Managing the Schizophrenic Role of Costs in Your Business

Jon Manning

Managing the Schizophrenic Role of Costs in your Business

According to the World Bank, the global economy (including Australia's), is in for several years of above average inflation and below average growth, a phenomenon that Economist's call "stagflation". There is a generation of business owners who have never had to operate in this sort of economic climate before, and they will need to juggle a different set of tools to manage their businesses.

Costs play a schizophrenic role in many businesses. On the one hand, if you can **manage costs** to below the amount of revenue you earn, you are in profitable territory. But if your business also uses cost-plus pricing (and by some estimates, 70% - 80% of companies do just that), then you are trying to manage your revenue in one direction and your expenses in another direction with the same tool, despite there being better tools in the toolbox.

Those better tools are **pricing management** and **behavioural economics**. And when combined with cost management, all three tools will better position your business to pass on price increases without losing customers, rather than trying to juggle the impact of costs on top-line revenue growth and an expanding costs base.

Ω Ω Ω

Pricing is always a huge challenge for businesses large and small, but for the many companies that don't manage pricing strategically, the current economic climate is making pricing a much bigger headache than normal.

There are around 2.5 million companies in Australia (2 million of which are Small & Medium-sized Enterprises) and a large chunk of them will be using cost-plus pricing. Its a methodology that involves totalling up a product or services' costs (that's the 'cost' bit in "cost-plus"), adding on a desired profit margin (that's the 'plus' bit) and BOOM, you have a price.

The problems with this methodology are numerous: calculations of costs and the mark-up can be flawed, you can over-price in weak markets and under-price in strong markets, there is a strong tendency to focus on historical costs while your prices are geared towards future sales, and the methodology pays little attention to demand.

And if you've been using cost-plus pricing over the last two and a half years of the pandemic, you've probably spent more time managing expenses than you have managing prices, revenue, and profits.

While the pandemic has been both a health and an economic crisis, from an economic perspective, I've seen three distinct phases:

1) An initial "Business Model Adaption" phase, where companies scrambled to adjust their business models to survive (e.g., introducing contactless payments, contactless delivery services, work-from-home arrangements and technology, etc).
2) Then there was a secondary phase when businesses started recouping some of the investments made in the previous Business Model Adaption phase through price increases. This started to manifest itself as "transitory inflation", with many commentors expecting a period rising prices to be short-lived.
3) But as we started turning the corner (?) out of the pandemic in 2022, many companies realised they had gone two years without

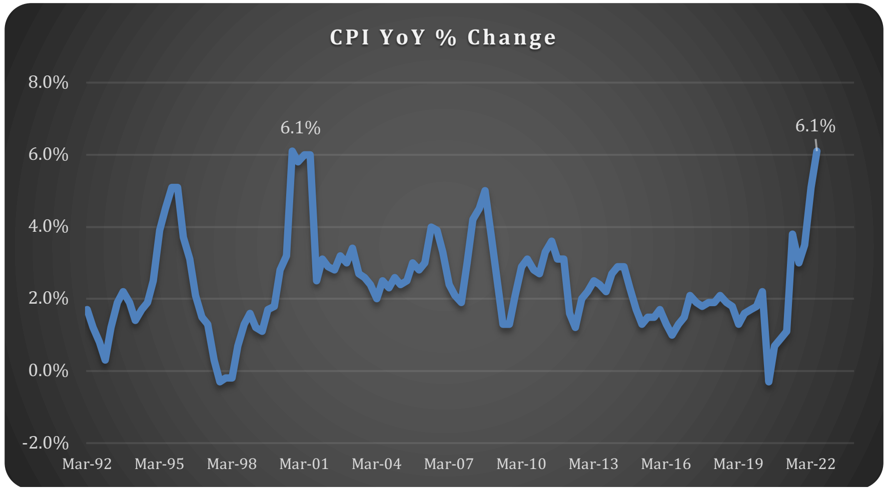
increasing prices, Russia invaded Ukraine, and that transitory inflation became anything but transitory. Some even called it "Putinflation".

In the first "Business Model Adaption" phase of the pandemic, costs played havoc with Australian businesses, as the following data points from the Australian Bureau of Statistics, released in March 2020 [1] prove:

- ✓ Fifty percent (50%) of Australian businesses made changes to their workforce, mainly a reduction in the hours staff work.
- ✓ Thirty-eight percent (38%) of businesses changed their methods of delivery.
- ✓ Thirty-eight percent (38%) of Australian businesses renegotiated property rental or lease arrangements.
- ✓ Twenty-nine percent (29%) of Australian businesses reported difficulty sourcing raw materials.
- ✓ And twenty-four percent (24%) of Australian businesses deferred loan repayments, which were funding investments in things such as stock, materials, vehicles, and technology.

