Business Learning by Dan

Understanding out Members' Businesses: Price and Volume

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"Wow! That's sticker shock!"

Who hasn't felt sticker shock when shopping these days? It's almost like some merchants are insulting you with prices. Recently, I paid as much for a single serving of my favorite beverage at a sporting event as I would have paid for a case at the grocery store. I complained. My wife pointed out that I still had a choice. Nonetheless, I still bought it. There was no way I was watching Olympic Curling without my favorite beverage. Ah, the pause that refreshes.

I'm reminded that customers look at pricing very differently than businesses do. Businesses have overhead, fixed costs, variable costs, owners, and other interests that affect the prices they charge. Customers are simply looking for the best deal.

Or are they?

Actually, if you think about it, customers are actually looking for the best value, not necessarily the lowest price. This principle is important. Everyone in your company must align to the value the business provides, otherwise your products and services are seen as "the same as" everyone else's. A commodity, if you will. I would guess that your senior management does not view your company as a "commodity."

A business will be successful if it can charge a bit more for its product or service than it cost to produce it. This is a fundamental rule of business. Some say, the only rule of business. Yet, it takes a bit of thought to apply this rule to your specific business.

Here is an example. Let's say you are an aircraft engine manufacturer. You are paid $1 million to deliver an engine to Boeing. It costs you $750,000 to produce it. Good deal? Perhaps. With a volume of one engine delivered, you've made a cool quarter of a million dollars.

How about another example. Now, you're an ice cream novelty company making ice pops. You are paid $1 to deliver one ice pop to a customer. It costs you $0.75 to produce it. Good deal? Perhaps. With the same volume, you've made a cool *quarter*. Ouch.

You see, pricing is one thing, but the relationship between the price we charge and the volume of our sales is quite another. Sure, if we charge enough, we don't need to sell much volume to make enough profits. However, if we charge a low price, we need to sell quite a bit more to make the profits we need.

Review this graph. I've illustrated three pricing strategies. Which one makes the most business sense?

	Here's where we start.	1. Let's raise prices 5%. What will happen?	2.Let's sell 50% more at the same price. What will happen?	3.Let's cut prices and sell more. What volume is needed?
Volume Sold in Units	100	100	**150**	**300**
Price per Unit	$100	**$105**	$100	**$95**
Sales (Price X Volume)	$10,000	$10,500	$15,000	**$28,500**
Cost per Unit	$90	$90	$90	$90
Total Cost (Cost X Volume)	9,000	9,000	$13,500	**$27,000**
Gross Profit	$1,000	**$1,500**	**$1,500**	**$1,500**

Example 1: Look what happens when we raise prices at the same volume sold. Our prices went up 5% but our profits went up 50%. We call that leverage.

Example 2: Look what happens when volumes increase 50%, but our gross profit also goes up 50%. That tells us that simply selling more volume may not be as efficient to our bottom line.

Example 3: Finally, look what volume we need if we reduce our prices and expect to make the same profits improvement. Wow! We'd need to double our volume in order to meet the same target that a 5% price increase earned us!

So, should we raise prices? Not necessarily. A more realistic and pragmatic view is to charge for the value you provide. Listen to the voice of the customer and study how they respond to pricing. For example, the reason that iTunes songs are $0.99 is that Apple learned that $1.00 was too much, and $0.98 was too little. You want to get the pricing and volume right, so you can maximize the potential returns.

Consider these questions for your company:

1. What would happen if you reduced revenues by 5% but kept volume constant? What impact would that have on profit?
2. What if you sold 10% more volume at 10% lower prices? What impact would that have on profits?
3. What if you sold your products at 2% higher prices, with value added services? What volume decrease could you see and still be more profitable than if you did nothing?

Your leadership is likely working on these questions as we speak. The training and development function at your company ought to align its content to drive the price and volume strategy at your company. If you are focusing on volume, are your people efficient, low cost, accurate, and timely? If you are focused on pricing, are your people experts in their field, knowledgeable, in demand, innovative, and differentiated?

By understanding price and volume, everyone in your company can better align their efforts toward business success. The price we charge and the volume we produce have a direct impact on the overall success of the company. Your leadership has a strategy for moving this forward for your company. How are you aligning training to deliver it? I'm thirsty!

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