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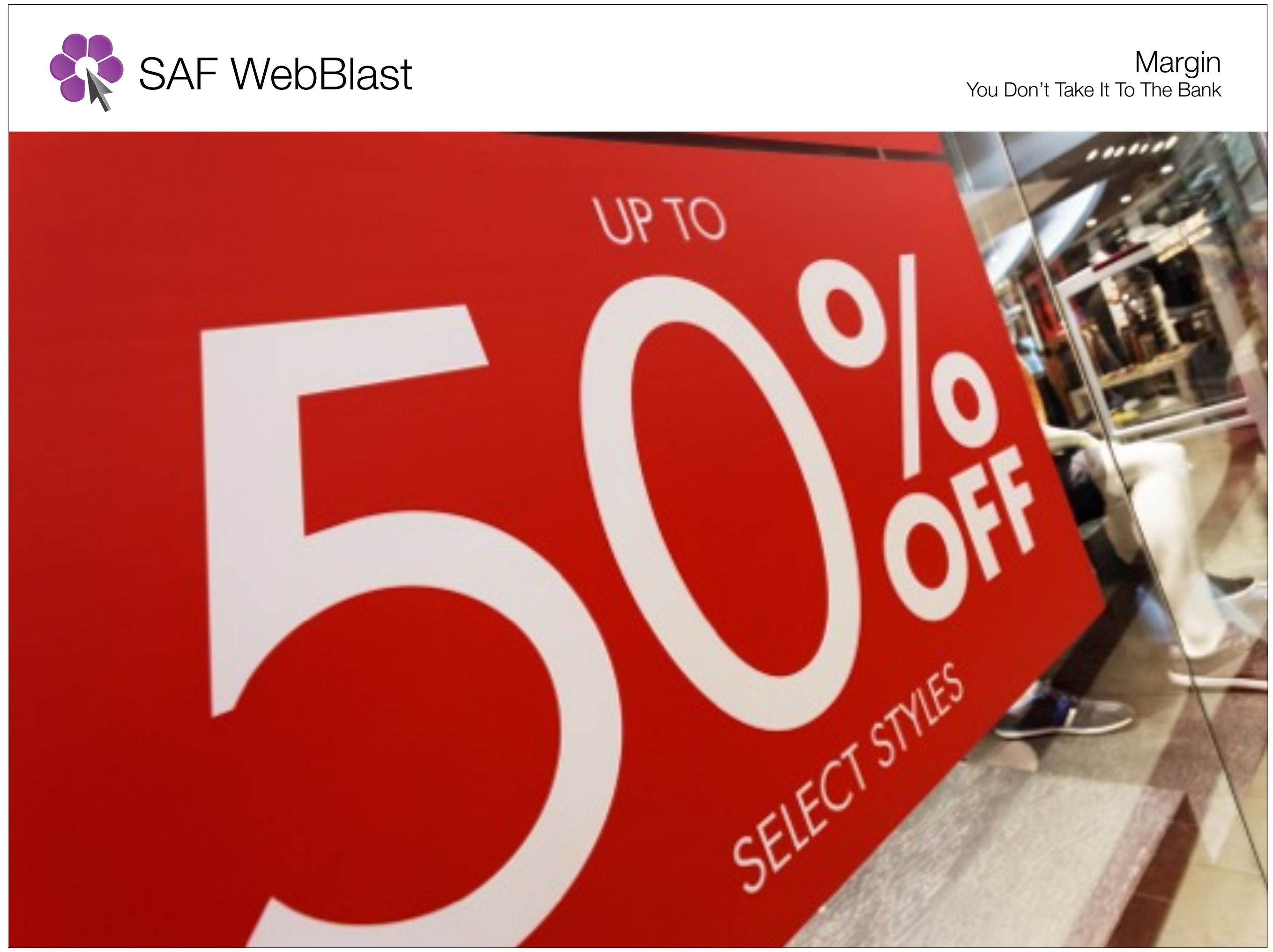
The Power of Pricing
Episode 3
You Don't Take Margin to the Bank
Wednesday, July 1, 2015
1:00 – 1:30 p.m. Eastern

You Don't Take Margin To The Bank

This is about how much importance should be placed on margin, and the role of discounting to increase sales and profits.

In the flower business we're often told that we need to preserve margin above all else. That we should never discount. Clearly that contradicts what we see in almost all other retail.



Discounts are everywhere. Preserving margin is important, but it's ok to sacrifice margin to increase profit. The questions are when, and how? And how do we avoid cannibalizing sales at the full price?

Why discount?

But first… why? Why would we choose to discount? Why would we choose to sacrifice margin?

The goal is bigger profit, and we do that by changing customer behavior.

Why discount?

Bigger Sales

First: Bigger sales. If somebody calls to buy one dozen roses we want them to buy two (and be happy about it - if they feel forced the whole thing breaks).

Why discount?

Bigger Sales

Sales to New Customers

Next: New customers – ones that would not purchase at full price.

Why discount?

Bigger Sales

Sales to New Customers

More Sales to Existing Customers

And finally more sales to existing customers. We want the ones that order once or twice a year to order twice as often.

Pricing Is Really About Aligning Prices With Value

That's the "why".

The "how" is the cornerstone of effective pricing: to align our prices we charge with the value the customer places on our products.

The Problem With Cost Plus

We hear a lot about "Cost Plus".

Cost plus is important, essential in fact, in that you need to understand your costs to make sure you cover those costs.

There is however one fundamental problem with cost plus…

Your Customers Don't Care About Your Costs

Your customers couldn't care less about your costs. Usually this is bad, but – if you pay too much for product you can't expect your customers to bail you out. But sometimes it's good. Derrick Myers always talks about getting a deal on product, and how that extra profit is all yours. And there are times that people are willing to pay more than your cost plus formula suggests. This is almost magic – charging more for the same product from people that will happily pay more. That's even more fun than discounting and hopefully we can cover it in another session some day.

Pricing Models

Safe: Price = Cost + Profit

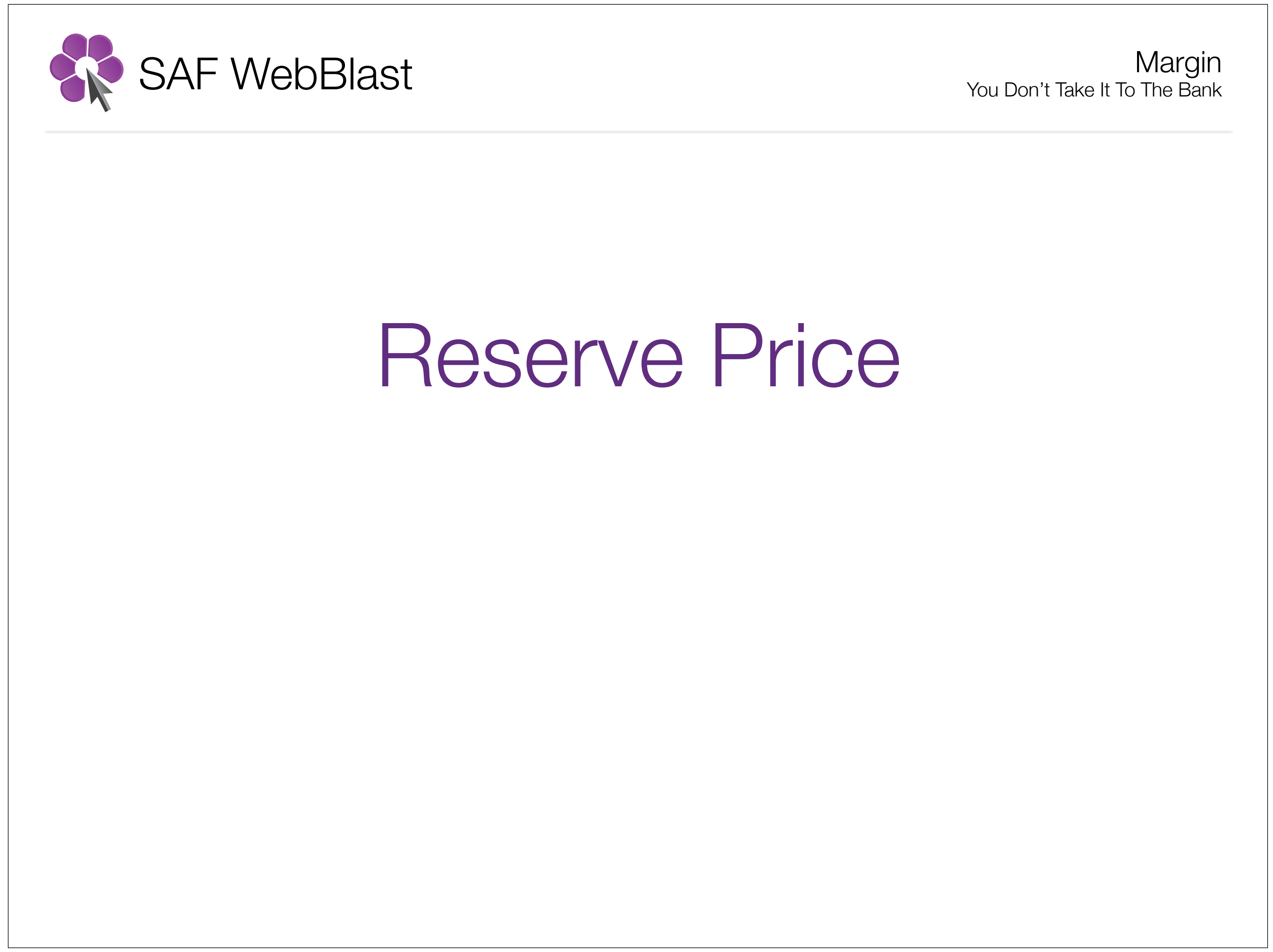
Profitable: Price = Customers Valuation

Safe pricing is about a cost plus formula.

Sophisticated and more profitable pricing is about aligning your prices with the value people place on your products.

Get Customers To Buy More Often

First we're going to look at how we can manipulate things to get a customer to buy more often.



There aren't many terms this time but we do have to talk about reserve or reservation price.

