

THOUGHTFUL GROWTH

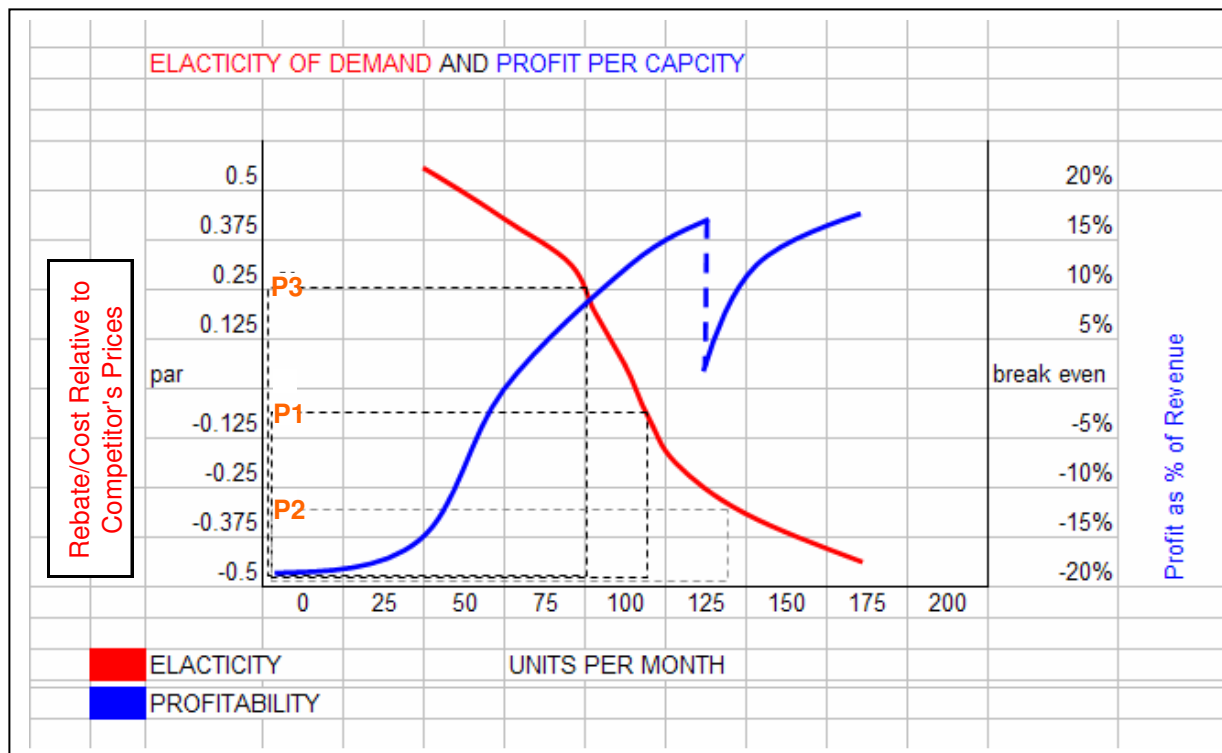
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Imagine being the owner of a company facing losses and having limited cash. One day your sales manager comes to you with a suggestion. He asks you to lower prices a bit and says he can lift unit sales by at least 25%. You do some competitor analysis, polling and confirm that the lift in sales is feasible. Should you do it? This is a common scenario that business owners face. Small businesses in particular are often pressured for growth and instinctively jump at the chance to grow the top line. However, small businesses are also more prone to the hidden pitfalls of expansion and their small scale means they may have an increased negative impact from a wrong decision. There are many firms we have all seen that aggressively pursue growth opportunities and would gladly lower prices to pick up shares. But why is it that these company's efforts repeatedly come up short preventing the small company from ever really breaking out? We will explore the possibilities of this topic with a hypothetical mortgage bank.

