

PRICE CUTTING – good or bad?

Look up the definition of 'price cutting' and you come up with "Reduction of retail prices to a level low enough to eliminate competition" or "Cutting the price of merchandise to one lower than the usual or advertised price".

It's the oldest sales tactic in the world but before you make your next price cut in the face of sales resistance, the question you have to ask yourself is not, "Does it work?," but rather, "Can you live with the bargain?"

The recession has forced many

businesses to believe that by cutting prices on merchandise, they can sell more for greater profit.

But they are falling for one of the greatest fallacies of merchandising.

All too often in our over-competitive economy high volume turnover allied with minimum profit margins leads to disaster.

Some traders will agree and satisfy themselves (and sometimes their listeners) with theoretical calculations based on the assumptions that increased volume will mean quicker merchandise turnovers - and this will then enable them to operate on a smaller gross margin.

We ran the following article back in March 1992 and while the price of goods will obviously vary in today's market, the figures - and the moral - remain the same.

IN PRACTICE

While these theories appear reasonable, close observation proves conclusively that they do not work out in practice.

Those who have used this mistaken theory (to their sorrow) did not go into their calculations deep enough to fully understand how much increased business must be secured to effect the loss sustained by cutting prices.

If this practice created a new additional field for this product there might be some justification for this action, but unfortunately this is seldom, if ever, true.

As a consequence it is not only an unprofitable procedure but usually is ruinous to the whole trade or industry.

DO THE ARITHMETIC

Many otherwise shrewd business people forget their sixth grade arithmetic.

Here are a few examples to prove that the arithmetic is the same today as it was when they were in school.

A merchant or manufacturer realises that he must make, let's say, 25 per cent gross margin on his sales.

Therefore he adds 33 1/3 percent to his costs in establishments his selling price.

Selling Price\$100
 Cost of material\$ 75
Gross margin\$ 25

Under the pressure of a "buyers market" he weakens, even though he knows that a 25 per cent margin is necessary to absorb his selling and administrative expenses.

He lulls his better judgement by thinking that the added volume and quicker turnover will surely compensate for a price cut of 10 per cent and secures the order.

The sale then appears as follows:

Selling Price\$90
 Cost of material\$75
Gross margin\$15

The table also shows the extra sales that must be achieved to attain the same profit after discounts have been applied.

Example: Your present margin is 25% and your cut your price by 10%.

Locate 10% in the left column, now follow across to the 25% column.

This shows you need to sell 66.7% more goods to earn the same cash margin as the previous price.

THE MORAL?

Price reductions can do nothing more than create a situation where you have to run twice as hard to stay in the same place! It is better to sell on QUALITY, BENEFITS and SERVICE than to cut your prices.

SALES vs PROFIT

HOW PRICE REDUCTIONS CAN POSSIBLY DO NOTHING MORE THAN CREATE A SITUATION WHEREIN YOU HAVE TO RUN TWICE AS HARD TO STAY IN THE SAME PLACE

e.g. To find the percentage of increase unit sales which will need to be sold to earn the same gross profit WHEN YOU CUT THE PRICE

DISCOUNT AMOUNT	PRESENT PROFIT							
	10%	15%	20%	25%	30%	35%	40%	
1%	11.1	7.1	5.3	4.2	3.4	2.9	2.6	
2%	25.0	15.5	11.1	8.7	7.1	6.1	5.3	
3%	42.8	25.0	17.6	13.6	11.1	9.4	8.1	
4%	66.6	36.4	25.0	19.0	15.4	12.9	11.1	
5%	100.0	50.0	33.3	25.0	20.0	16.7	14.3	
6%	150.0	66.7	42.9	31.6	25.0	20.7	17.6	
7%	233.3	87.5	53.8	38.9	30.4	25.0	21.2	
8%	400.0	114.3	66.7	47.1	36.4	29.6	25.0	
9%	1000.0	150.0	81.8	56.3	42.9	34.6	29.0	
10%		200.0	100.0	66.7	50.0	40.0	33.3	
11%		275.0	122.2	78.6	57.9	45.8	37.9	
12%		400.0	150.0	92.3	66.7	52.2	42.9	
13%		650.0	185.7	108.3	76.5	59.1	48.1	
14%		1400.0	233.3	127.3	87.5	66.7	53.8	
15%			300.0	150.0	100.0	75.0	60.0	
16%			400.0	177.8	114.3	84.2	66.7	
17%			566.7	212.5	130.8	94.4	73.9	
18%			900.0	257.1	150.0	105.9	81.8	
19%			1900.0	316.7	172.7	118.8	90.5	
20%				400.0	200.0	133.3	100.0	

EXAMPLE

Your current margin is 25% and you cut your price by 10%. Locate 10% in left column, now follow across to the 25% column. This shows you need to sell 66.7% more goods to earn the same cash margin at the previous price.

e.g. **25%**
less 10% = $\frac{10}{15}$ or $\frac{100}{1} = 66.7\%$

Therefore it is better to sell on QUALITY, BENEFITS & SERVICE etc. in many cases rather than cut the price.