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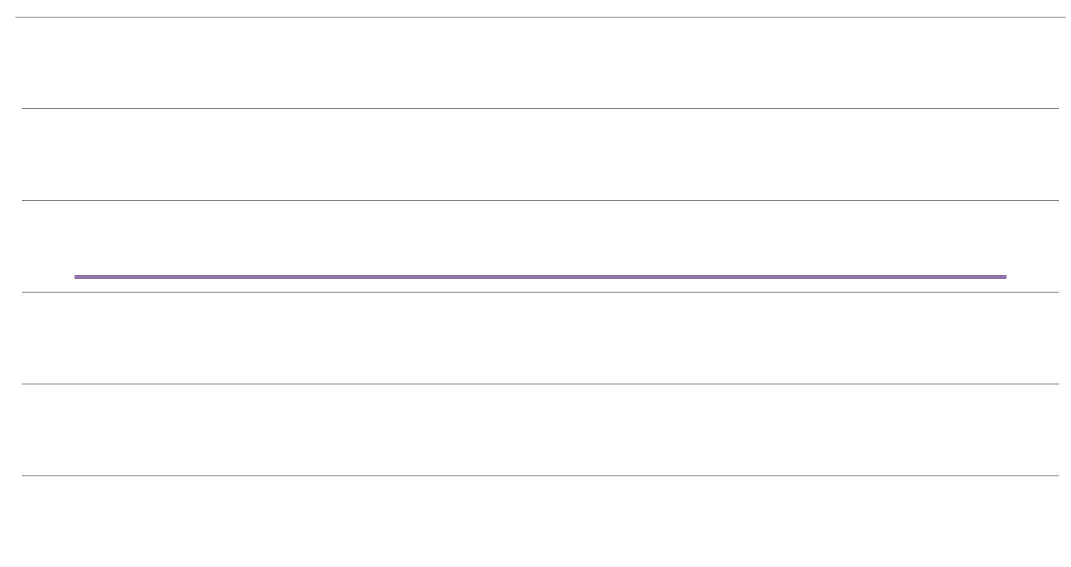
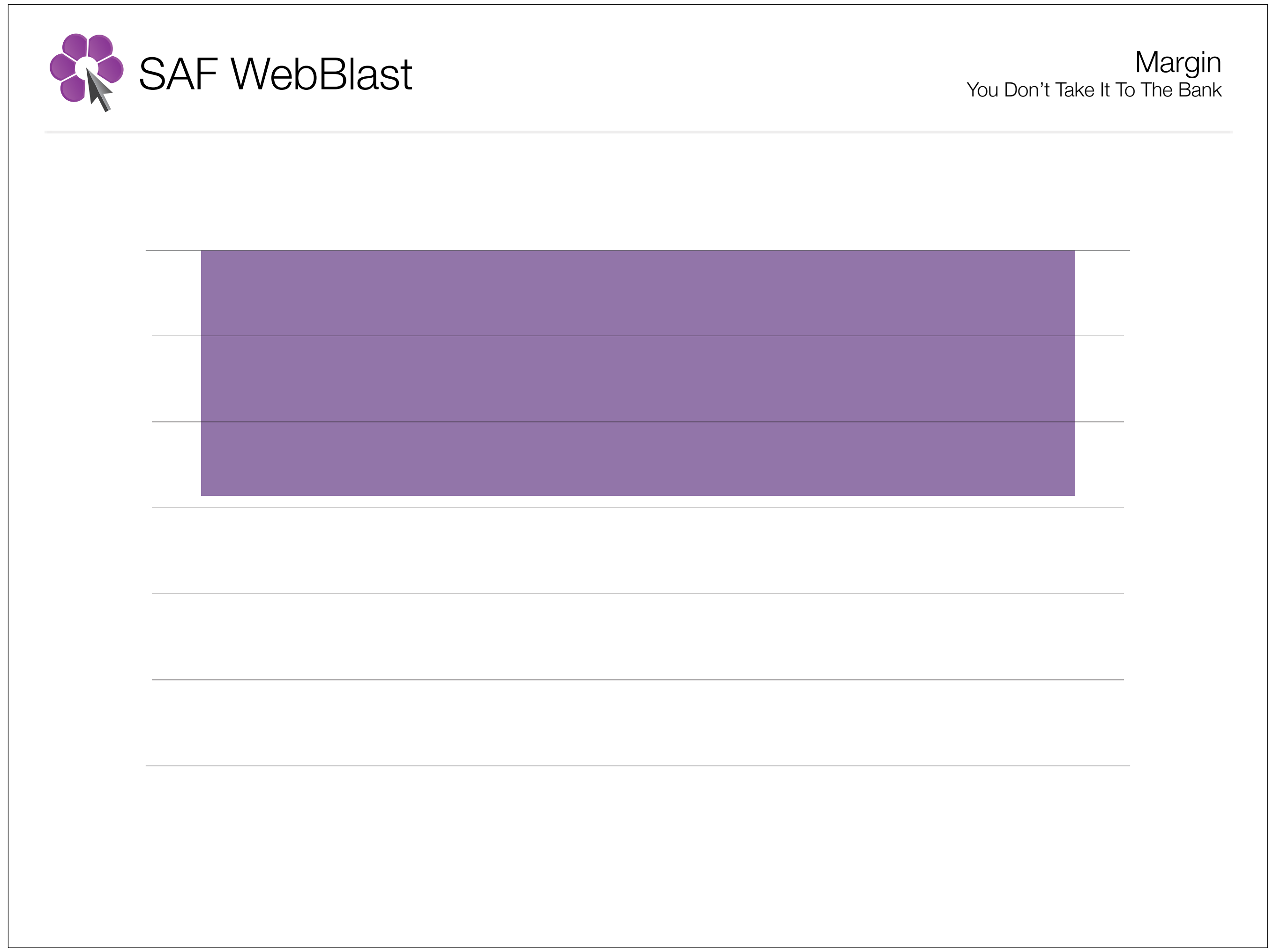


If you are the seller it means the lowest price at which you will sell your product. We'll use the example of a dozen roses.

Numbers are distracting but low prices go to the bottom of this chart and high prices are at the top. Your reserve price is shown by the purple line. Your cost plus formula says you should not sell below that line.



Of course you'd happily accept more too, so we'll finish the graph like this. You'll sell your products at any price above your reserve.

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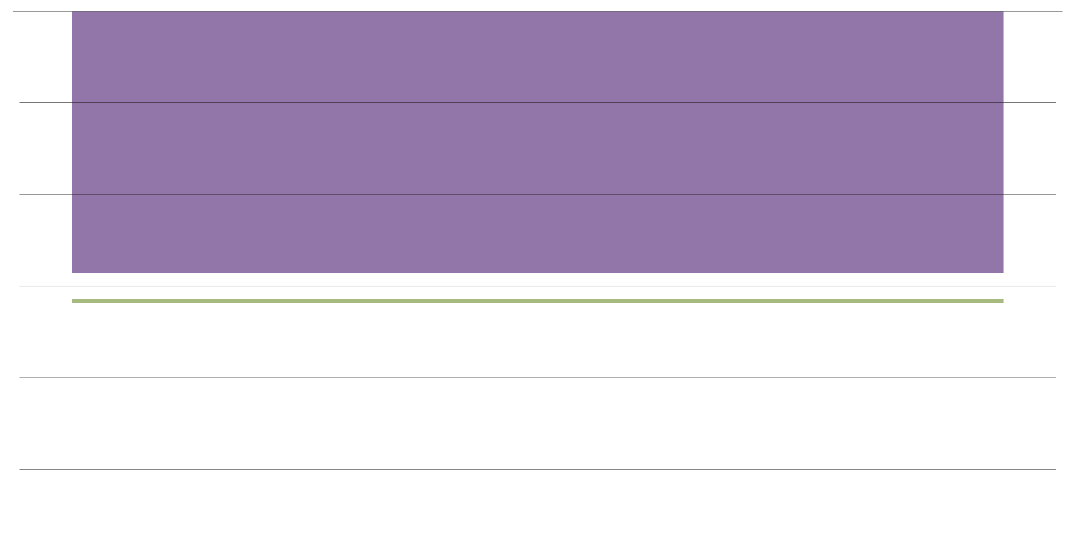

From the buyer perspective reserve price means something different. To the buyer the reserve price is the maximum price that they will pay for the product.

And, of course, they'd also happily pay less, so we complete the graph like this. They'll pay anything in the green box.

And here we see a problem. The price at which you will sell your roses is higher than what the customer is prepared to pay. There is no overlap and no sales.

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How do you fix it? One thing is to increase the value the customer puts on the product. If you can raise that value you can, hopefully, bring their reserve price above, or at least closer to yours. This is what you are trying to do when you promote your product – you want people to see the value in flowers.

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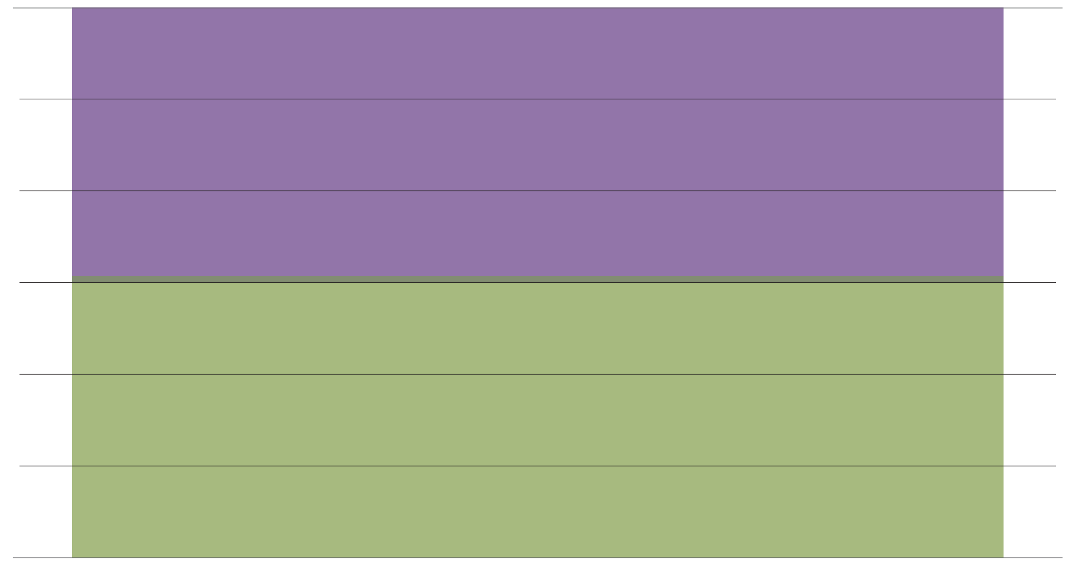

The other option is to reduce your reserve price by discounting a little. You have to remain profitable, but less profit on a sale you would not get at full price is better than no profit at all. You don't take margin to the bank.

