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Common Beliefs that Lead to Unprofitable Pricing

Price is an outcome, not an input.

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The pricing of products and services is among the most critical decision processes in every business. Despite its importance, we find it is also one of the most misunderstood areas. There are two primary misconceptions that can be fatal: 1) Management has control over price; and 2) Pricing must cover all costs.

Misconception #1 — Management has control over price.

The illusion of price control is understandable. It seems obvious that a manager has complete control over the price of the products and services the company sells. You simply state your price and then market it. However, although managers have control in that respect, what they don't have control over is whether a customer will pay that price. In other words, managers forget that price is usually an outcome not an input.

Ultimately, the price that a business can command is driven by market dynamics (supply vs. demand), differentiation (value-added products and services), and competitive positioning (economic cost advantage).

We find that the illusion of price control can be especially disastrous during economic downturns, especially in organizations that focus on managing profit margins. By trying to hold onto margins by not conceding to the pricing pressures in the market, volume invariably declines. As a result, achieving success in maintaining margins by stubbornly ignoring market forces comes at the cost of market share, asset utilization, and ultimately economic profit.

Despite worsening conditions, managers often maintain their conviction in the hope that competitors will come to their senses and follow the company's lead. They can become trapped in a downward spiral that accelerates as they confuse "market denial" with "pricing discipline." It is often too late when reality sets in, and as a last resort, there is a mad scramble to cut prices and reduce costs.

Sadly and all too often, these belated cost-cutting efforts require a sledgehammer rather than a scalpel, leading to the next misconception.

Misconception #2 — Price must cover all costs.

"Price must cover all costs" or "we need to charge more to cover our overhead" are variations of the same misguided message that often stems from misreading a costing problem as a pricing problem. These managers think that price must not only cover the marginal cost of "doing business" but also the "total cost of being in business." In accounting terms, they focus too much on total cost rather than variable costs.

Admittedly, determining which costs to consider when making a pricing decision is not always straightforward. The following simple case study can help to illustrate and avoid the misconceptions of which costs need to be covered when making a pricing decision.

Assume HypothetiCo Inc. is a typical stable business that has sold 1 million units of "stuff" at a $100 per unit, generating $100 million in revenue in the last 12 months. The company outsources the production at a cost of $50 per unit. Beyond these direct variable costs, the company has fixed contractual costs of $45 million that won't expire or are unavoidable, or fixed, for the next 12 months (i.e., leases, contracts, capital charges).

Consequently, the company has generated a profit of $5 million in the last 12 months, which is the $100 million in revenue less $95 million in total cost ($50 million direct variable costs plus $45 million unavoidable costs). Historically, management has used cost plus a "reasonable" margin to set prices, in which it uses the total cost of production of $95 per unit ($95 million divided by 1 million units) as the basis for the cost per unit.

Most recently, the company's sales rep warns that if HypothetiCo doesn't match a competitor's price by discounting 10%, it will lose its biggest customer. That customer accounts for 50% of revenue. Management tells the sales rep that the company can't afford to drop the price by 10% because it can't cover its costs ($90 price minus $95 total cost per unit = $5 loss per unit). Management estimates that if the company drops the price it will lose roughly $2.5 million ($5 loss per unit times 500,000 units).

Management also fears that if it lowers the price the rest of its customers would learn of the price cut and demand the same pricing. Management projects the loss could then grow to $5 million. However, in reality, the company would be better off discounting the price, even if all its customers wound up getting the same discount.

Consider what happens if HypothetiCo loses its top customer. It will sell 500,000 units to other customers, presumably for $100 per unit. Revenue would therefore be $50 million. The variable cost at $50 per unit would be $25 million. But the company would still have the $45 million of fixed cost. Profit would plummet to a loss of $20 million, based on $50 million in revenue less $70 million of total cost ($25 million plus $45 million).

Losing the big customer would certainly be disastrous for the coming year. Worse, the decline in volume will make the total cost per unit higher, which might induce a misguided management team to raise prices on the remaining clients, possibly leading to more loss of volume.

What if HypothetiCo meets the top customer's pricing demands? It will sell 500,000 units for $100 to other customers and 500,000 for $90 to the top customer. Revenue would therefore be $95 million. Variable cost at $50 per unit would be $50 million, which when coupled with the $45 million of fixed cost would lead to a breakeven profit, based on $95 million in revenue less $95 million of total cost (same as last year at $50 million plus $45 million). Breakeven isn't great but it's much better than losing $20 million.

And what if the other customers demand similar pricing? Total revenue would drop to $90 million and the company would run a loss of $5 million. Again, hardly a great year but not as bad as losing $20 million.

When all costs are considered in pricing decisions, managers are effectively assuming that total costs increase and decrease as a function of volume when in fact this is not the case. We lose perspective that as long as the price exceeds the "variable" or "marginal" costs of "doing business," any amount of revenue will generate a contribution to profit that can offset the unavoidable costs of "being in business."

However, this example poses a conundrum. Don't we need to consider all costs, because a company can't exist long-term if it's unprofitable? The answers has two parts.

The first is that costs needs to be considered in the context of the decision. In the context of a short-term transactional decision, as in the illustration above, the transactional variable costs of "doing business" are the only costs that matter. Since the unavoidable fixed costs will be incurred next year regardless of whether you get the business or not, you might as well generate some contribution profit to offset the unavoidable cost of "being in business." Shortsighted efforts to recoup sunk costs by charging an above-market rate usually lead to lost contribution profit and, as shown above, less overall profit.

However, in the context of a long-term strategic decision of whether you should "be in business" (businesses to enter or exit), all costs for the most part are avoidable or semi-fixed and hence should be considered when thinking about pricing decisions.

In other words, if the above case occurred in a downturn and management felt all would revert to normal a year later, the short-term decision should be to accommodate the top customer. If, instead, this situation is viewed as sustainable and is not likely to revert to the previous pricing norm, management must question whether it should be in business. Can the outsourced manufacturing be done at a lower per unit cost? Can any of the fixed costs be cut? If not, the business might not be viable.

When thinking about costs and how they relate to price, they must be analyzed in the context of whether it is a short-term transactional decision of "doing business" or a long-term strategic decision of "being in business."

Second, recognizing prices are an outcome of market economics and competitive position and not an input should stimulate a different set of questions, such as "How can we improve our technology and innovate our processes so that we can differentiate our product with a cost structure that is profitable under any competitive price pressure?" Although there are some costs that management can't control and are dictated by market economics, such as fuel costs in the airline industry, even those costs can be mitigated by management choices, through the processes they choose to transform inputs to output, the markets and customer segments they choose to serve, and the businesses they choose to enter or exit.

For more than 15 years, Marwaan Karame has been an adviser to CEOs and CFOs on how to create value through strategic and financial planning, process improvement, cost reduction, pricing, incentives, and M&A transactions. Before becoming a partner at Fortuna Advisors, he worked for DLJ/CSFB in Investment Banking, Stern Stewart & Co. and Xerox.