PROFITABLE PRICING STRATEGY - By Robert Lindgren

GETTING TO REAL MONEY

The vast majority of firms in our industry produce profits of 4% or less. Granted, these results are somewhat distorted by the efforts of their owner/managers to avoid sharing with the government, but they're hardly silicon valley numbers. However, a few firms break out of this mold and move into the 10% to 15% range. Almost always the difference is utilization of plant capacity. Every firm needs to have a plant, which may be quite large due to the storage of paper and finished goods. They also need expensive presses, finishing equipment and software systems. These all cost the same whether they are in use for eight hours or twenty-four hours per day. The power of using the plant and machinery that is already in place for more hours is enormous. Additional jobs only involve the expenditure of operator wages, materials and sales commission which together average about 60% of the typical sales dollar. Just think of the power of selling sixty cent dollars and getting a dollar for them! Of course, moving from eight hours to twenty-four involves the necessary organization and expansion of the workforce, but that's not what keeps firms from getting there. It's the challenge of building the sales volume that is the barrier.

Naturally, you have to make a sales effort and call on prospects to build sales, but actually getting the order is the tough part. Firms that have broken out of the one-shift mode usually discover that a major impediment to success is their own estimating system. They have found that success lies in rethinking the pricing process. They grasp the reality that pricing is not about manufacturing cost but is really about value to client and the client's understanding of their alternatives. This paper tries to systematically lay out a path to pricing that gets as much as there is to get but it also gets the order.

WHAT'S OUR OBJECTIVE?

To begin our discussion, we should consider the objective of pricing policy. Prices in a competitive marketplace (which we surely are in!) are set by external forces—customers and our competitors. In that environment, our objective ought to be to maximize revenue. Every time that we are called upon to set a price for our work, our pricing policy should charge as much as these external forces will permit. To charge more is impossible (unless we are selling printing with a gun in our hand), to charge less is plain foolishness.

HOW DO WE PRICE NOW?

Given our revenue maximization objective, we should then ask ourselves whether our existing pricing method meets our goal. Pricing in most firms starts out with an "estimate". This is prepared by an estimator who understands his primary mission as accurately predicting the fully allocated (i.e. including all overhead) cost of producing the proposed job. This definition of cost uses budgeted hour costs which have been carefully calculated (or perhaps taken from an industry source such as the PIA Blue Book or NAPL or just inherited from your father) together with mark-ups on materials and outside purchases derived in the same way. To this predicted cost we add a profit markup which is usually an arbitrary percentage. In those now rare instances where the customer has told us to print the job without getting a quote, the pricing process may differ in that we add our profit markup to the cost sheet rather than the estimate.

In the experience of most users of this traditional approach, the actual pricing runs below that indicated by the system since our customers and our salesforce bombard us with inputs that our prices are too high while we can count on the fingers of one hand the number of times we have been told that they are too low. Thus, the system is downward averaging.

You will note that this traditional approach suffers from the anomaly that the factors it considers are internal—the cost of production while the factors that govern revenue maximization are external—customers and competitors. This can be best seen by this little scene played out across America each day. One day we hire a top pressman who can makeready on our single color 29 in fifteen minutes less than anyone else. We are immensely pleased and give him a $ 10 a week raise. Unfortunately, our estimator finds about the new pressman and, since he prides himself on accurate cost prediction, immediately lowers the makeready time in his estimates by 0.25 hours. Since our cost rate for the 29 is $50 per hour and pressman's wages are $15 per hour we have recognized the possible saving of $3.75 in wages per makeready (remember, that the overhead costs are unaffected) by cutting our price by $12.50. Our estimator

not only passed along the saving to our customers, but he marked it up before he gave it to them!

To balance this tale of dollars slipping through the hapless printer's fingers, we have the story of the printer who escaped the hour cost trap. Our hero's plant operated a heat set web producing 16 page 4 color signatures. Pricing was based on a fully allocated hour cost of $300 per hour and the output was being successfully sold. One day, after careful deliberation, a new press was ordered which would produce 32 page 4 color signatures. The firm's controller was asked to compute an hour rate for the new press. After much number crunching, he concluded that it should be $375 per hour. When he presented his conclusion to the owner it was rejected! Why, because the owner in a flash of insight realized that he was selling printing and not press time. He decided that he had not made a major investment in order to give it to his customers—the new hour rate would be $600 per hour.