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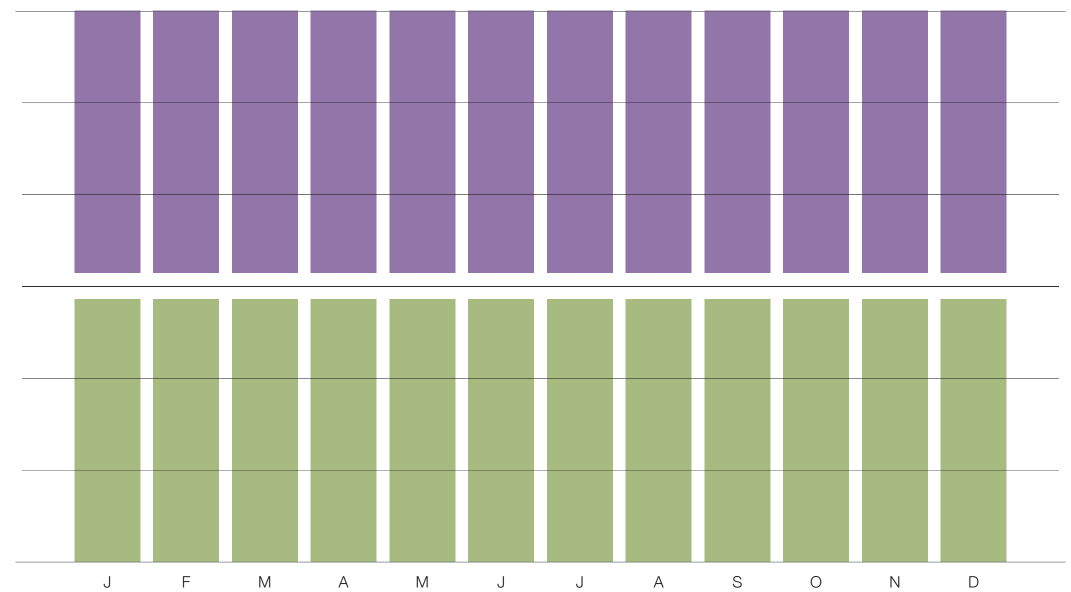
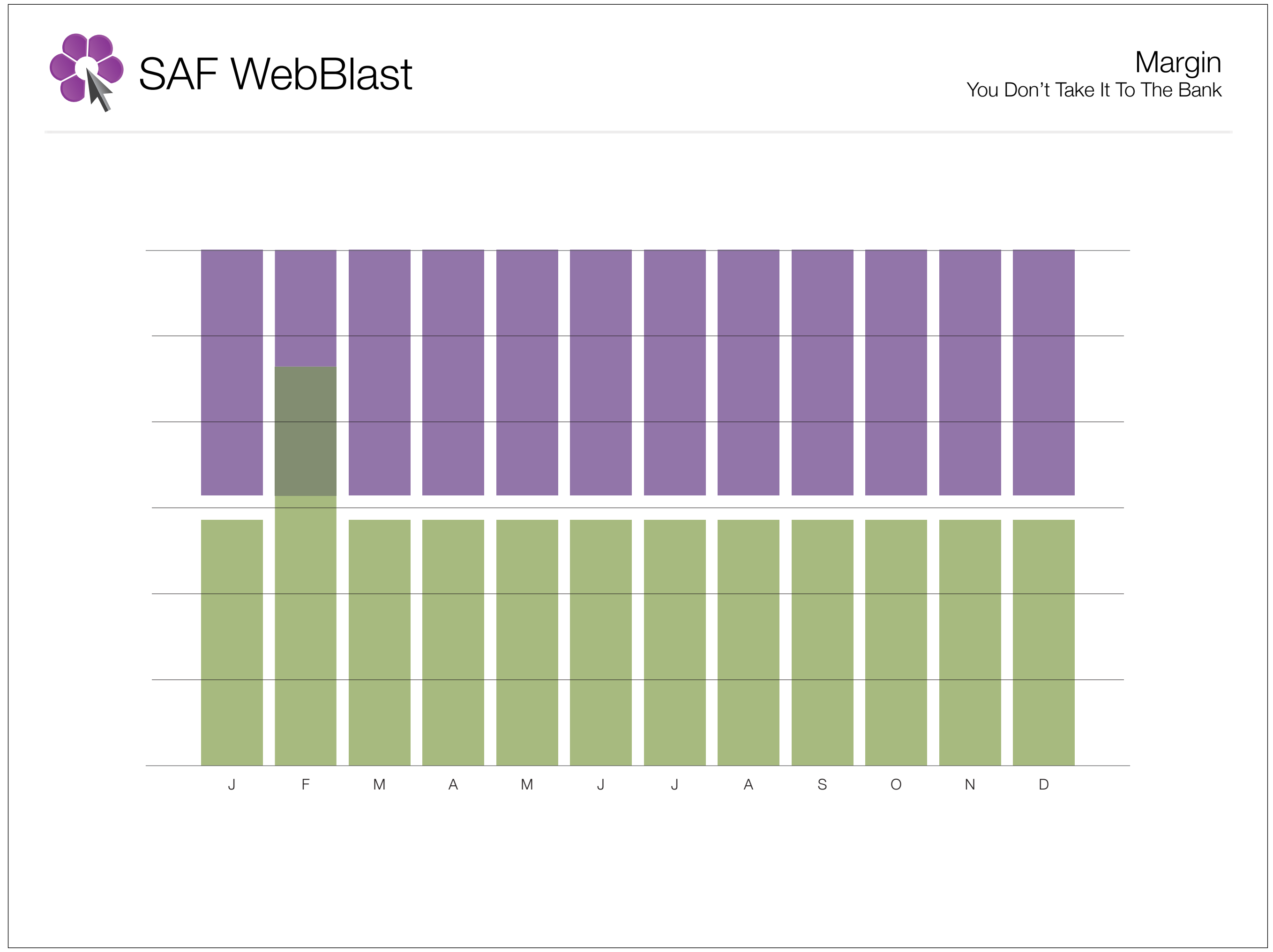


Now let's look at reserve prices by month. At first our chart looks busted – it shows that nobody would ever buy flowers.

But we know that in North America the average guy might buy flowers a couple of times a year. Lets see what that looks like.



If they're in a relationship they place a higher value on flowers at Valentine's Day. They'll pay more on February 14th than at any other time of year, and their reserve price suddenly looks like this.

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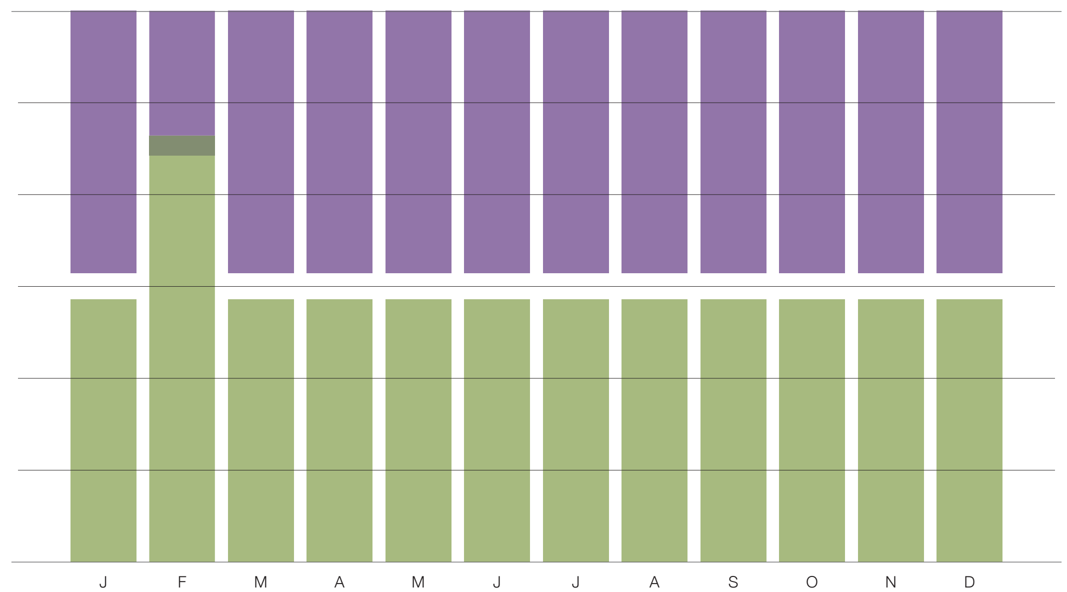
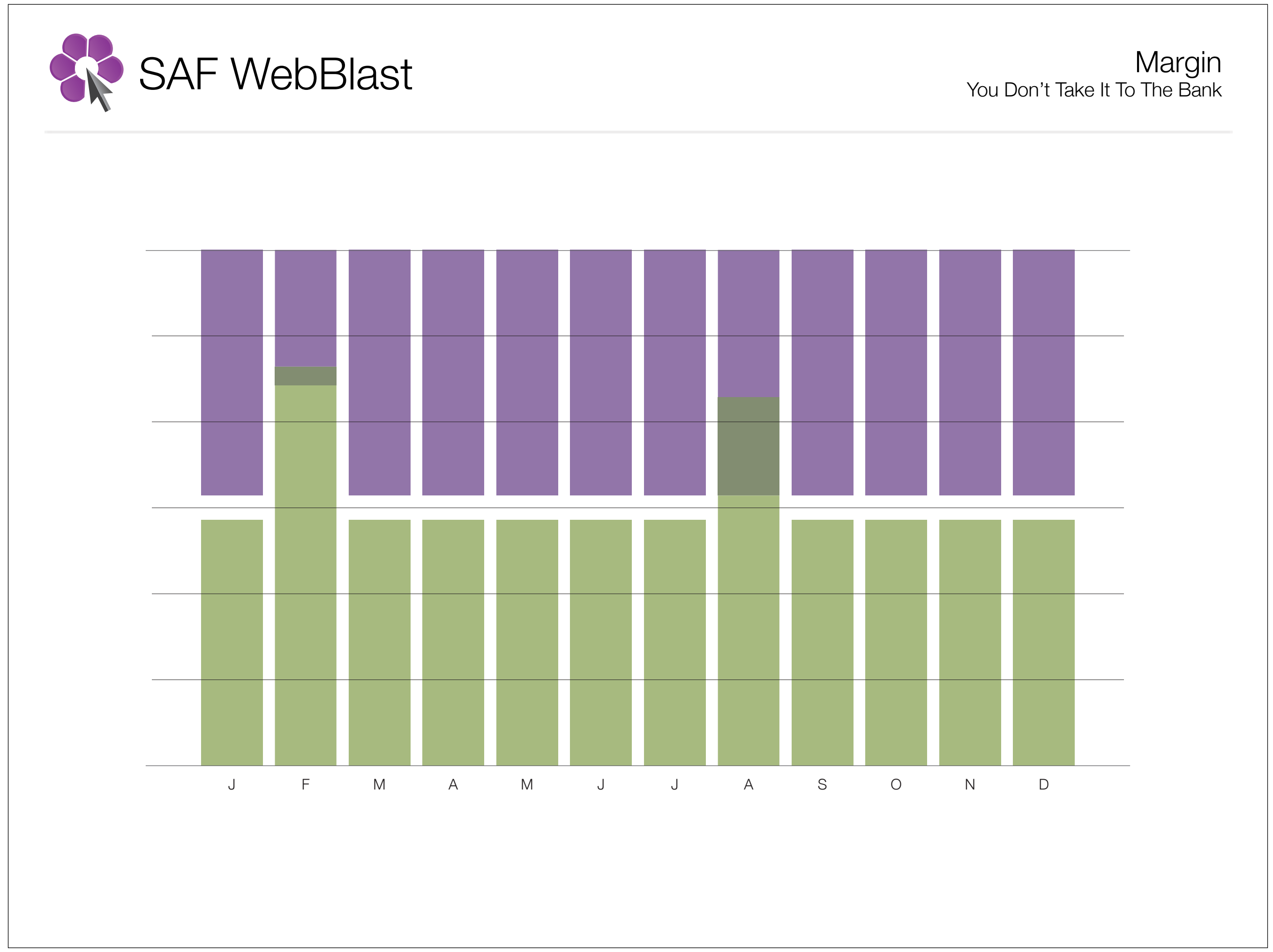


