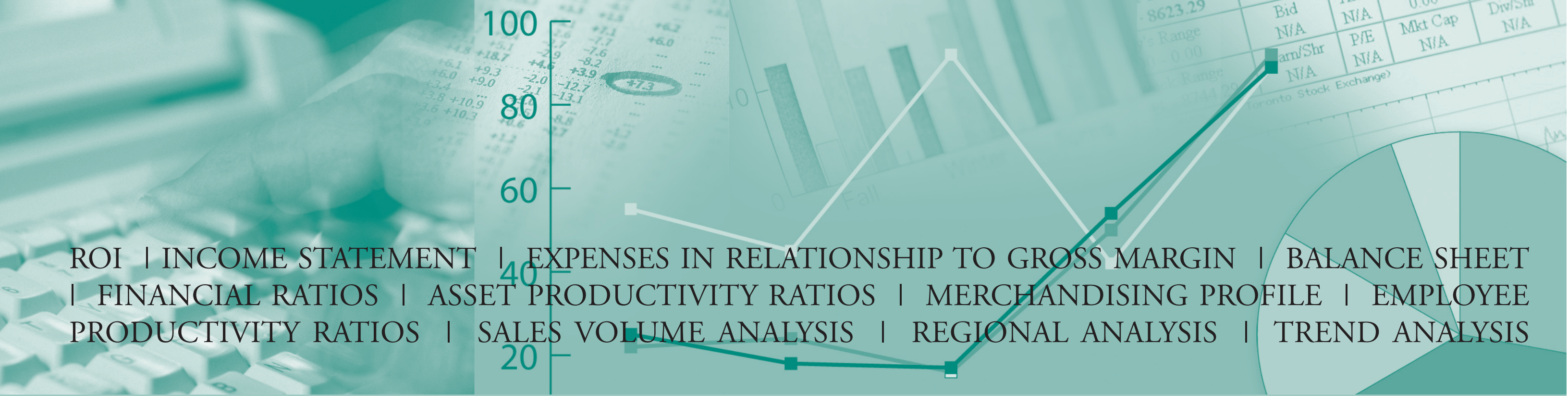

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Vol. 17, No. 2

2008

Profit Improvement Report

"Let's Make Things Worse: Cutting Prices in a Down Market"

Sponsored By the Door and Hardware Institute
and the Foundation for the Advancement of Life Safety and Security

Profit Improvement Report

Prepared for DHI
Vol. 17, No. 2
June, 2008

Let's Make Things Worse: Cutting Prices in a Down Market

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In periods of economic growth price cutting is a serious problem. In tougher economic times price cutting morphs into an absolute disaster. However, when sales volume is soft, firms almost instinctively resort to reducing prices in an effort to "keep things going" even if they are going poorly.

This report will address the issue of price cutting, particularly with regard to its impact on profit in slower economic times. It will do so from two perspectives:

- **The Impact of Price Cutting on the Bottom Line—**An examination of how price cutting affects the profit structure of the firm.
- **Alternatives to Price Cutting—**A review of the opportunities for actually enhancing gross margin in down times.

The Impact of Price Cutting on the Bottom Line

In good times, DHI members generate good profits. In slower times, the profit numbers are much less exciting. This makes the industry much like the rest of the economy. Despite this obvious relationship, many managers do not fully understand exactly how economic factors truly drive profit.

			Additional 5% Price Reduction	
Income Statement	**Current Results**	**5% Sales Decrease**	**No Sales Increase**	**Sales Increase**
Dollars				
Net Sales	$8,000,000	$7,600,000	$7,220,000	$8,913,580
Cost of Goods Sold	5,600,000	5,320,000	5,320,000	6,567,901
Gross Margin	2,400,000	2,280,000	1,900,000	2,345,679
Expenses				
Variable Expenses	400,000	380,000	361,000	445,679
Fixed Expenses	1,840,000	1,840,000	1,840,000	1,840,000
Total Expenses	2,240,000	2,220,000	2,201,000	2,285,679
Profit Before Taxes	$160,000	$60,000	-$301,000	$60,000
Percent of Sales				
Net Sales	100.0 %	100.0 %	100.0 %	100.0 %
Cost of Goods Sold	70.0	70.0	73.7	73.7
Gross Margin	30.0	30.0	26.3	26.3
Expenses				
Variable Expenses	5.0	5.0	5.0	5.0
Fixed Expenses	23.0	24.2	25.5	20.6
Total Expenses	28.0	29.2	30.5	25.6
Profit Before Taxes	2.0 %	0.8 %	-4.2 %	0.7 %

Exhibit 1. The Impact of Price Reductions in a Recessionary Environment

Exhibit 1 presents financial information for a typical DHI member during an economically neutral period. That is, the firm is experiencing moderate growth, and sales, including inflation, are increasing somewhere around 5.0% per year. This is the set of results is presented in the first column of Exhibit 1.

As can be seen, the typical firm generates $8,000,000 in sales, operates on a gross margin percentage of 30.0% of sales and brings 2.0% to the bottom line on a pre-tax basis. Things are comfortable, although certainly not as exciting as when sales are growing rapidly.

Like every firm in every industry, this typical DHI member has both fixed expenses and variable expenses. Fixed expenses are overhead expenses that tend to be difficult to shed as sales fall. Variable expenses, including things like commissions, are expenses that rise and fall with sales volume. For analysis purposes, variable expenses are assumed to be 5.0% of sales—a figure that would be reasonably close for most DHI members.