Both of these real-life stories bring home the point that cost (however measured) has nothing to do with price.

WANTED: ONE CRYSTAL BALL

Earlier we said that our objective was maximize revenue and this was a process controlled by our customers and our competitors. Now, what exactly does that mean? First, the customers. Even if you had no competition (oh were it only true!) you could not charge any more for a job than it is worth to the customer. Faced with a quote for $1,000 for 500 business cards, most customers would do without since in their judgement the value added by the business cards would be less than $1,000. In the real world, we hear this every day when a customer says "the budget's tight this year, we'll have to cut back to 32 pages and go with a self cover". But since you do have competitors, their pricing policy also constrains yours. By competitors we are referring to those firms that your customer knows about, would trust with the project and has a quotation from (or, at least, has a belief as to what they would charge).

By the way, this customer/competitor relationship is at the heart of creative selling. Effective selling is really all about understanding the customer's business well enough to help him see that these business cards will really produce much more than $1,000 of value. It is also about demonstrating that no other firm than ours can be trusted with this critical project which is central to the success of the customer's business and the print buyer's career.

What we would really like to have when we come to put a number on the quote is a magic crystal ball on which we could read the value to the buyer and our competitor's prices. With this information, we could take the lower of the values subtract a dollar and deliver the quote, confident in the knowledge that we would both get the order and not leave money on the table. Pricing nirvana!

Before we leave our crystal ball, we might want to consider why we took the lowest of the values. Suppose the value to the customer was $1,000 and competitive prices were $1,100 and $900. We would pick $899 because any price higher than $900 would lead to our competitor doing the job or higher than $ 1,000 would lead to the job not being produced even if we had no competition. Of course, prices less than $899 just leave money on the table as an unappreciated gift to the customer. Too much money left on the table may even undermine your credibility. Now, it may be that, for the price indicated on the crystal ball, we don't want to do the job. That, however, is not a pricing decision and the situation is better responded to by politely declining to quote rather than identifying yourself as the high cost producer.

OK, WE DON'T HAVE A CRYSTAL BALL— THEN WHAT?

Unfortunately, crystal balls are not to be had and therefore we have to create an artificial one by building an externally driven, rational pricing system. This is easier than it appears if it is approached on a step-by-step basis.

The first step is to re-evaluate the hour cost rates and mark-ups used in your present system. This involves meeting with all of the persons in the organization with current experience in our firm's market. Those involved should include the salesforce, sales manager, CEO, possibly not the estimator, certainly not the controller (these are not bad people, their focus is just internal). The group should apply its collective experience to the question "to the best of our knowledge, what are the hour rates and markups in our market?". When their best guess is put on paper it probably won't look much different than the current rates (if it did, the firm would be in big trouble already). But we have begun to make a key transition—that of thinking of the numbers as prices rather than costs, we have begun to look outside rather than inside.

At this point, we should be thinking of developing a price list (for internal use, of course). At its simplest

form, it is a single number representing a plate, a washup, a makeready and the running of 5,000 impressions on our 29 press. In its fully developed form it is a single number representing 5,000 8.5 x 11, self cover, 2 color, saddle wire booklets. The great advantage of price lists is that they prevent accidental horrors like the 0.25 hour reduction in makeready time. In their developed form, they relate directly to the products that the customer buys and improve our ability to focus on the market. A not insignificant advantage is they save the expensive estimator from reinventing the wheel four times a day. If you think a price list would be too difficult consider that the business forms industry has used them for many years. Consider also that the typical supermarket carries 20,000 items, deals with hundreds of customers each day with different mixes of purchases by using a price list. As a final thought, estimating software running on your micro incorporates some but not all of the advantages of a price list.

CUSTOMERS ARE DIFFERENT

The next step is the real gold. It's realizing that customers are not created equal—their relationships with us are different, their buying behaviors and needs are different and that our prices should recognize this. We might begin by dividing our customer base into three groups. Class A customers—those who recognize our unique ability to deliver their time sensitive, high qual- ity projects (or where the buyer is our brother-in-law). Class B customers—the average customer, who knows us reasonably well but routinely considers several other printers as well, whose printed products may also be peripheral to his business. Class C customers—these customers think every printer in the yellow pages is an acceptable supplier, get ten quotes on every order and buy strictly on price, typically they may be a government agency.

If we think about these relationships, the Class B customer is the person we were talking about when we set our hour rates—he is "Mr. Average" in our marketplace.

