Making It Up With Volume: Return of the Periodic Plague

Every 15 or so years, there is a recurring idea that the key to higher profit is to "make it up with volume." Just like 17-year locusts, the price-cutting concept returns on a regular basis. It is fascinating to watch, and is also highly disgusting.

DR. ALBERT D. BATES is Principal of the Distribution Performance Project. His latest book, *Breaking Down the Profit Barriers in Distribution*, is available online at Amazon and Barnes & Noble. It covers concepts that every decision maker should understand.

In the current iteration, the phenomenon is driven by the "Amazon effect" which now permeates management thought. Simply put, every distributor feels threatened by unbridled price competition from Amazon or other internet-based sellers. Interestingly, this price pressure is even felt in lines of trade where Amazon has no market presence.

This report will suggest that the on-going fascination with price cutting inevitably leads to a dramatic reduction in profit. It does so from two perspectives:

- **The Economics of Price Cutting**–A discussion of the impact price reductions have on the firm's overall profitability.
- **Actions for Price Success**–An analysis of the requirements for prospering in a price-sensitive world.

THE ECONOMICS OF PRICE CUTTING

Seemingly, price is the major factor in purchasing behavior for a large number of customers. While that may or may not be true, if the firm believes all of it customers expect price reductions, then severe price competition becomes a way of life. The fact that Amazon garners massive publicity for its price-driven sales model creates something of an "only one model of success" world.

The truth is DHI members face a very different cost structure than most of the role models engaging in price cutting. The unique expense structure in the industry makes it extremely difficult to employ price cutting successfully without a significant change in operations. That change must either come through large expense reductions or massive sales gains. Neither is easy to accomplish.

Exhibit 1 looks at the economics of the typical DHI member. According to the most recent PROFIT report, this firm generates $15 million in sales as shown in the first column of numbers. It operates on a gross margin percentage of 30 percent of sales. Finally, it produces a pre-tax profit of $525,000 or 3.5 percent of sales.

Of significance when considering a price cutting strategy, the firm tends to be a high-service operation. It follows then that it has relatively high expenses to support that service. For the typical firm, expenses are 26.5 percent of sales.

The second column of numbers reflects the impact of a 5 percent price reduction assuming that no other changes occur. That is, there is neither an increase in sales nor a decrease in operating expenses. The result is nothing short of devastating, producing a loss equal to 1.6 percent of sales.

The third column of numbers reflects the reduction in expenses that would be required to exactly offset the price cut. That is, the decrease in expenses required to maintain profit at the original $525,000 level. As can be seen, the reduction required is 18.9 percent. For most firms that is a significant, and probably very difficult to achieve, reduction.

It is important to note the expense reduction is a linear relationship. That is, each 1 percent reduction in price would require about a 3.8 percent reduction in expenses. Hence a 5 percent price reduction necessitates a 18.9 percent reduction in expenses. A 10 percent price cut would require a 37.7 percent expense cut, and so on.

The final column of numbers examines the increase in sales that would be required to also maintain profit at its existing level. The numbers are based upon one critical assumption regarding expenses. It is assumed that the sales increase can be produced at the existing level of expenses. For small sales increases this might reflect reality. For larger sales increases it is virtually impossible.

As can be seen, the 5 percent price reduction would be offset by a 14 percent sales increase if expenses are held constant. Again, whether or not such a sales increase could be generated is an open issue.

As noted before the expense reduction required was linear across any price reduction. In sharp contrast, the sales increase required is geometric. That is each succeeding price reduction requires an increasingly-larger sales increase to offset it. Specifically, for DHI members the relationship is as follows:

It must be remembered that the sales increases are assumed to be achievable with no increase in operating expenses. It is an increasingly difficult proposition as the sales increases grow larger.

ACTIONS FOR PRICE SUCCESS

In looking to the future, the first issue firms must address is whether or not price reductions are inevitable. All further actions drive from that perspective.

If price reductions are essential, then expenses must be reduced, probably dramatically. A portion of this can be achieved through eliminating redundant services. Another component would be to tie a change in ordering requirements to the change in pricing. That is, orders must be larger and, therefore, more economical to manage. Discipline on minimum orders becomes paramount.

For most firms, price cutting should still be the last option. Margins can be maintained if two important activities are employed.

Sales Force Control–The sales force is continually bombarded with requests to lower prices. Eventually, the course of least resistance becomes inevitable, even for the best salespeople. Continual education is essential. Controls via absolute minimum price levels and sliding commission scales are also required.

Margin Enhancements–Most of the severe price competition is focused on the commodity end of the product line. At the slow-selling end of the assortment there are always opportunities to build margin back. There should be no hesitation in getting fair value for slower-moving items.

MOVING FORWARD

Price pressures are not likely to go away any time soon. To continue to be successful, DHI members must make sure every decision maker in the firm understands the impact of price cutting on the bottom line, unless accompanied by offsetting actions. They must also appreciate the ways that gross margins can be maintained, even in the face of such pressures. +

EXHIBIT 1 THE IMPACT OF DIFFERENT PRICE STRATEGIES FOR THE TYPICAL DHI MEMBER

		5% Overall Price Decrease		
Income Statement–$	**Current Results**	**No Reduction in Expenses**	**Offsetting Cost Reduction**	**Offsetting Sales Increase**
Net Sales	$15,000,000	$15,750,000	$15,750,000	$15,750,000
Cost of Goods Sold	10,500,000	11,025,000	11,025,000	11,025,000
Gross Margin	4,500,000	4,725,000	4,725,000	4,725,000
Total Expenses	3,975,000	4,094,250	4,173,750	4,253,250
Profit Before Taxes	$525,000	$630,750	$551,250	$471,750
Income Statement–%	**Current Results**	**No Reduction in Expenses**	**Offsetting Cost Reduction**	**Offsetting Sales Increase**
Net Sales	100.0	100.0	100.0	100.0
Cost of Goods Sold	70.0	73.7	73.7	73.7
Gross Margin	30.0	26.3	26.3	26.3
Total Expenses	26.5	27.9	22.6	23.2
Profit Before Taxes	3.5	-1.6	3.7	3.1
Percent Change		**No Reduction in Expenses**	**Offsetting Cost Reduction**	**Offsetting Sales Increase**
Net Sales		-5.0	-5.0	14.0
Total Expenses		0.0	-18.9	0.0
Profit Before Taxes		-142.9	0.0	0.0