During the second phase of the pandemic prices slowly started to rise, but the anticipation was that these price rises would only be temporary. Some companies started to recoup their investments in business model adaption. Scarcity was in abundance as supply chains across many industries became increasingly congested. Hundreds of container ships awaited berths at major shipping ports like Singapore, Shanghai, Rotterdam and Los Angeles/Long Beach, unable to load or unload. Growers, shippers, suppliers, wholesalers, manufacturers, retailers - everyone was affected, and this inflation was not demand-driven.

But as we started to emerge from the second year of the pandemic, inflation changed from transitory to entrenched. In the June 2022 quarter, Australian inflation reached 6.1% pa, a level last reached following the introduction of the GST (see chart below), as companies realised they hadn't changed prices for two years now. The driving categories of this inflation was transportation, housing and household expenditure.



On top of that has come the recent Fair Work Commission decision on 15th June 2022 to increase the national minimum wage by 5.2%, followed a couple of weeks later by an increase in the superannuation guarantee rate from 10.0% to 10.5% on 1st July 2022.

[1] ABS, Business Impacts of COVID-19, Week Commencing 30th March 2020

So, what should an Australian business, possibly utilising cost-plus pricing, do in this sort of environment, other than throwing their hands up in the air in despair?

- **Firstly**, understand which costs are rising and where, as well as where they are not rising. For a manufacturer, that may mean looking at raw material costs, for a tech company it may mean looking at software licences and office costs. Are these costs rising in urban markets and not regional markets, are they rising on some materials and not others? Understand the dynamics of your cost base.

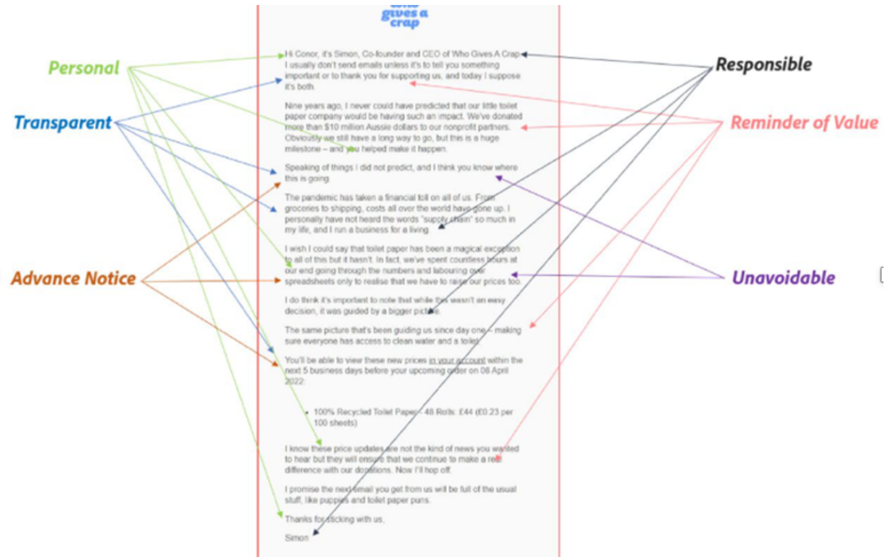
- **Secondly**, have you got under-performing assets or locations that you could close to eliminate expenses. Too much office space, perhaps? If you've moved to offering a delivery service during the "Business Model Adaption" phase mentioned above, do you still need (all) your physical, bricks-and-mortar locations? With rising fuel prices, large car-dependant locations are likely to struggle with footfall and sales. Getting these assets off the books can help lower rent, utility and financial expenses.

  You may also want to re-prioritise any geographic expansion plans, favouring markets where the signs of demand and growth are strongest.

- **Thirdly**, review your working capital (inventory, plus what is owed by customers, less what is owed to suppliers). Have you got too much inventory, or some obsolete or slow-moving items you should fire sale? Have you got the best terms from suppliers, and are your own terms and conditions optimal? In Inflationary times, you're much better off getting cash today than customers paying you in 30-, 60- or 90-days' time.

- **Finally**, you need to be effective with communicating price changes. Customers rarely care about your costs (more on what they do care about below), but right now, you in effect have a license to justify a price increase on the basis of rising costs, be it via an email or letter to customers, or a sign on the shop window or by the cash register.

What does a best practice price changes communication look like? As you can see from the example below, it has six hallmarks: its personal, its transparent, it gives advance notice, it explains responsibility, its reminds readers of the value you provide and it explains why its unavoidable.