In response our reserve price changes too. It gets higher. Why prices get higher can be argued, but it’s a chicken vs egg situation.

It all comes back to the fact that consumers place a higher value on roses at Valentine's Day. Knowing that wholesalers can charge florists more and florists have to charge more in turn.



This customer also buys at one other time of the year – maybe a birthday or anniversary. Here we see again that they suddenly place a much higher value on the product.

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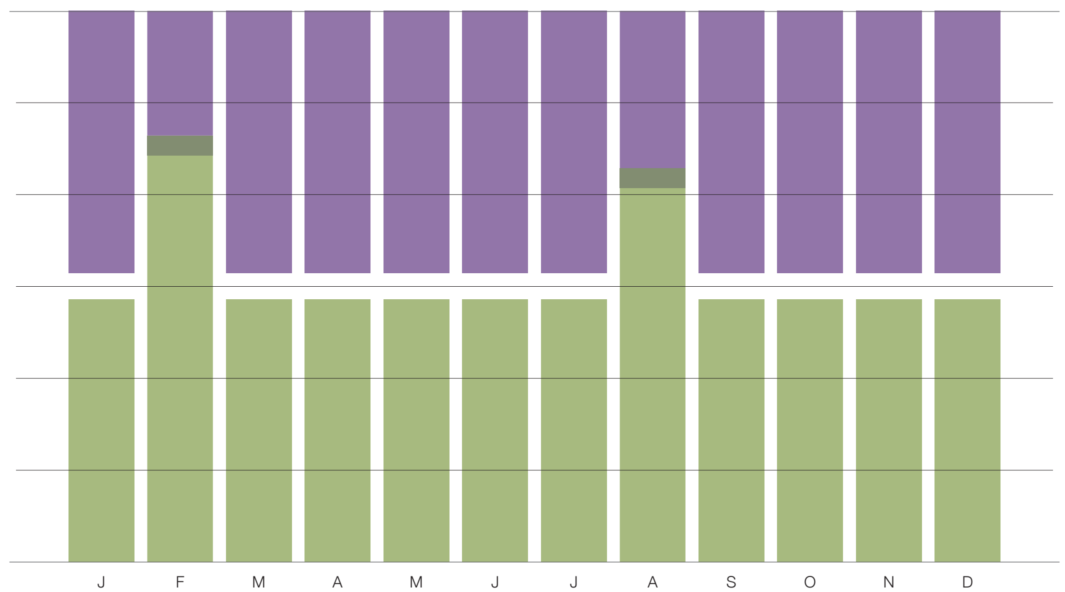

Here the FloralStrategies sales method will help you understand the value and charge accordingly. If the customer explains that it is their 25 wedding anniversary you'll know, if you follow Tim's method, that you should be leading with a higher price.

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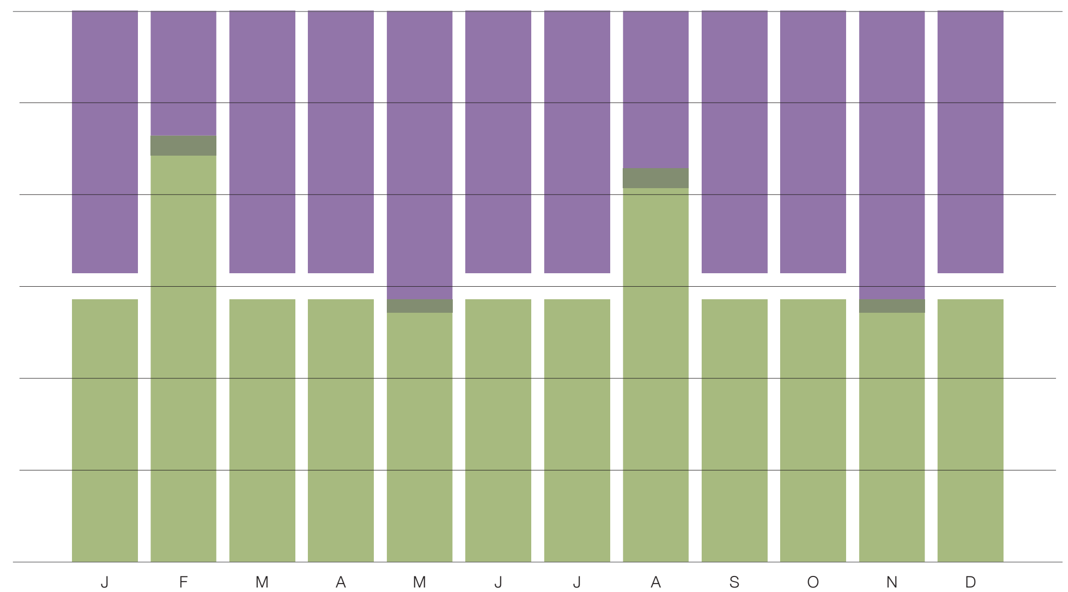
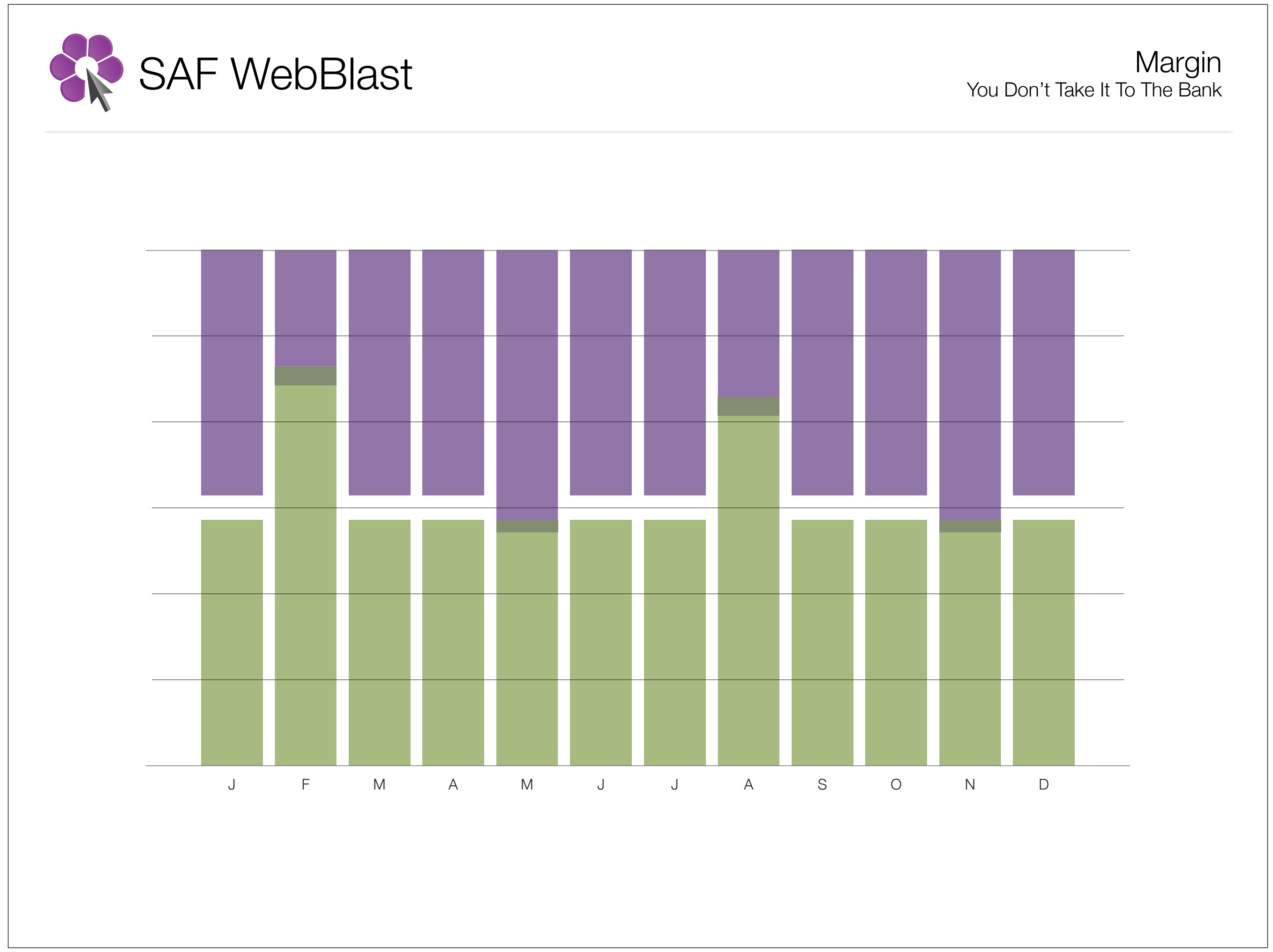


But we also want two more sales a year from this customer. We do that by aligning prices with value so that they buy more often. We do this by discounting selectively.