But with Class A customers we have separated ourselves from all or most of our competitors eliminating or reducing the perceived competitive price problem. Chances are that we also know enough about a Class A's business to be able to make value enhancing suggestions for his printing needs. This adds up to our ability to take an additional markup on his work (and well deserved too!).

At the other end of the spectrum are class C's—the dogs. We would really like to stop doing business with them but there are just not enough A's and B's to fill our plant. If we are going to get their business we have to price to meet their values and thus our normal prices will be discounted. In practically every firm, C's, of necessity, make up part of the sales mix and pay for part of the overhead. Remember also that most new customers start as C's since at some point we have to be low bidder to get an order and start a relationship. There are C's that we don't want but when you identify them, don't call on them and don't give them quotes that you know are too high for their ballpark—it never does you any good to be identified as the high cost producer.

The power of systematic customer differentiation can be illustrated by the following example. In this case the same job (in mechanical terms) is quoted to three customers, one of each class by a firm that does not understand differentiation.

Class A quote	$1,000	Job sells
Class B quote	$1,000	Job sells
Class C quote	$1,000	No order - price too high

Total sales revenue $2,000

The same job series is now quoted by a firm that has read this monograph.

Class A quote	$1,100	Job sells
Class B quote	$1,000	Job sells
Class C quote	$ 900	Job sells

Total Sales Revenue $3,000

As you can see the second firm increased sales revenue by 50% by not leaving money on the table on the first order and by selling the third.

DID WE GUESS RIGHT?

The final step in this process is to deal with the fact that you may have been wrong when you established the hour rates, markups and customer classifications. And then too, even if you were right, the market is a moving target with competitive behavior and customer relationships changing all the time.

To address this, we need to create a feedback loop—a simple process to get real world information. You might start with a supply of red and green 5x8 cards—red for jobs you quoted on and didn't get and green for those you did. The cards will contain the

name of the customer, basic job information, and the major pieces of equipment that the job would run on as well as the quoted price. Now comes the good part—on the red "jobs lost" cards we write our best guess as to how much we missed it by (how high were we?). In the same way we enter on the green "jobs sold" cards the dollars left on the table (how low were we?).

At first brush, these two pieces of key information may seem hard to get, but that's not quite true. First in a government agency open bid situation we will know the number exactly. In others we can make an educated guess and if we are close to our customers, asking the right question will help. The important thing to remember is that our best guess number is far more useful than "I don't know" in our pricing decision process. Finally, the whole process is simplified by realizing that a minority of the jobs constitute a majority of the sales volume in most plants. On average, 20% to 30% of the quotes will make up at least 80% of the sales. In most commercial printers 75 to 100 cards per month will cover the waterfront.

Each month, sort the cards in various combinations and see what they look like. We might find that jobs running on our 6 color press have more dollars left on the table than dollars high (more greens than reds) and conclude that we can bump the six color rate. Or we might see that our Class C's are a red sea and want to increase our Class C discount to improve our sales. It's just possible we may notice that the Jones Company appears due for an upgrading from B to A. When you implement these pricing moves, it is always better to make small changes frequently rather than saving them up for the big hit. While it takes time, a monthly review and fine tuning of pricing policy is fully justified and one of the best uses of management time around.

BUT, WHAT ABOUT THE COST?

The careful reader will have noticed that we have said nothing about cost—that was deliberate since cost is an internal fact that does not relate to the external realities that determine prices (whether we like it or not). That does not mean that cost is not important to a well managed firm, it just means that is of no value as a price setting tool. After the price is determined, cost can and should be used to determine whether we wish to do the job—a go/no go type decision not a grey scale. The appropriate definition of cost for this purpose is the out-of-pocket (sometimes called variable or incremental) cost of production. This includes materials and outside purchases at cost, factory direct labor wages and sales commissions. It does not include overhead (whether factory or administrative) or any cost which would continue if the job were not produced.

The general decision rule is that any job which will produce sales revenue greater than out-of-pocket cost should be accepted and all others rejected. This assumes that the firm has the plant capacity to produce the job and that it does not conflict with another job. If there is a delivery conflict (we can't run both jobs and meet the delivery requirements) or full plant capacity has been reached, then we would prefer the jobs that produce the highest excess of revenue over out-of-pocket cost.

GO FOR IT!

Firm after firm has found that gaining control of the pricing policy and making its optimization a management priority has provided better returns than any other management initiative.

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