Separating cost management from pricing management is the first step in getting on top of your rising costs in times of stagflation. Let's now turn the attention to initiatives focused on pricing management and customers.

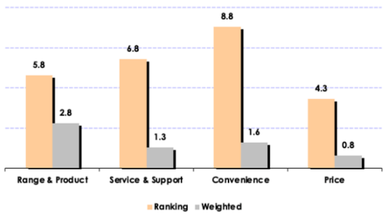
Ω Ω Ω

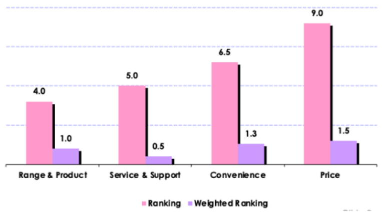
Lets now turn our attention to **pricing management** and **behavioural economics** as a stagflation tool: why it is more important to use value rather than costs to manage pricing, as well as understanding customer psychology. Combining the three tools should solidify the elusive skill set of being able to pass on price increases without losing customers.

I have already devoted a fair amount of column space in this piece to talking about costs, while also pointing out that customers rarely care about them. What they ultimately care about is value.

A few years back, as part of a consulting project I was engaged for, I asked florists what was most important to them when it came to dealing with a wholesaler, asking them to allocate 100 percentage points across four attributes. Range and Product attracted a 45.8% weighting, Service & Support and Convenience both weighed in at 18.3%, with the balance of 17.5% being associated with price.

I then asked the florists to rank their wholesalers across those attributes on a scale of 1 – 10. The graph's below show the raw scores, as well as scores weighted by the percentages above, for two wholesalers.





The wholesaler on the left is focused on providing value by focusing on Range & Product, Service and Support, and Convenience. This has enabled them to successfully de-sensitised customers to price. The wholesaler on the right on the other hand, has been less successful in capitalising on non-price value attributes. It is not difficult to work out which wholesaler understands the value s/he provides and thus has the pricing power to command higher prices.

Beside understanding the value that you provide, how else can pricing management help you through this stagflation environment?

- **First**, take a segmented approach to products, customers, and pricing. Start by identifying KVI's (or "Known Value Items"). These are the products and services that your customers know the price of off the top of their head. You should also identify non-discretionary products that will remain essential to customers through good times and bad. Leverage the differences in demand, in different geographies, and adjust product-specific prices, upwards and downwards accordingly (not across-the-board).

- **Second**, adopt the same segmented approach with any promotions. Remembers that excess inventory you found while looking at your working capital above? Put that on promotion, rather than the inventory for which demand is still healthy.

- **Third**, when running promotions, always time-box them with start and end dates and conduct a Post Implementation Review (PIR) at their conclusion. Answering the following questions, and applying the learnings, will make you next promotion even more successful:
  - ✓ What was supposed to happen?
  - ✓ What actually did happen?
  - ✓ Why was there a difference?
  - ✓ What can we learn from this?

- **Fourth**, take stock of both your brand power and brand positioning. How did Unilever raise prices 8.3% in Q1 of 2022, and their volumes declined by only 1%? How did McDonald's, in the same quarter, raise menu prices by 8% and grow overall sales by 3.5% and same-store sales by 11.8%? [2] Heinz's 12.4% price rise in Q2 yielded a 2.3% drop in sales units but a 10% increase in sales value. [3]

Not all Australian companies have the brand strength of Unliever, McDonalds or Heinz, which would have undoubtedly been a factor in the results mentioned above. But for a SME running multiple brands, manage them properly. If you've got one brand selling non-discretionary products, geared towards price sensitive customers, that's where your demand is likely to remain the strongest, rather than a premium priced brand selling discretionary products.

- **Fifth,** consider changing your pricing model. Consumers and customers are more likely to try something new in difficult economic times than when things are going along swimmingly (which explains why companies like IBM, Microsoft, Apple, Uber, Airbnb (to name a few) were started during recessions or difficult economic times).

  For example, can you introduce dynamic pricing If demand varies by, say, the hour of the day, the day of the week or month of the year. Airlines do it, hotels do it. While writing this article, Mercedes Benz were advertising a C Class vehicle on Melbourne radio station 3AW as "dynamically priced".

- **Sixth**, can you de-risk big purchases for your customers? In 2009, Hyundai in the US offered to buy their cars back if customers lost their job. The US car market fell by 20% in 2009, but Hyundai's sales increased by 8%, and they only purchased 50 cars back from customers in the first 9 months of this campaign.

