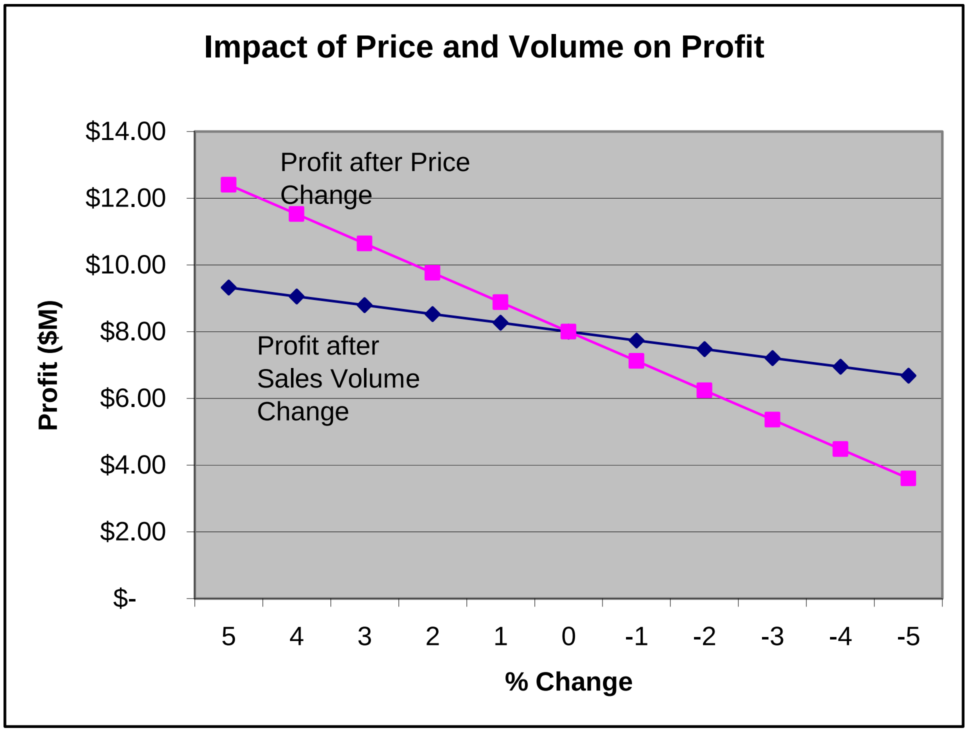
Price and Profit

By Jonathan Bein, Ph.D.

In today's challenging economy, many companies are experiencing a decline in profitability as a result of reduced sales volume. This profit reduction is often compounded by price reductions and concessions as well. To understand the impact of sales volume and price reductions, consider a well known study of 2,400 companies. It showed that a 1% movement in sales volume changes the bottom line by 3.3%, whereas a 1% movement in price changes the bottom line by 11.1%. For a company with $100M in annual sales and $8M bottom line profit, the graph below shows the impact on profit of different changes to sales volume and to price.



The graph shows that a change to price has **three to four times** the effect on bottom line as a comparable change to sales volume. Of course, the specific ratio will vary by company, however, the power of price relative to sales volume for improving bottom line will apply to almost all companies. For companies that are losing sales volume, price optimization may be a means for mitigating the effect to the bottom line.

Improving Profitability through Buyer and Market Selection

In highly volatile times such as now, there are several pricing questions that may apply to your company and its direction:

- How can we improve the pricing performance in existing accounts?
- Which prospects within existing target markets are likely to offer the best pricing performance?
- Which target markets are attractive to remain in or to pursue based on pricing performance?

The processes of segmentation, re-segmentation, and micro-segmentation are necessary to find market territory where profitable prices can be routinely charged. These processed are confounded by the fact that for most emerging and mid-market B2B vendors it is not possible to know the demand curve or to calculate elasticity. Furthermore, these vendors do not have a large customer base in which to run pricing experiments.

Pragmatic Price Optimization
Given that B2B vendors have imperfect information, how should you proceed? The trick in this setting is to reduce the buying power of existing customers and prospects by better understanding their true price sensitivity and bargaining leverage. A key aspect of this analysis is to separate sensitivity from leverage.

Regarding price sensitivity, there are several questions to ask:

- How financially healthy is the customer?
- What is your product's value measured in TCO or ROI after TCO to the customer?
- How meaningful is your brand in promoting not only loyalty, but a price premium?
- Are the products in your market segment similar and commoditized or have the main vendors taken different parts of the market, e.g. high price/high value, medium price/medium value, etc.
- How much of the buyer's budget does your product represent?

For bargaining leverage, the following questions are relevant:

- What is the presence of substitute products and how well do they perform relative to your product?
- Can the buyer build this product themselves?
- How much does the buyer know about your COGS and competitor prices and features?
- What is the economic and emotional cost for the buyer to switch to your product or to switch from your product?
- How crowded is the market with other vendors?

Once you have assessed this information for each of your accounts or prospects, then you can begin to optimize. For buyers with high bargaining leverage and high price sensitivity, you may only be able to maintain price. In fact, it may be necessary to give up additional value in the form of, e.g. more training, professional service, or support if you want to retain this customer. You might choose to do this only for accounts that are highly profitable. For buyers that have neither high bargaining leverage nor high price sensitivity, you should be able to get price improvement either by increasing the price or delivering less value for the same price.

The net effect of these small changes can yield material price improvement and offset sales volume loss. This process has the side benefit of helping you focus more precious resources on your key accounts and prospects.

Jonathan Bein, Ph.D., Managing Partner at Z2M4 has successfully led and been part of executive management for software product and services companies in information technology, healthcare, and communications. He is currently focusing on using economic value modeling for sales enablement, pricing, and competitive positioning for emerging and mid-market companies. He can be reached at 303-898-8636 or jonathan@z2m4.com.