In our example, we have a wholesale mortgage bank that caters to independent brokers who sell the loans to borrowers. The bank prices its products as a percentage of the loan. The higher the interest rate charged to the borrower, the more the broker earns (as a percentage of the loan amount known as rebate). So, brokers usually look for lenders that offer them the most rebate at a given rate. We first examine how our example company is priced in the market today across this range. The current advertised pricing (the mean spread across the rebate/cost spectrum on the left column of our illustration below) in comparison to competitors in the same market, is approximately 12.5 basis points [BPS: One hundredth of a percentage point (0.01%)] below the market (12.5 equals 1/8th of one percent). Now that we know where our example company stacks up against the competition today (labeled P1), we will examine two additional scenarios (P2 and P3) explained below with their effects on unit production and profitability in the graph:

- P1: The company's current pricing (12.5 BPS) **below** the competition
- P2: A price decrease of 25 BPS (resulting in 37.5 BPS **below** the competition)
- P3: A price increase to 25 BPS above the mean of competitors. (37.5 BPS **above** the current position)

The red line in the following graph illustrates the elasticity of pricing. This was developed by estimating the historical growth and pricing of competitors coupled with informal broker interviews. Reading left to right, the lower the red line is; the lower pricing is. Also, the further to the right we move the more units that are produced. At the company's current pricing (P1) it is producing just over 100 units a month. There is also a blue line showing that the company is netting approximately a 3% loss at its current production level.



Now let's examine taking our sales manager's suggestion. If we lower prices to 37.5 BPS below the competitor's average, it takes us from P1 to P2 and creates a reasonable probability that 125 or more units are produced. It would appear we have success. We reached our goal of a 25% increase in monthly volume. However, at what cost did we achieve the additional 25 units? Upon closer inspection, we see our profitability (blue line) significantly declines to break-even as we reach 125 units. Herein lies the need for thoughtful consideration to growth. Not only did a reduction in prices lower our profit on all of the units produced, but we also encounter a second hit to our profits; the cost of additional capacity. The dotted blue line shows a point in time where our subject company must hire four additional people to meet the demand. The industry requires four unique skill sets for each loan and does not have the option of hiring one individual to cover the new volume. The addition of this team of four people puts the company quickly back into over-capacity [assuming \$20,000 in monthly wages and 50 units (funded loans) of new capacity]. The increase in fixed costs without any increase to cash reserves puts the enterprise into a higher risk profile and the additional units of P2 no longer seems as attractive as it once did.

With P1 losing money and P2 breaking-even at our expected volume from the price cut, what alternatives can be explored? A unique feature of the elasticity curve (red line) in this example is a rather inelastic element running a 37.5 BPS spread (P1 to P3) in the rebate/cost spectrum with the tail ends being largely elastic. The curve is explained as follows. A broker who is offered a quality product and who has a good relationship with the salesperson is not as price sensitive as would be otherwise, but only until a point. If pricing rises too far out of the market, the broker has several alternatives to turn to for funding and the quantity demanded declines very quickly thereafter. On the opposite end of the spectrum, if prices are too far below the market and service and quality are tolerable, volume exponentially increases to the lender because brokers can earn in some cases,

thousands of dollars for 25 BPS in extra rebate. To take advantage of this curve, the company could raise prices to 25 BPS above the market average to P3. At this point profitability increases to about a 10% margin and no additional capacity is required. The company can then be in the position to grow cash. Now that a baseline of pricing has been identified, can we use price strategically in some other way?

To address the question about using pricing strategically, we could use some questions to guide our conversation.

Pricing Policy

Reactive →	Proactive
What price do we need to cover our cost and profit objectives?	What sales changes would be necessary or tolerable for us to profit from a price change?
	Can we deploy a marketing strategy that will keep those sales changes within acceptable ranges?
	What costs can we afford to incur, given the prices achievable in the market, and still earn a profit?
	Are our unit cost averages hiding non-profitable incremental units?
	What are the opportunity costs associated with our pricing policy?
What price is this customer willing to pay?	Is our price justifiable given the objective value of our product and service to the customer?
	How can we better communicate that value, thus justifying the price?
	How do we frame the pricing for the customer? Incentive or penalty?
How can we discount to price-sensitive buyers without others finding out?	How can we convince the customer that our pricing has integrity and was measured against value?
	How can we better segment the market to justify pricing differently when the value is different? (Buyer, Location, Time, Quantity, Design, Bundeling)
	How do we approach value, relationship, price, and convenience buyers?
What prices do we need to meet our sales or market-share objectives?	What level of sales or market share can we most profitably achieve?
	What marketing tools should we use to win market share most cost-effectively?
	What pricing best matches our production capacity and deliberately enhances net margin?
	Does our pricing in relation to volume, take into concern our incremental increases in production costs? Sunk costs?
	Do we price on product or customer value? Do we consider differentiated discounts for retention or trial?

