How to Generate More Profit in a Low-Margin Industry

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Do you work in an industry that is described as commodity? I worked in one of these industries: materials handling (or forklifts). Quite a number of years ago I was asked to help set up the pricing and pricing strategy for a forklift company. When I started to look at the numbers in detail, it struck me that it was a "cost-plus" culture. We'd get the forklift from the factory overseas, and there'd be a cost and a mark-up percentage put on it. It didn't matter what the forklift was, the capacity, model or type-- the same percentage mark-up would be applied.

I started to dig a little bit deeper and I began to notice some anomalies: I found an anomaly in one of the forklift capacities, which was the 7 tonne forklift capacity—but there was no 7 tonne forklift?

In other words, is there a particular product or service in your portfolio that is being grossly underpriced, and where you could increase the price substantially and not lose a single unit of volume?

Or, alternatively, you could actually sell more. In fact, that is exactly what happened in the case of an alcohol company: They rebranded and rebadged some brandy from $700 a bottle to $1500 a bottle and they sold out. That kind of pricing power is not necessarily apparent in materials handling, but substantial earnings improvement is possible.

Here's how: Traditionally, the most popular forklift is the 2.5 tonne capacity forklift. If you think of the leading keystone product in your industry or portfolio, the 2.5 tonner is the equivalent and the gross margin is around 15% margin on sell. When you go down in capacity, the margins actually contract as well. So, when you look at the smaller capacity forklift, the 1.5 tonner, you end up with margins of between 5 and 7%. Very slim—and it's also a high-volume game. Sometimes it can be a leader into selling the higher capacities.

So, you would think there is a possible trend here—that higher capacities do equal higher margins. Well, that's true in some cases, but when it came to the 7 tonne forklift we found the margins to be substantially greater: We were able to sell them for 25% margins. With these particular gross margins, what I learnt was:

- Never apply a mark up to a category, to set prices
- Always identify, at a micro level, the value proposition of each of your products
- Reverse-engineer your sell price--**not** based on the margin that you are going to make, but on the ***value*** that that product or service represents to the customer.

Now, in keeping with our framework of value in use and value at risk (which you may have seen in one of our other whitepapers or clips on the core value management system), the reason this 7 tonne forklift can demand such high margins and a high dollar value is because it's used often in the timber industry or the mining industry and they cannot afford to have downtime or any kind of equipment breakage. It needs to be sturdy equipment—and so they are prepared to pay a premium to avoid that "value at risk" component that we talk about, and to ensure maximum uptime. This is what drives that particular margin outcome.

So, in summary: Avoid “cost-plus” at all costs. If you don’t, you’ll end up overpricing your product and possibly losing volume--or underpricing your product and losing margin. And always price your product according to its value to the customer--not traditional mark-up or margin on sell per category.

To arrange a discovery call, please go to www.pricinginsight.com.au to schedule a booking.

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