In the next three columns of numbers, sales have been impacted by recessionary pressures. In the second column the sales decline is only 5.0%, which is the sort of reduction experienced in most moderate recessions. The reality, though, is that profit is sharply reduced because of the inability to shed overhead expenses. With a 5.0% sales decline, profits fall by 62.5%.

In slower economic times there is a very natural tendency to lower prices in the hope that such price cutting will jump-start sales volume. The last two columns examine the impact of a 5.0% price reduction coupled with two very different sales assumptions.

In the third column of numbers the price reduction has no impact at all on sales volume. This represents a situation where demand is not influenced by price reductions—a very common event in recessions. Under this assumption, two things happen. First, the gross margin percentage falls to 26.3% and second, profits disappear. In short, a bad situation becomes much worse.

The final column of numbers examines how much additional sales would have to be generated due to the price cut just to keep profits at the level they were after the initial sales decline. That is, what sales increase is required to keep profits at $60,000. The answer is a rather staggering 23.5%.

In summary, price cutting is always problematic. In a recession, price cutting does little more than make things much worse. However, in a recession, every competitor seems to resort to price cutting. If the firm doesn't react, it may experience an even larger sales decline. It does not appear to leave the firm with any options other than bad choices. However, with some planning, that may not have to be the case.

Alternatives to Price Cutting

The title of this section is somewhat deceptive. Realistically, there are no alternatives to price cutting in a down market. However, there are some very legitimate ways to minimize the impact of price cutting to the point that profits can be maintained. There are two major tools at the firm's disposal. They need to be applied, as an old football coach once said, with rigor and vigor.

Targeted Price Cutting—For most firms there are only a few items that are exceptionally price sensitive. These are the ones on which the firm absolutely must be price competitive, even if competitors are making bizarre pricing decisions. They are also the ones where the firm must communicate how price competitive it is. It is not enough to cut prices here, the cut must be known.

Typically, the SKUs that deliver the largest sales activity are the ones that are the most price sensitive. The issues is determining exactly how many of these there are in the assortment. As a general rule, the items that deliver the top 10.0% of sales volume are the genuinely price-sensitive SKUs. That means that if all of the SKUs are arrayed in order from most the highest to lowest sales, the SKUs at the top of the list that provide 10.0% of sales are the ones where prices need to match competition to the penny.

From a financial perspective, a 5.0% price cut on items producing the top 10.0% of sales amounts to only a .5% price cut for the total firm. It gives the firm the ability to be competitive without incurring the massive profit loss associated with price cuts made across the board.

It is tempting to cut prices beyond this point. In fact, there may be selected items beyond the top 10.0% that need to have price cuts, but there are probably only a few of them. The essential marketing point remains. The firm must cut on highly price-sensitive SKUs and brag about it so customers are aware the cuts have been made.

Margin Build Backs—At the other end of the product spectrum, there are lots of SKUs that are not price sensitive. In addition, during slower sales periods these are products where competition may have reduced inventory and may not have the items in stock. These are the items on which prices can actually be adjusted upwards—even during a recession—to build back gross margin sacrificed in the targeted price cutting.

Probably half of the SKUs qualify as margin build-back candidates. Since they only generate something like 5.0% of sales, the increase in price needs to be more than a nickel and dime effort. On these items, the value added that the firm provides is availability. It should be a focal point of the selling effort.

Moving Forward

Price cutting is a fact of life in slow economic times. The challenge for reputable firms is to maintain a competitive posture without destroying its profit structure. If the firm can price competitively where it has to and build back margin where it can, it should be able to minimize the impact of the recession and be in a much stronger financial position when the economy starts to recover.

A Managerial Sidebar: Making It Up With Volume

Exhibit 1 looked at the sales increase required to offset a price reduction after the gross margin had been reduced. The following table looks at the "making it up with volume" equation starting with normal operations. That is, the firm has a typical DHI gross margin of 30.0%, a bottom line of 2.0% and variable expenses of 5.0%. Each of the following sets of price reductions and increases in dollar sales will keep profit at the initial level of $160,000.

Price Cut	Required Increase in Dollar Sales
1.0%	2.9%
2.0%	6.1%
5.0%	17.3%
10.0%	45.2%
15.0%	97.7%

As can be seen, the required sales increases start out small, then begin to increase geometrically. Once the price reductions reach a moderate size, it is apparent that the firm simply can't ever make it up with volume.

About the Author:
Dr. Albert D. Bates is founder and president of Profit Planning Group, a distribution research firm headquartered in Boulder, Colorado.

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As the direction of the Foundation has changed, now so has its name. The DHI Education Foundation is now the "Foundation for the Advancement of Life Safety and Security."This name change reflects the work that the Foundation has undertaken on behalf of our industry. The name reflects an area of growth opportunity—security. There is much to be done to provide enhanced security within the buildings we touch.

Along with providing security, we also have an opportunity to play a very important leadership role in life safety - through the fire-door inspection process. If we can achieve increased financial support, the Foundation can begin to implement a program that will raise the awareness level of this important new code change. The fire-door inspection concept is a huge opportunity for the architectural openings community - an opportunity to provide valuable insight into the safety and security of each and every fire-rated door.

The Foundation's core purpose is to raise funds to provide education and research for the advancement of the architectural openings industry and the safety and security of the built environment.

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