Price Cutting Economics:
Know Before You Go

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In distribution at the present time there is a feeling that firms must become more price aggressive than they ever before. A large component of this perception can be attributed to the emergence of new internet-based competition. Some of it is simply the feeling that price is a significant driver of purchasing behavior in a slowly-recovering economy.

Whatever the reasons for the increasing price aggressiveness behavior, a word of caution is in order. Lowering prices can be a successful strategy only when if the firm achieves two goals. First, the new pricing must produce a significant sales gain. Second, lower margins must be offset by lower costs.

This report looks at the issues of enhanced price aggressiveness from two distinct perspectives:

- **The Economics of Price Cutting—**An analysis of the changes in operating economics required to make price reductions a positive profit move.
- **Marketing Realities—**A review of the extent to which the world really is becoming more price oriented.

The Economics of Price Cutting

Any profitability analysis of lowering prices must be based upon three factors, all of which are difficult to predict. First, how large of a price reduction is required to get attention in the marketplace. Second, what sales increase, if any, will accrue from the price reduction. Third, to what extent can operating costs be reduced to support a lower-gross margin strategy.

Every firm will have distinct ideas regarding these three factors. However, some insight into how these factors interact is presented in **Exhibit 1**. That exhibit examines the financial performance of the typical distribution firm.

The first column of numbers indicates the current operating structure of typical firm right now. As can be seen it produces $20,000,000 in sales, operates on a gross margin percentage of 25.0% of sales and generates a pre-tax profit of $500,000 or 2.5%. With regard to expenses, payroll and associated fringe benefits are the major expense category to deal with.

The last three columns all look at the financial impact of a 5.0% price cut. This does not mean that prices are cut by this much across the board. Instead, there

may be selective price cuts in more price-sensitive categories that in aggregate equate to a 5.0% cut across the board.

The three price-cut scenarios look at very different situations. The first is that physical sales volume increases by 10.0%. This, of course, is offset by the price reduction, so dollar sales increase by only 4.5%. However, cost of goods sold increased by the full 10.0%. This scenario assumes that the firm can generate the added volume with no increase in expenses. Even so, profit declines by an unpleasant 120.0%.

The second scenario assumes that the price cut produces no increase in physical volume. Consequently, sales decline by 5.0%. However, the firm is able to offset the price reduction by reducing expenses by 10.0%. Again, the profit impact is highly negative.

The final column combines the sales increase with the expense reduction. Candidly, these are two very difficult factors to combine. However, if such a program can be put into effect, the firm can increase profit by -30.0%. It can also maintain its position in a more price-driven market.

Exhibit 1 presents only one specific price cut, 5.0%, and three different scenarios. There are, of course, an almost infinite number of assumptions that can be made. In addition, every firm starts with a slightly different set of operating economics. Exhibit 1 can provide some understanding of the nature of price cutting for a typical distributor, but it can't examine the specifics for individual firms.

To help in this evaluation process the Distribution Performance Project is offering a free Excel® template. It allows firms to tailor the analysis by entering their current results as well as assumptions about the size of price cuts and any changes in sales and expenses—both payroll and all other expenses.

To download the template, go to distperf.com and click on the Programs section and then to the Hands-On Tools section. Follow the instructions provided there.

Marketing Realities

Exhibit 1 can do nothing more than provide a framework for understanding the economics of price reductions. It has nothing to say about a much more fundamental issue—whether the price-aggressive market is reality or hysteria.

Seemingly every ten years or so, another new, highly-innovative competitor enters distribution. As always, the new competitor supposedly will lead to the end of the world as we know it. While no competitor should ever be taken lightly, it is beneficial to understand exactly what can be done to parry the competitive thrust. There are three significant issues to consider.

Market Position—In any competitive battle, the firms that suffer the most are the ones without a clear market position. Unfortunately that description covers far too many distributors at the present time.

A low-price, low cost posture is a brilliant strategy. Alternatively, a high-price, high-cost structure is equally brilliant. However, a hybrid approach—caught in the middle and fighting battles on two fronts—is almost a guarantee of failure. Every firm must stake out a market position, ideally as far from the center as possible.

Focusing On Customer Needs—For day-to-day procurement decisions, customers continually express the same hierarchy of needs. First, they would like distributors to be in stock more often than they are. Second, they would like a broader product selection to facilitate one-stop shopping. Third, they want error-free performance by suppliers. Finally, price is never ranked higher than fourth.

If firms can deliver with excellence on the first three factors, they can mitigate—but not eliminate—the challenge of price competition. If there is only parity on the first three then price will dominate the competitive battle.

Stretching the Price Matrix—Firms continue to sell a wide range of products. At the fast-moving end of the product line, many items are commodities and must be priced aggressively, even by higher-service distributors. At the slow-selling end of the product line there will always be major opportunities to replace any margin dollars that may be lost at the commodity end.

Firms need to stretch the price matrix. If prices are cut on commodities, firms must respond by raising prices on the slower sellers. For most items at the lower end the key issue is availability. Firms can maintain margins and still be close to price competitive.

Moving Forward

The distribution world is probably as price competitive as it has ever been. Survival requires an understanding of the trade-offs between price reductions, sales and expenses. Beyond that, firms must develop a strong marketing position. That is, they have to stand for something in the marketplace. Once that position is established, they can develop the appropriate marketing and pricing programs to be both price competitive and profitable at the same time.

About the Author:
Dr. Albert D. Bates is founder and president of Profit Planning Group. He is the author of the newly-released ***Breaking Down the Profit Barriers in Distribution***. It is a book every manager should have. It is available from Amazon and Barnes & Noble.

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Exhibit 1
The Impact of a 5% Price Combined With Sales and Expense Improvements for the Typical Distribution Firm

		-----------5% Price Cut-----------		
Income Statement ($)	**Current Results**	**Volume Increase**	**Expense Cut**	**Volume and Expenses**
Net Sales	$20,000,000	$20,900,000	$19,000,000	$20,900,000
Cost of Goods Sold	15,000,000	16,500,000	15,000,000	16,500,000
Gross Margin	5,000,000	4,400,000	4,000,000	4,400,000
Expenses				
Payroll and Fringe Benefits	3,000,000	3,000,000	2,700,000	2,700,000
All Other Expenses	1,500,000	1,500,000	1,350,000	1,350,000
Total Expenses	4,500,000	4,500,000	4,050,000	4,050,000
Profit Before Taxes	$500,000	-$100,000	-$50,000	$350,000
Change in Profit (%)		-120.0%	-110.0%	-30.0%
Income Statement (%)				
Net Sales	100.0	100.0	100.0	100.0
Cost of Goods Sold	75.0	78.9	78.9	78.9
Gross Margin	25.0	21.1	21.1	21.1
Expenses				
Payroll and Fringe Benefits	15.0	14.4	14.2	12.9
All Other Expenses	7.5	7.2	7.1	6.5
Total Expenses	22.5	21.5	21.3	19.4
Profit Before Taxes	2.5	-0.5	-0.3	1.7