Every time somebody place an order they get a reminder three months later… as long as that does not fall on a peak period. If it does move it one month back or one month forward. In this business we're good at repeat business, not as good at new business.

Rules for discounting for additional sales…

Remember the Goal: It's about additional sales, not discounting sales that would have been made anyway.

Avoid Cannibalization: Do not offer discounts at times when there is a high value on your product, or the customer is likely to buy anyway.

Watch Your Timing: Every coupon or discount code has a lifespan that does not conflict with high value periods.

Watch Costs: Each sale still needs to be profitable. Don't fall into the "market share" or "brand building" traps.

Get New Customers

Another reason to discount is to recruit new customers, ones that won't pay your full prices.

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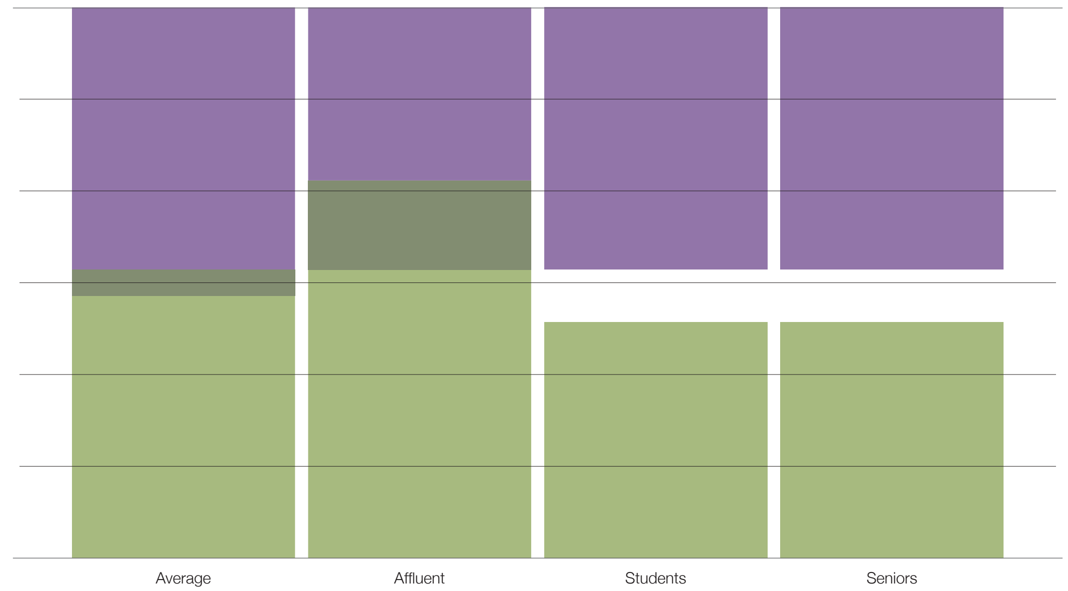

Over on the far left we have your typical customer and, hopefully they are taken care of with your standard pricing. There's an equilibrium that gets you a few sales a year.

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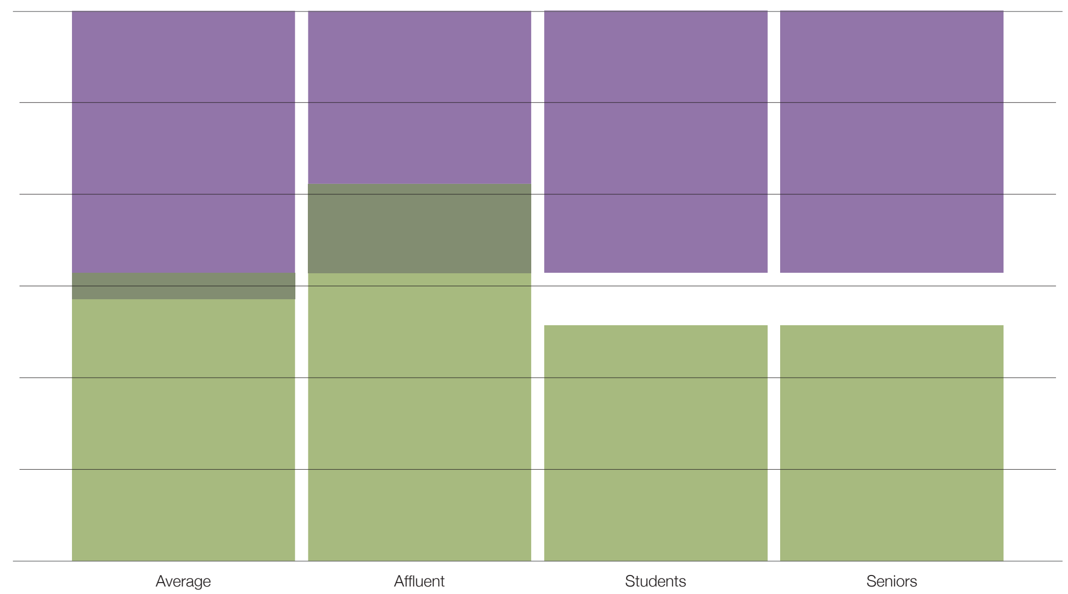
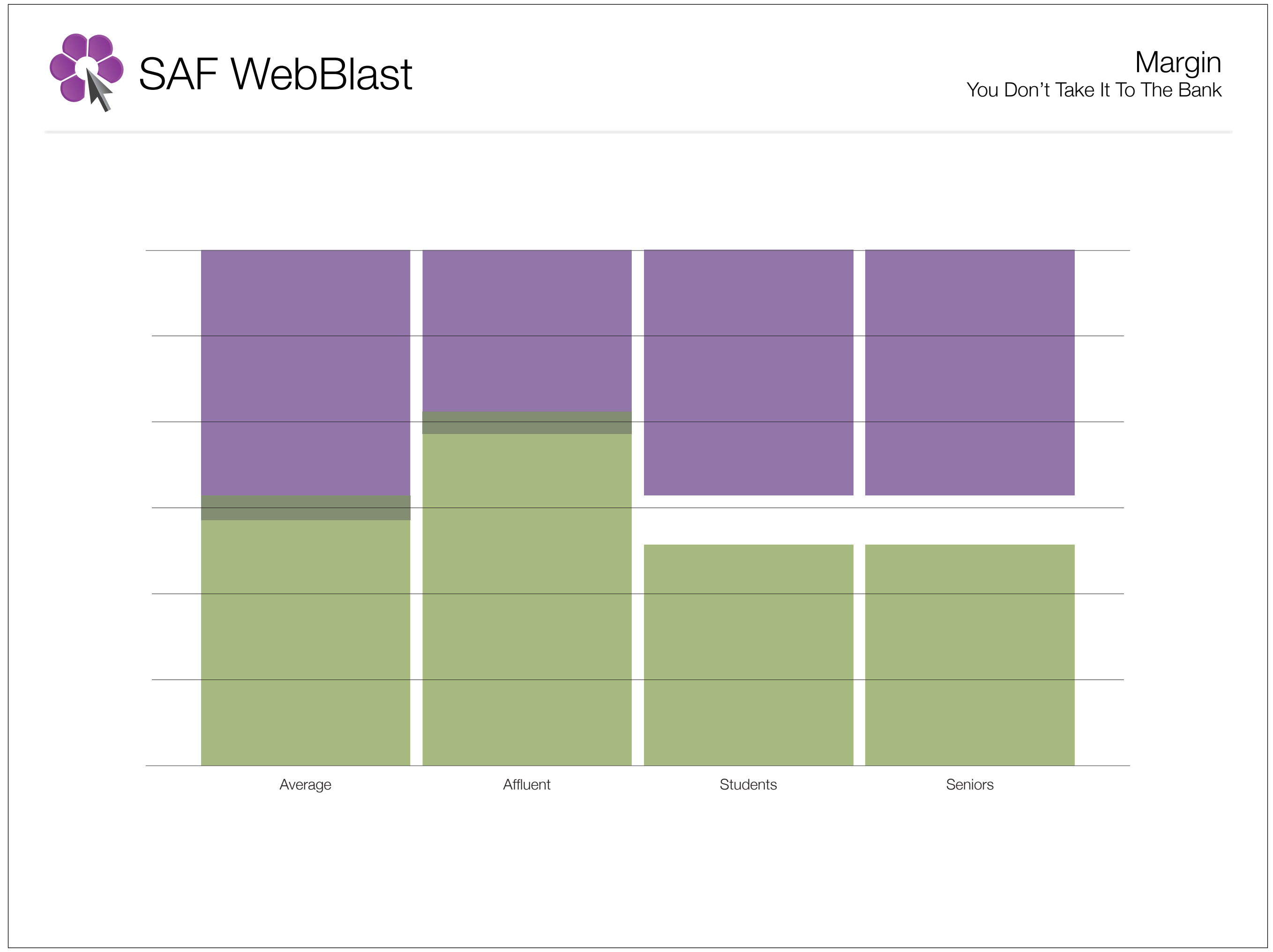
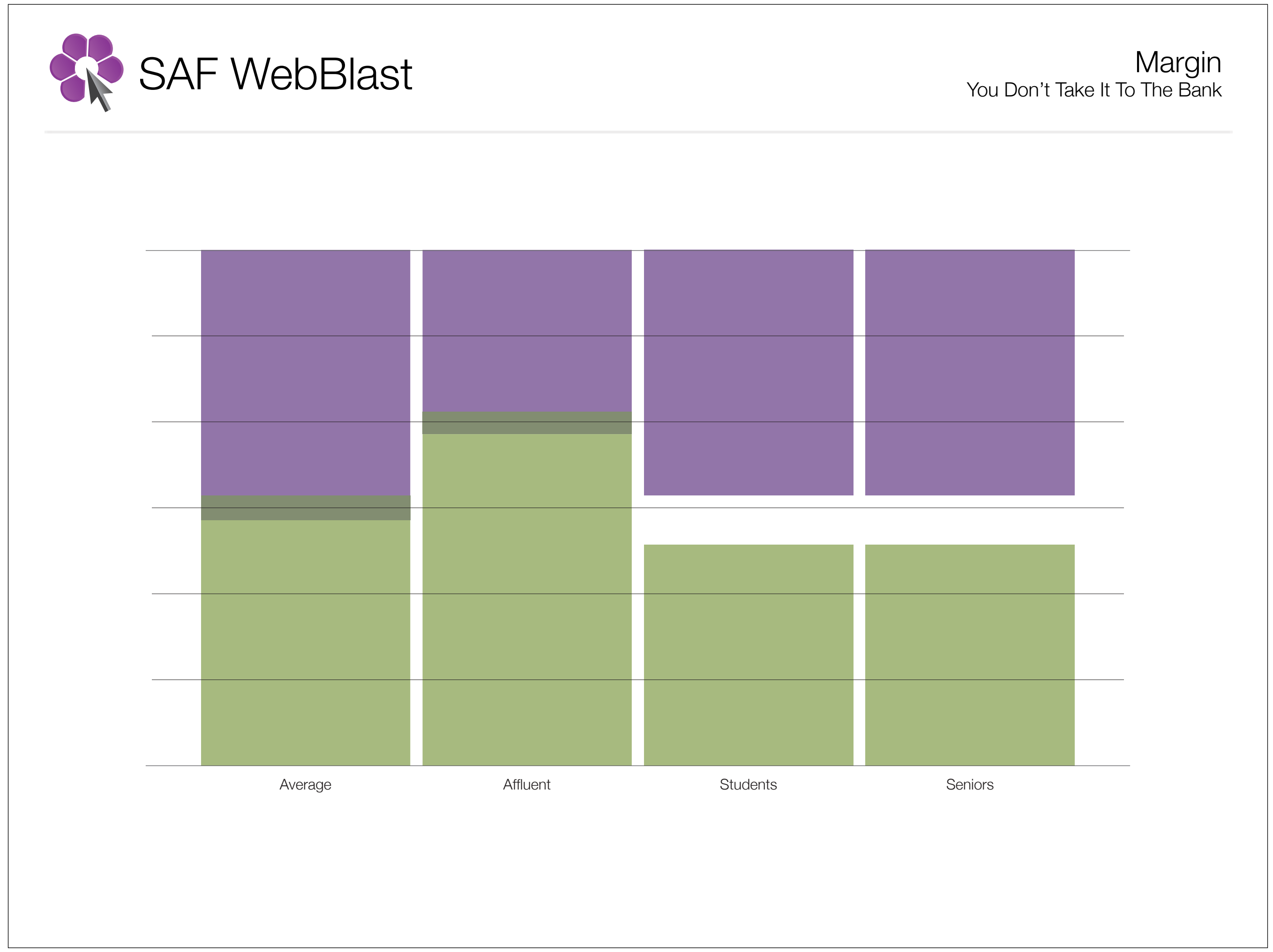


