largest sales activity. The issue is determining exactly how many of these there are in the assortment.

As a general rule, the items that deliver the top 60.0% of sales volume are the genuinely price-sensitive SKUs. That means that if all of the SKUs are arrayed in order from highest to lowest dollar sales, the SKUs at the top of the list—probably 10.0% of the SKUs—provide 60.0% of sales. These are items that require a careful pricing review. The emphasis should be on careful.

From a financial perspective, a 5.0% price cut on items producing the top 60.0% of sales amounts to a 3.0% reduction in gross margin dollars for the total firm. That is the figure used in the Price Reduction column in Exhibit 1.

Luckily, not all of the SKUs in this group are equally price sensitive. With prudence it might be possible to appear price aggressive where price awareness is strong while minimizing the impact on overall margin by holding prices elsewhere.

It is tempting to cut prices beyond this point. In fact, there may be selected items beyond the top 10.0% of the SKUs that need to have price cuts, but there are probably only a very few of them. The essential marketing point remains. If the firm must cut on highly price-sensitive SKUs it should brag about it so customers are aware the cuts have been made.

Margin Build Backs—At the other end of the product spectrum, there are lots of SKUs that are not price sensitive at all. In addition, during slower sales periods these are products where competition may have reduced inventory and may not have the items in stock. These are the items on which prices can actually be adjusted upwards—even during a recession—to build back gross margin sacrificed in the targeted price cutting.

Probably somewhere around half of the SKUs may qualify as margin build-back candidates. Unfortunately, they only generate something like 5.0% of total sales, so the increase in price needs to be significant.

However, significant is attainable. On these items, the value added that the firm provides is availability. It is not a minor value added, it is a major one. It should be a focal point of the selling effort.

Moving Forward

Price cutting is a fact of life in slow economic times. The challenge for reputable firms is to maintain a competitive posture without destroying its profit structure. If the firm can price competitively where it has to and build back margin where it can, it should be able to minimize the impact of the recession.

About the Author:
Dr. Albert D. Bates is founder and Principal of the Distribution Performance Project and a Senior Advisor to Benchmarking Analytics. His latest book, Breaking Down the Profit Barriers in Distribution, is available online at Barnes & Noble and Amazon. It covers concepts that every decision maker should understand.

Exhibit 1
The Profit Impact of Price Reduction Challenges

Income Statement--$	**Current Results**	**Sales Decline**	**Price Reduction**
Net Sales	$20,000,000	$18,000,000	$17,865,000
Cost of Goods Sold	15,000,000	13,500,000	13,500,000
Gross Margin	5,000,000	4,500,000	4,365,000
Fixed Expenses	3,500,000	3,500,000	3,500,000
Variable Expenses (5% of Sales)	1,000,000	900,000	893,250
Total Expenses	4,500,000	4,400,000	4,393,250
Profit Before Taxes	$500,000	$100,000	-$28,250
Sales Change From Previous Column--%		-10.0	-0.8
Income Statement--%			
Net Sales	100.0	100.0	100.0
Cost of Goods Sold	75.0	75.0	75.6
Gross Margin	25.0	25.0	24.4
Fixed Expenses	17.5	19.4	19.6
Variable Expenses (5% of Sales)	5.0	5.0	5.0
Total Expenses	22.5	24.4	24.6
Profit Before Taxes	2.5	0.6	-0.2