- **Finally**, give some thought to the following:
  - ✓ accepting a customer on a lower-priced product is a better outcome than losing them altogether.
  - ✓ Revisit your terms and conditions. T&Cs are how you get the prices you set. Revisit clauses such as payment terms, upgrades, downgrades and cancellations, for example.
  - ✓ Are there extra's or value-adds that you can provide without increasing your own cost base (like electronic data interchange, advice or research, for example)?
  - ✓ If you have a pricing forum / council / committee, this should now meet a bit more frequently, changing prices accordingly. If you don't have one, you should.
  - ✓ Introduce temporary surcharges, for example to reflect the higher price of fuel, while leaving the price of your own products and services at their current levels. This associates the price change with factors unrelated (or less related) to you, and outside of your control, preserving margins on your own product. They are easier to withdraw later, without diluting your own pricing when the time is right.
  - ✓ Unbundle products and services. Offering them individually priced will create cheaper perceived price points.

The best way to manage price is with a dedicated pricing function. In many businesses, pricing is a **"tragedy of the commons".** It attracts too much attention from internal stakeholders across the entire business who are pursuing their own goals (Finance want higher prices, Sales can't sell without discounts). This often manifests itself in an undisciplined approach to external customers, and as a result of the under-investment in pricing, it never becomes a strategic corporate capability and competitive advantage. The current challenges ailing the Australian construction industry might have

[2] Chaudhuri, Saabira (2022, April 29). Unilever Increases Prices over 8%, Hurting Demand. Wall Street Journal, B6. And Haddon, Heather (2022, April 29). McDonald's Price Increases Help Boost Sales in the U.S. Wall Street Journal, B3

[3] Butler, Sarah (28th July 2022) Double Digit price increase pays off for Heinz and Reckitt, The Guardian, p33

been avoided if this action had been taken (20:20 hindsight acknowledged).

The other pricing opportunities for SME's is to apply some of the learnings from **Behavioural Economics**, a body of thought that combines economics and psychology. It looks at how humans actually behave in markets and how they make choices and decisions, rather than how orthodox, neo-classical economics has thought humans should behave. It is the difference between what a rational, selfish and independent (wo)man says they will do, and what they irrationally actually do. And if there are times when consumers are going to act more irrationally than normal, it's the times we are living in now.

A large number of heuristics has evolved from this body of knowledge that can be applied not only to the pricing of products and services, but also the acquisition of customers, sales generation or customer loyalty (to name a few). Here are some of those "hacks" that have the potential to further assist you through the current difficult trading conditions.

- **The Weber-Fechner Law:** Tell customers they are getting a discount. If you're at a clothing store and you see two dresses (or suits), one for $349 and the other for $399 with $50 off, which one do you buy? Despite both offers being identical, more customers will buy the latter. Why? Because they can see they are getting a deal.

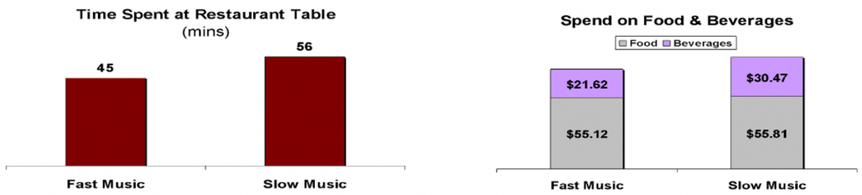
  Consumers today love "the thrill of the hunt" (finding a deal) and "the thrill of the kill" (getting the deal and the bragging rights that accompany a discounted purchase).

- **Decoys**: Consider introducing a "decoy" offering, with a high "shock price" that makes existing alternatives look more attractive. Norma's restaurant at Le Meridian Hotel in New York has a $1,000 omelette on its menu to make the $100 omelette look good. Many fine dining restaurants have an $800 bottle of wine on their menu, which few, if any diners purchase. But it helps sell the $80 bottle of wine.

- **Offer a Five Star Experience:** Invest in the context in which your prices appear, whether it's in your store, on your website or in your quote or business proposal.

  In the 1980's, Nobel Prize winning Economist Richard Thaler conducted the famous "Beer on the Beach" experiment". Your best friend, with whom you are enjoying a day at the beach, offers to get you an ice-cold bottle of your favourite beer from the run-down grocery store at the end of the beach and asks what you're willing to pay. Changing his mind, he then asks what you'd be prepared to pay for the same beer purchased from the five-star hotel at the other end of the breach. Like the dress / suit example above, the offers are identical, but Thaler's research found the willingness to pay is higher at the five-star hotel than the run-down grocery store for an identical product.