Then, one over to the right, there are probably some affluent customers, or customers that place a high value on flowers that are prepared to pay more. When we sell something we get so focussed on the people that won't pay that we lose sight of the fact that there are always people who will pay more. This is why there is an organic section in the grocery store - some people are happy to pay more! Every local grocer begrudges the fact that people go to Walmart or Costco but Whole foods recognized that there are lots of customers that will cheerfully pay more.



And it is absolutely your responsibility to charge them more! Otherwise you are leaving money on the table. There are ways to do that but it's another topic for another day.



Right of that we start getting into problems. We have two groups that place a lower value on flowers. Perhaps because they have less money to spend, or just have a hard time coming to terms with inflation. Whatever the case they won't pay full price.

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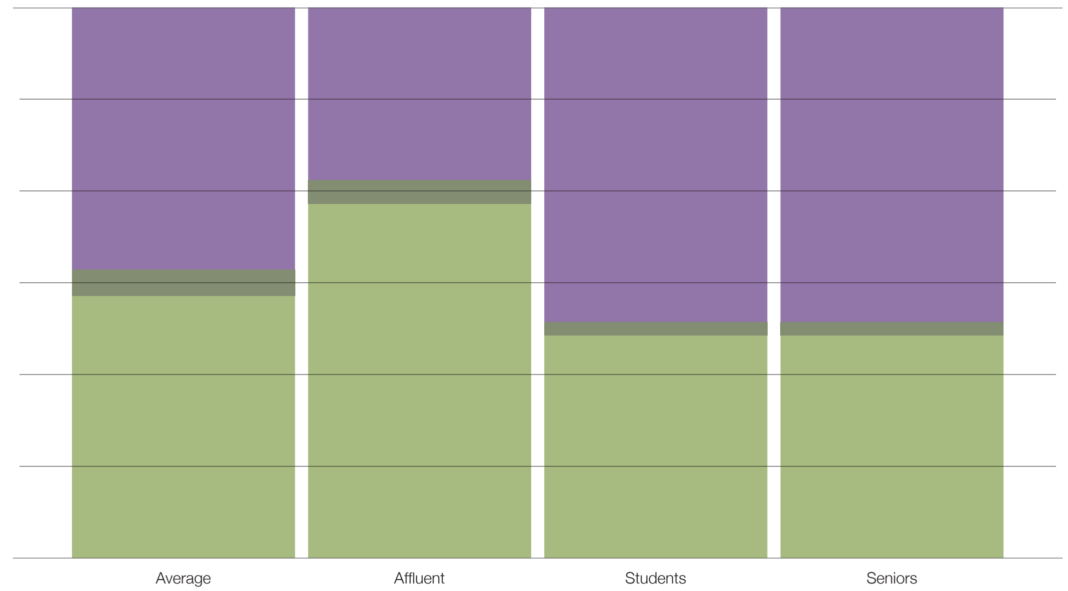

We need to offer them lower prices. We need to align our prices with the value they place in our product to recruit them as customers. But we need to be selective.

This is typically done through a kind of profiling or affiliation. When you see student discounts, or seniors discounts, it's easy to think "awww… that's so nice! They're so generous they're giving discounts to those poor students and sweet old people!"

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It's great to be able to get that PR benefit, but this tactic is not about kindness. Instead it's about recognizing that there are some groups that are more likely to be price sensitive, and less likely to pay full price, and offering them an exclusive discount.

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AAA is another one. AAA membership is often considered to imply price sensitivity, and identify a group of people that will respond well to discounting.

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Here's another one that also introduces a hurdle in that the discount is only offered on Wednesdays. Hurdles are another great tactic, but one we can leave for another day.

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This discount and the one before it are both a little sloppy. Remember, the goal is to get new customers through the door and spending money. The last two examples reward students that were already in the store and ready to spend money.

This is a Burger King, and it makes sense for them because a student might eat Burger King four times a week. Here they're hoping to encourage repeat business, and maybe some degree of virality.

This is less likely to work with flowers because people, especially people in these groups, buy flowers so infrequently. Putting up a sign like this is easy, but the goal is to reach people outside the store and get them into the store.

Rules for discounting for new customers…

Take It To Them: The discount is to get new people into the store, not reward those that were there anyway. Promote!

We're all attracted to the path of least resistance, and it's tempting to just put up a student discount sign. All you are really doing is giving away a discount you don't have too.

Rules for discounting for new customers…

Take It To Them:	The discount is to get new people into the store, not reward those that were there anyway. Promote!
Don’t Force It:	Don’t offer the discount unless they ask.

Don’t offer unless they ask… again it’s easy to do that and think “wow, I’m really marketing aggressively”, but again you are just cannibalizing full price sales.

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Rules for discounting for new customers…

Take It To Them: The discount is to get new people into the store, not reward those that were there anyway. Promote!

Don't Force It: Don't offer the discount unless they ask.

Be Selective: Don't target groups that are not price sensitive.

Don't discount to any group that is not likely to be price sensitive or, worse, a group that might associate discounts with diminished quality. A special discount for members of Augusta National Golf Club is counter-productive.

Get Customers To Spend More

This is where “you don’t take margin to the bank comes from”. Once again we’re talking about changing behavior – getting the customer that called to buy one dozen roses to buy two. Wayne story, if time allows.

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When you buy the large popcorn you get six times as much popcorn for just $1 or 14% more money. There is a huge discount, and a tremendous sacrifice of margin, to get you to spend more money.