Example Commission Control for Profitability

$$\text{Sales Credit} = [\text{Target Price} - k (\text{Target Price} - \text{Actual Price})] \text{ Units Sold}$$

k = the profitability factor

Excerpts from *The Strategy and Tactics of Pricing*, Nagle and Holden

Now that we have some pricing strategies to consider, we must determine how flexible we can be so that we can make intelligent decisions regarding pricing and whether or not to use discounts to increase volume. To help us analyze this problem, we can perform a break-even analysis. This will tell us if we cut our price by “x” we must increase our units by “y”. This process also looks at contribution margin. In other words, it accounts for our variable and fixed expenses as follows.

Current prices are at 12.5 BPS below the average price of competitors and the company produces 100 units per month with an average loan amount of \$300,000 yielding a 2.5% premium in the secondary market (selling the loan and making a 2.5% premium as revenue), the break-even is calculated as follows:

✓ Determine current Revenue:

- Monthly Production $30,000,000 \times 2.5\% = \$750,000$ (\$7,500 per unit)
- (Given: a 52% variable expense which means \$360,000 in monthly fixed expenses)

✓ Reduce by our Price Decrease: (we assume 10% as a starting point)

- \$7,500 less 10% = \$6,750 per unit

✓ Variable Cost Per unit = Total Variable Costs / Expected Number of Units to be Sold

- $\$390,000 / 100 = \$3,900$

✓ Fixed Costs + Variable Costs = Net Sales Revenue (our new price)

- $\$360,000 + \$3,900X = \$6,750X$

And, solve for x:

$$\$360,000 = \$3,900X - \$6,750X$$

$$\$360,000 = \$2,850X$$

$$126 = X$$

or X = approximately 126 units (loans)

Therefore, 26 units are required to break-even with a 10% price cut. However, examining the graph shows that moving from the current 100 units to 126 units puts the company at its maximum capacity with no addition to profit. Therefore, we find that we would not want to use the 10% discount to increase volume. Instead we might grow volume through quality and value added offerings rather than pricing discounts. Discounts and increases in price (adjusted through incentives) however should be used to manage profitability by controlling volume to fall within the most profitable production level.

From this exercise, we can see that P1 is losing money and that moving to P2 will cause us to breakeven if we have to hire a new team while moving to P3 allows us to save cash and increase the profit margin. When we have enough cash in reserves to safely afford an expansion, we realize that a price cut alone (at 10%) will not produce enough new units to break-even. (Other discounts can be explored however) Therefore, after running through this quantitative exercise and qualitative questions we might consider the following examples of pricing strategies:

- One, to take advantage of our economic model we may use company controlled pricing to slightly encourage or discourage volume to fall into our optimal capacity zone (sweet spot). The idea is to have the maximum number of units our staff can handle and to ensure that the last units to come in (to avoid surpassing capacity) are the most profitable.
- Two, taking advantage of the inelastic element in our example can be done by pricing higher advertised rates and then allowing our sales people to negotiate a range of pricing. This localized control (in addition to the above volume centralized control) provides the salespeople with a closer working relationship with brokers rather than overly commoditizing the offering

with inflexible published rates. This allows the company to average a higher price with the potential of also increasing units by encouraging interaction and negotiation that creates opportunities for salespeople to communicate value.

- Three, to avoid rapid margin erosion, we can use the previously stated commission calculation to keep our sales force aligned with company objectives by decreasing commission with discounts. When using discounts, the effect to the bottom line can be cushioned by the decrease and the salespeople have incentive to sell higher prices. This also helps the company from giving discounts to customers that do not making their purchasing decisions based on price.
- Four, to segregate out demand types, the company can charge a rush fee for time sensitive customers. Another way to package this offering is as a discount for customers that are not in a rush so as to reward them for their patience. This fee income can also be used to offset the volatility of premium income from loan sales.

With the above possibilities, think of how these may apply to your company. What other creative pricing strategies could your team pursue? The next time someone suggests cutting prices to gain a quick increase in volume, you'll now be armed with a qualitative and quantitative approach to ensure a thoughtful reply with your company's best interests in mind.