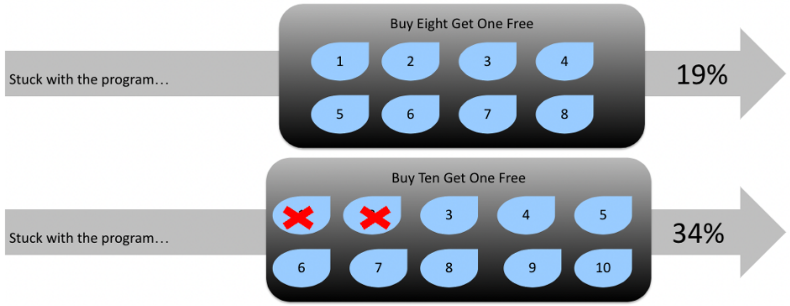
  Having improved the context in which your prices are seen, how about improving the **ambience**? An 8-week restaurant study found that customers spent 11 mins more at a table when slow beat music was played (compared to fast beat music), resulting in their beverage spend increasing by 41%, and total gross margins increasing by 15%.



But staff in a data input centre processed 12.5% more vouchers when listening to fast music (compared to no music) and 22.3% more vouchers when compared to slow music.

- **Choice architecture:** Always offer customers three options, with the equivalent of (but better names than) "Good / Better / Best", or "Small / Medium / Large". If you offer customers one choice, you've got a 50:50 chance of closing the deal, and that's it. If you offer two choices, you will force the customer to make a price-based decision (and in the majority of purchase decisions, that will be the cheapest of the two). But when you offer the customer three choices, two things happen: firstly, you force the customer to make a value-based decision and secondly, they ask themselves "which one do I buy?" not "should I buy?".

- **Help the customer reach their goal:** In an experiment conducted at a Los Angeles car wash, 19% of drivers visited 8 times, enough to earn a free car wash. But when the first two washes on a 10 wash loyalty card are crossed off pro bono (once again, making both offers identical), 34% of customers visited the car wash eight times, earning the free clean.



- **Finally**, some other ideas to tick of the list:
  - ✓ Mention the daily equivalent price, rather than a weekly, monthly or annual price.
  - ✓ Remove the dollar symbol from price list (it reinforces that customers are parting with their money).
  - ✓ Count the syllables in your price points. Prices with more syllables are perceived as more expensive than those with less.
  - ✓ Focus on the price difference: if the price is $200 and the customer wants to pay $150, focus the discussion on the $50 difference.
  - ✓ And provide social proof: this is our most popular product.

As Churchill once said: "Never let a good crisis go to waste". For many Australian businesses, getting their pricing in better shape during this difficult trading period would be a Churchillian achievement.

Managing the Schizophrenic Role of Costs in your Business

About the Author

Jon Manning is the Melbourne-based founder of www.PricingProphets.com, a start-up mentor (at MAP, AIM, Blackbird Giants & River City Labs), a micro & behavioural economist, and the author of the most ridiculously titled book ever: "Overcoming Floccinaucinihilipilification: Valuing and Monetizing Products and Services", a guide to value-based pricing for start-ups, entrepreneurs, and side-hustlers.

Jon has +30 years of experience in pricing strategies, pricing models, business models, monetisation and the use of behavioral economics and pricing psychology.

Over the years, Jon has completed dozens of consulting projects for companies in the Dow Jones Industrial Average, the Fortune 100, the FTSE100 and the CAC Next20 stock market indices, and in the process has generated millions of dollars in incremental revenue for clients in places such as the UK, USA, India, & Australia. One recent client quipped *"for every $1 we spent on you, we got $166 back."*

Jon holds a Bachelor of Business (Applied Economics) from Deakin University (Australia), a Graduate Diploma of Business (Management) from Monash University (Australia) and a Master of Arts (European Studies), from the University of West London (formerly Thames Valley University) in the UK.

His articles have been published in The Journal of Professional Pricing, The Journal of Revenue and Pricing Management, The Pricing Advisor, The Wiglaf Journal.

About Pricing Prophets.com

Most people in business frequently talk to an accountant and a lawyer, but why don't they talk to a Pricing expert? One reason is that they don't know Pricing experts exist and another is that they don't know there are alternatives to the 'traditional' cost-plus approach to Pricing.

In 2011, Jon launched the world's first and only crowd-souring pricing advisory service (PricingProphets.com) where companies can ask a panel of global pricing experts and thought leaders what price they should charge for a product or service and why.

Today, PricingProphets offers pre-paid telephone calls with pricing experts from all around the world.

http://twitter.com/PricingProphets

http://www.youtube.com/user/PricingProphets

http://au.linkedin.com/pub/jon-manning/0/96/664

http://www.linkedin.com/company/pricing-prophets