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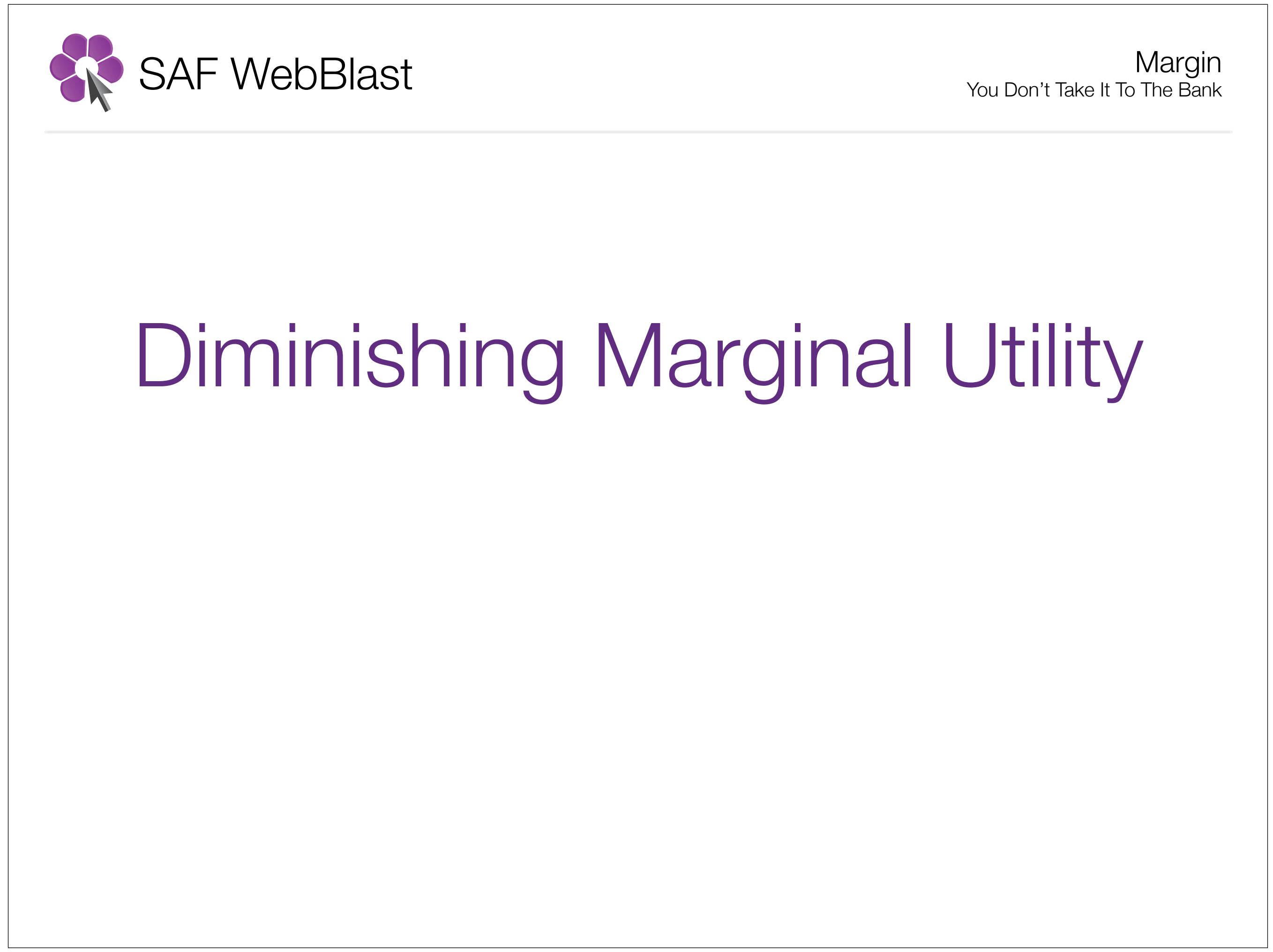
Here we see the exact opposite. No matter how much gas you buy there is no discount. How are the two things different? Two main ways...



The first is diminishing marginal utility.

Diminishing Marginal Utility

Each additional unit of a product provides less utility (in the case of flowers this means enjoyment) than the one that came before it.

It means that each additional unit of a product provides a little less utility than the one that came before it. It applies to some products more than others.

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The gas station doesn't have to worry. The utility of a gallon of gasoline is the ability to travel a certain distance. The last gallon of gas provides just as much utility as the first. It gets you just as far, and the gas station doesn't have to worry about discounting to compensate.

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Here it's different - that last handful of popcorn provides a lot less utility, in this case enjoyment, than the first. The first handful of salty, buttery popcorn is awesome. The second one is great. By the end it's disgusting. Each mouthful is a little less enjoyable than the one that came before it, and they price to account for that. They're aligning their pricing for the extra units of popcorn with the diminished value we place on them.

Flowers Provide Diminishing Marginal Utility

We don't like to admit this but it's true. When someone has asked for one dozen, an extra dozen for twice the money is not attractive. Twice the flowers do not provide twice the happiness.

Flowers Provide Diminishing Marginal Utility

There is a ton of research on this. Researchers give a subject ten dollars, and the subject reports being very happy. "How much would it take for you to be twice as happy?" they then ask. The answers are typically between $35 and $50. It takes, on average, more than four times as much to double happiness.

Perishability

The next thing is perishability.

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If the gas station offered volume discounts we'd buy as much gasoline as possible at once and stockpile the product, which would cannibalize full price sales at a later date.

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Here the product is very perishable. After a couple of hours it is junk. You can't order the large and save half for your next trip to the movies.

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Same thing here. 200% more ice cream for 31% more money, but it's worthless very quickly.

Flowers Are Highly Perishable

You can’t buy two dozen at Valentine's Day and save half for Mother's Day. And unless you’re really cheap you can’t split a dozen, giving half to your wife and half to your mistress.

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Flowers Are A Great Candidate For Discounting

They offer diminishing marginal returns and are highly perishable. They meet all the criteria we see for this kind of discounting.

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Costs By Size

Version	Good	Better	Best
Size	1.0	1.5	2.0
Costs			
Container & Packaging	$2.60	$3.90	$5.20
Labor	$12.00	$15.00	$18.00
Flowers & Foliage	$11.70	$17.55	$23.40
Total Cost	$26.30	$36.45	$46.60
Increment Cost	$26.30	$10.15	$10.15

Costs for each increment.

Prices & Profits – No Discount

Version	Good	Better	Best
Size	1.0	1.5	2.0
Total Price	$60.00	$90.00	$120.00
Total Gross Profit	$33.70	$53.55	$73.40
Increment Price	$60.00	$30.00	$30.00
Increment Gross Profit	$33.70	$19.85	$19.85

Great profits… but why would I upgrade? If I wanted twice the flowers for twice the money that is where I would have started. Think about the restaurant when you order a draft beer – they don't say "would you like two?". Instead they say "would you like to upsize that?"

Prices & Profits – Discounted

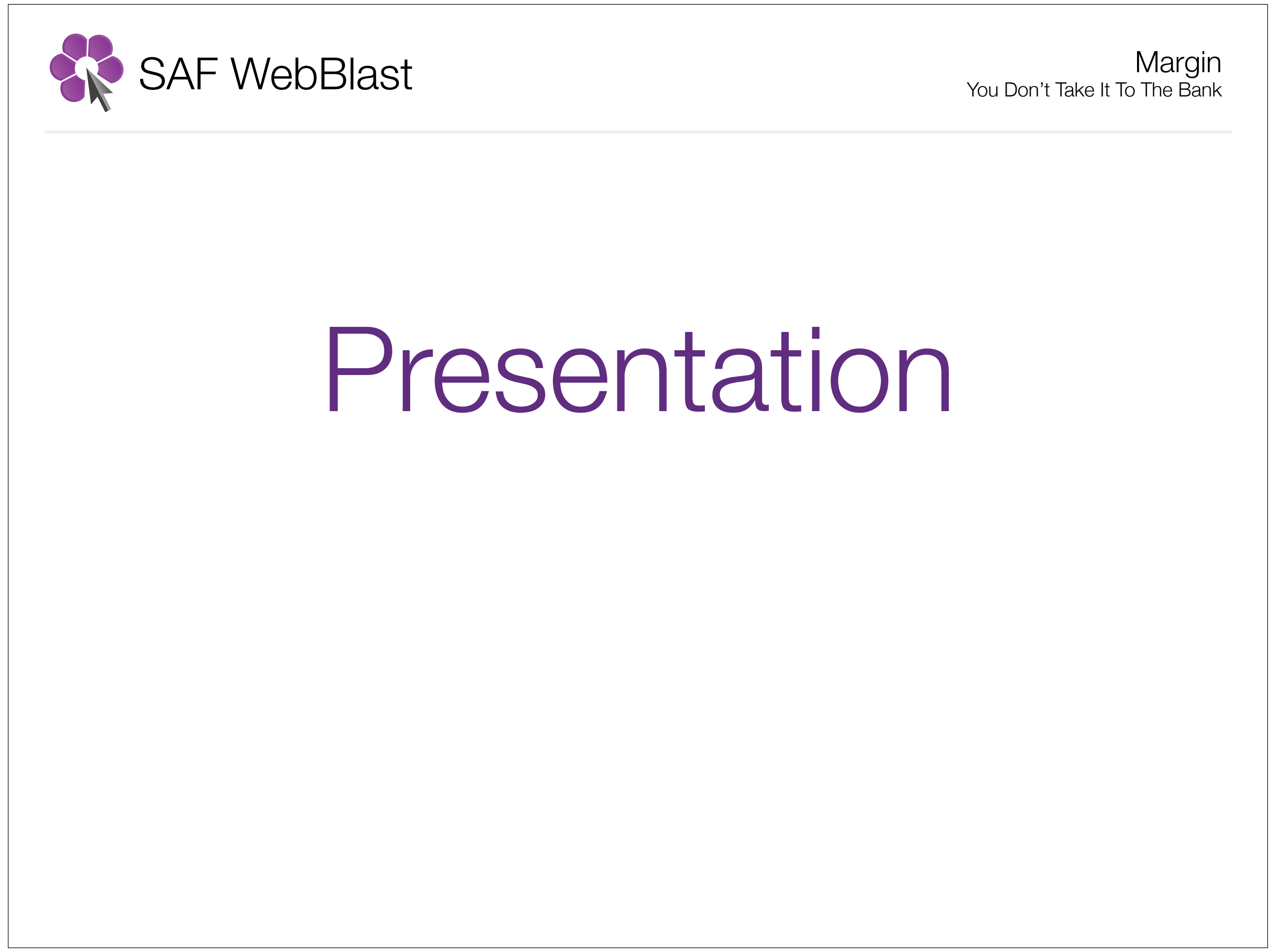
Version	Good	Better	Best
Size	1.0	1.5	2.0
Total Price	$60.00	$75.00	$90.00
Total Gross Profit	$33.70	$38.55	$43.40
Increment Price	$60.00	$15.00	$15.00
Increment Gross Profit	$33.70	$4.85	$4.85

Here is our heavily incentivized pricing.

