Profit is not a dirty word

By David Kane and Josée Santoni

Why do some people associate profit with greed and criminality?

Profit is quite a straightforward concept: it's simply revenue less costs. It's an essential element for any organization that intends to stick around.

Most people fully support this concept. For some, however, a large profit is a sure sign of a scam, or a company that is taking advantage of customers and suppliers.

Films such as *The Tin Man, Glengarry Glenross* and *Wall Street* do little to change this image. The recent events surrounding Enron, Tyco and the like tend to associate profit with greed and criminality rather than seeing it as a reward for a good product, sound strategies, hard work and innovation.

Michael Douglas's line in *Wall Street* -- "Greed is good" -- may be a little extreme, and it is not necessarily ethical or moral. However, it does encapsulate a very focused business objective.

How much is enough?

Why is it that commodity businesses operate on single-digit margins, while technology or pharmaceutical companies set theirs much higher? Why does bottled water sell at a higher price per liter than does gasoline?

It's not that the inherent value of the product justifies the price; it's that the manufacturer is committed to sell its product based on the product's perceived value in the eyes of the consumer. So it is the market's determination of value that dictates pricing, thereby affecting margins. As long as the product or service satisfies the needs or desires of the target market, this perceived value determines the selling price.

Greeting cards are a prime example of price/value incongruity. They sell at an average price of $4 or $5 – almost the same as photo albums that are capable of storing 100-plus photos. Here we have an industry that promotes the value of sending greeting cards and expresses this value in terms of the emotional satisfaction enjoyed by both the sender and the recipient. It would be inappropriate -- even offensive -- to put a price on such a joyful and considerate act.

Photo albums, however, are usually promoted on price. Even though billions of photos are developed every year and consumers place great value on their cherished memories, about 90% of all photos are stored in shoeboxes and envelopes. (Anyone interested in a business opportunity?) It was interesting to see Rubbermaid take advantage of this opportunity by offering a new plastic container that helps organize and protect valuable personal memories such as photographs.

Managers, especially accountants, are undisputed experts at managing the cost side of the profit equation; but only true marketers know how to develop and manage pricing strategies that maximize profits. Marketing and product positioning are crucial to the success of any business.

Do not leave money on the table.

One way to maximize profit is to understand the value clients see in your product.
Researchers often use focus groups to determine this value and to identify some of the softer elements that can be used to promote the product. They ask three questions:

1. What would you be willing to pay for this product?
2. At what price does this product become so ridiculously expensive that you would not consider buying it?
3. At what price does this product become so inexpensive that you start to question its true value?

This approach allows marketers to determine a range of value rather than a specific price. Researchers can also position the product in different ways to determine what impact this will have on the product's perceived value.

Price competition is ferocious. It is designed to drive volume. But some sellers are quick to play the price card without fully understanding the buyer's mindset. In so doing, they leave potential revenue on the table for fear of losing the sale.

Sellers without a conscious "will not be undersold" strategy are reinforcing the belief that there is always room to negotiate. Therefore, the buyer will expect a better price the next time around. The focus then shifts from determining fair value to winning the negotiation.

If you have ever been in sales, you will understand the temptation to play the price card and to play it early because it is easily understood by both parties and it is an effective tool in closing the sale. Wal-Mart has made a conscious decision to play the price card all the time. It has decided to make its money on turnover and low-cost operations. It needs volume to achieve its objectives. This is a very sound and well-executed price strategy.

Effective as the price card can be, it is not the only option. For example, Saturn has adopted a fair price strategy and leaves little room to negotiate on price. Saturn is convinced that it is offering good value for the posted price and expects to make a reasonable profit in doing so. The company will not sacrifice per-unit contribution for higher volume. In adopting this strategy, it is expressing confidence in its product; it also intends to differentiate itself from the rest of the market and to maximize profit in the long run.

Strategies must be well executed to be successful. A colleague recently bought a household item at a large department store. At the cash, she commented that the price was higher than anticipated, but she was still willing to pay. She was not complaining -- simply making a comment. The clerk then told her the product would be on promotion within a couple of weeks and if she came back with her receipt, she would be reimbursed for the difference.

Quite a conundrum: the sales clerk was doing his job by providing good customer service, but the organization gave up some of its margin. However, this flexible price strategy should generate interest in the products offered, help promote the outlet's price competitiveness and instill confidence in the consumer. This strategy is as sound as any other, as long as the interest generated is converted into sufficient additional sales.

As we were writing this article, our cellular supplier called to say our voice mail service, for which we pay $6 a month per account, will be offered free for the next three months. In other words, we will get a 10% reduction for being good customers. Of course, the supplier offered us another service but we didn't have to take it. With this strategy, the company hopes enough customers will buy the additional service to compensate for the $18 rebate given to each voice mail customer.

In the end, it is about trade-offs: higher profit per unit versus higher volume and reduced margin. It is all a matter of strategy.

The treacherous road to market development

Since pricing is based on perceived value, it makes sense to promote this value. This costs money – often a lot of money, sometimes with limited short-term gains.

There are many ways to promote your organization, brands and products – everything from trade shows to magazine articles to advertising campaigns.

We recently spoke to an entrepreneur who had generated a major consulting assignment in northern Africa through a lot of hard work and perseverance. While the increase in volume gave him cause to celebrate, the cost of maintaining the relationship with the client and controlling resources thousands of miles away was higher than forecast. He ended up with a break-even situation. So, even though he didn't lose money, he still increased the company's legal exposure by taking on the new business.

In these types of "no margin" transactions, the justifications are many and varied: "At least it increased our sales," "We learned from the experience," etc. Even though such ventures are sometimes useful, or even necessary, they must be undertaken only when the long-term benefits have been clearly identified.

In a recent *Time* article, Sherry Lansing, chair of Paramount Pictures, expresses her contempt for the rest of Hollywood's obsession with market share; i.e., the annual ranking of studios based entirely on box-office receipts. "It's a meaningless thing," she says. "What we should talk about is profitability."

In any case, all types of market development activities need to be thoroughly assessed. What trade shows should be attended? What advertising campaign will be most effective and how many additional cases of product must be sold to recover the related expenses? Is this client strategic enough to justify a severely reduced margin?

But these questions are not easy to answer. Think of the milk moustache campaign in the US -- a highly successful ad campaign according to many in the advertising community. But statistics show it has done little to increase per capita consumption of milk. Supporters claim the decline would have been greater without the promotion. This is a valid statement, but extremely difficult to quantify.

The key here is if you are going to make the effort, make sure there is something to gain.

Profit isn't good or bad; it is essential

It has been said that in business, there is no other scoreboard than profit. This always generates many objections and discussions but whether you like it or not, it is true.

For good, honest organizations, profitability is the result of a lot of hard work, good management -- and a little luck. A business that generates a profit can also choose its future direction. It can create jobs and security for many, sponsor research and good causes and invest in earth-friendly technologies.

When profit is scarce or non-existent, budgets are reduced and layoffs occur. Employees may look for greener pastures and the company runs the risk of spiraling out of control.

Profitability is the lifeblood of an organization. You owe it to your employees, customers, suppliers and investors to maximize it. Make sure you understand perceived value, do not leave money on the table, and do not give anything away for free. Promotional and market development activities are good only if they truly improve your situation. Be wise and be blunt.

Business is not forgiving; you can't afford to be, either.

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