Prices & Profits – Compared

Version	Good	Better	Best
Size	1.0	1.5	2.0
Increment Price	$60.00	$30.00	$30.00
Increment Gross Profit	$33.70	$19.85	$19.85
Increment Price	$60.00	$15.00	$15.00
Increment Gross Profit	$33.70	$4.85	$4.85

Much, much smaller profits, but many more sales.



It's all about the presentation, and a kind of what we call progressive disclosure.

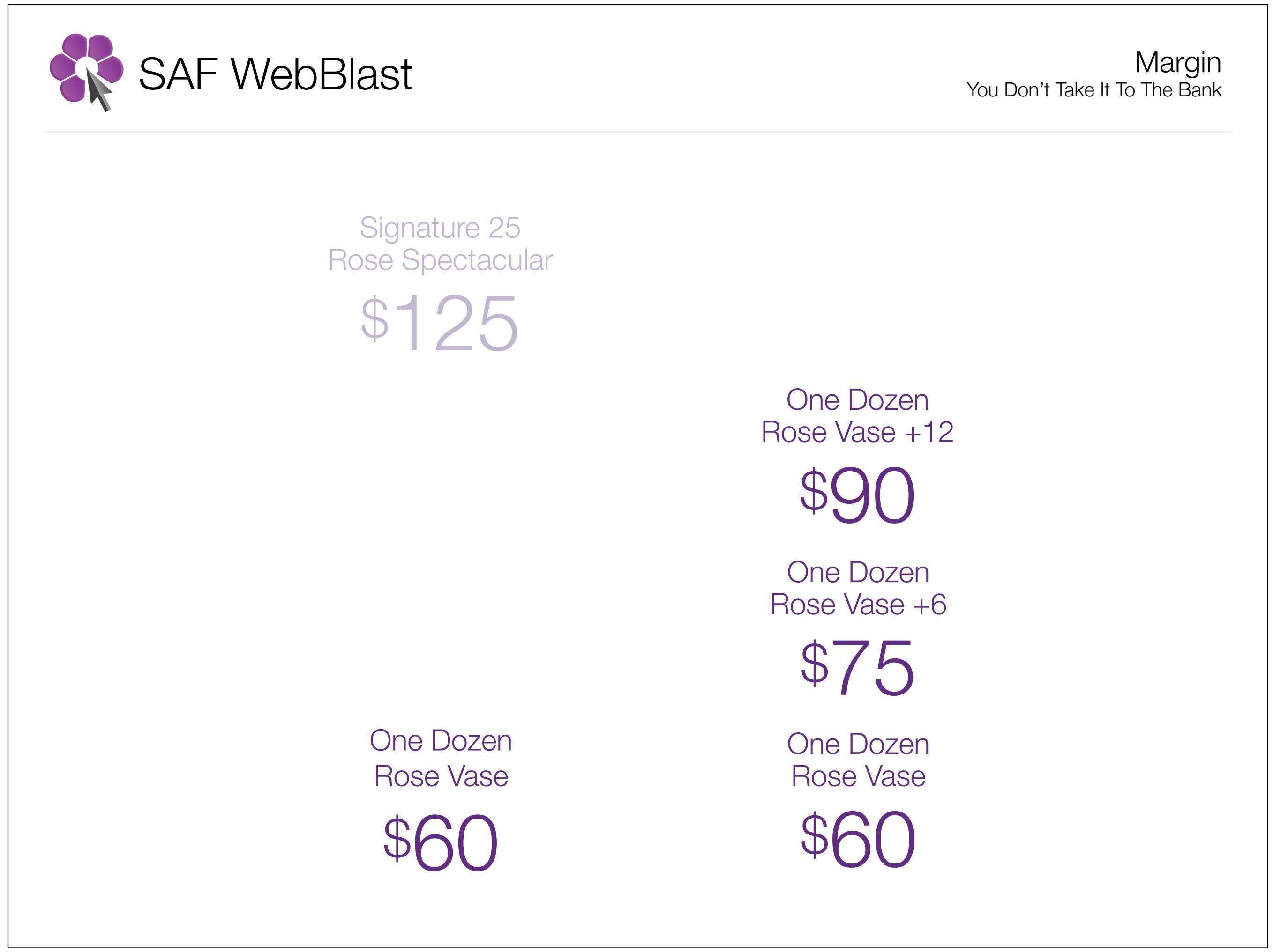
Signature 25
Rose Spectacular

$125

One Dozen
Rose Vase

$60

You offer what they ask for and a higher priced premium version. A dozed roses at $60 and the “Signature 25 Rose Spectacular” at $125.



If they go with the dozen ok. We didn't get what we wanted but we're not giving up. We have options.

It is always a good idea to present these upsizes as specials. It creates a sense of urgency, establishes the potential for loss, and gets you off the hook for next time.

Thank you!

Thank you for participating and also thank you to SAF for being so generous with me and so great with all of their members. We're really lucky to have them looking out for us.

Appendix

Extra content that arose from questions during the session.

Volume Premiums

We generally assume that larger pack sizes mean savings. There should be a volume discount, and the price should reflect the fact that there is less packaging, handling, etc. That all reflects a cost-plus mindset. The model now is to understand what people value about a product or version and charge for that.

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Here the largest pack size is actually far more expensive. The smaller pack size is $22 a liter, the larger pack size is 50% more expensive at over $33 a liter.

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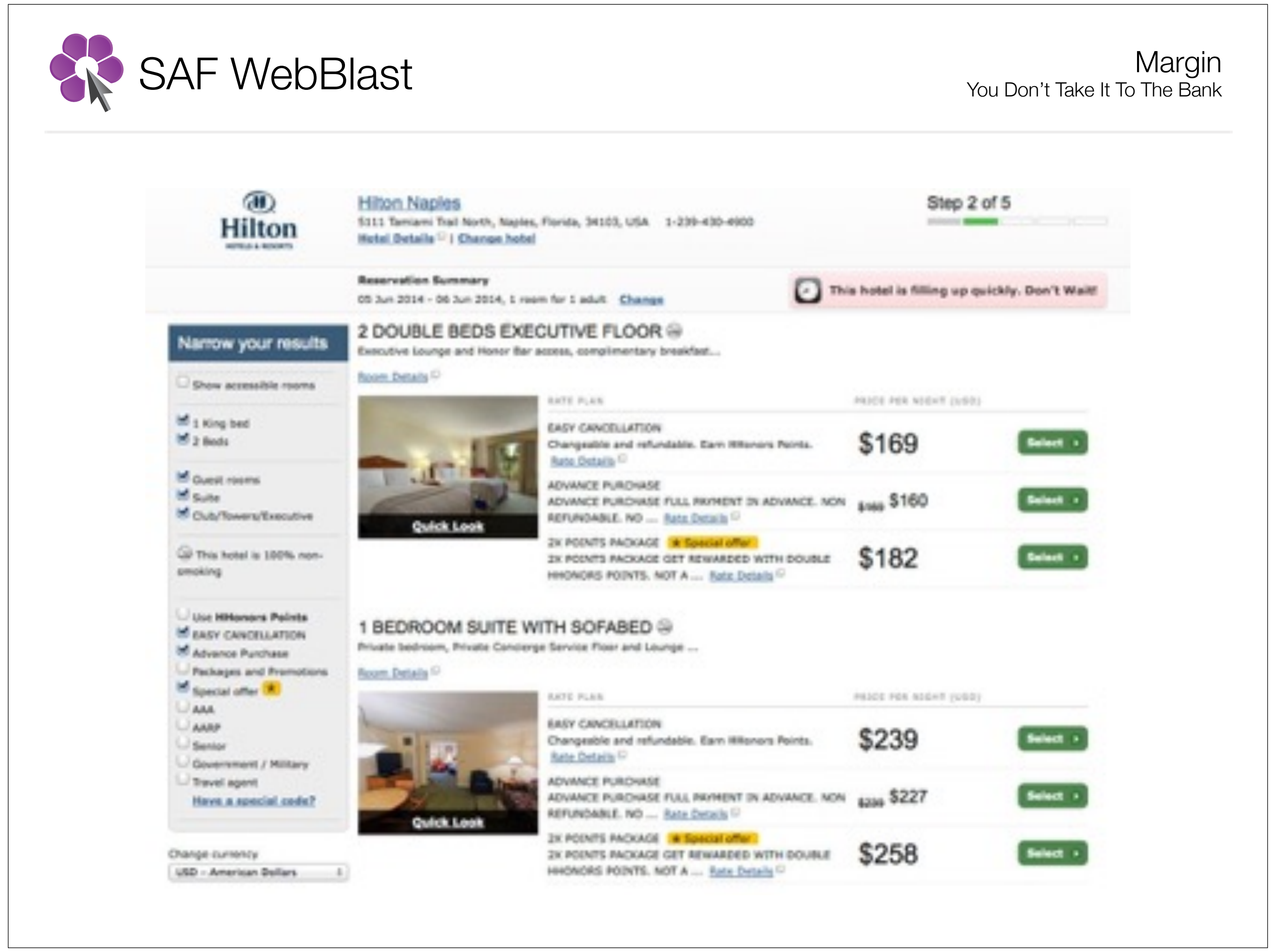
Here the largest pack size is even more expensive. The smaller pack size is $27 a liter, the larger pack size is 60% more expensive at over $42 a liter.

The seller recognizes that there are two different buyers. The one that just wants a whole lot of vodka buys two bottles (and there are often further discounts for that) – this is like the person that purchases the add-on dozen. The person buys the big bottle wants a big presentation and they pay a premium for that – this is like the customer that buys the "Signature 25 Rose Spectacular" we discussed earlier.

Progressive Disclosure

The key is how the offers are presented. Here is a real world example.



When first making the reservation you are offered the special rooms and suites with the full price options.

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After you have completed the checkout you have the option of upgrading to a special room or suite at a much lower price. Ignoring the initial suite offer and reserving the standard room is the equivalent of walking out of the car dealership to show that you are serious.