Chapter 1

Ignorance Isn't Bliss; It's EXPENSIVE

Every business owner I've met has been able to tell me exactly why his offerings are better than his competitors'. Yet, when I ask how he prices his offerings, he's almost always *at or below* market. Why this incongruity? Here are some of the more common reasons I'm given:

- We don't have the name awareness of the big boys
- Our customers only care about price
- Our competitors won't raise prices, so we can't
- We'll lose sales (market share)

As you'll see later in this chapter, these "reasons" are smoke and mirrors. They mask the real reason why business owners don't charge higher prices – *they don't know how to convert value into dollars and cents*.

Unless you've entered business from an accounting or finance background, you are probably experiencing the same problem. You simply haven't been trained to make these conversions. We're going to remedy that in Chapter 3, "Elementary School Math: Quantifying Value." Before we do, let's take a look at how costly this lack of knowledge can be.

Costly For You

First, let's look at lost revenues and their impact on your bottom line. Then we'll look at some less obvious costs.

Lost Revenues: Leaving Money on the Table

In this section you're going to get a sense for how much money you're leaving on the table because you don't have the tools to quantify value. We're going to begin with some illustrative price increases to demonstrate the magnitude of the dollars available to you through price increases. In Chapter 3, we'll get into the specific formulae you need to determine what price increases are available to you for the products and services you offer. For now, I simply want you to get a sense for the dollars you're foregoing. Let's begin with a very small increase.

What would a 1 percent price increase do for you? There aren't any additional production costs or overhead costs associated with a price increase. Although you have to pay additional income taxes, the rest of the price increase falls to your bottom line. How much is that? Here's the formula for a 1 percent price increase:

(1% x revenues) – (revenue increase x income tax rate) = bottom line improvement

Table 1-1 shows what a 1 percent increase would do for the bottom line of three different size companies (state income taxes have been ignored for these calculations because the rates vary from state to state and some states do not have corporate income taxes).

Current revenues	$1 million	$10 million	$100 million
1% increase	$10,000	$100,000	$1,000,000
Federal corporate income tax rate	35%	35%	35%
Income tax	$3,500	$35,000	$350,000
Profit gained from a 1% price increase	$6,500	$65,000	$650,000

Table 1-1 Bottom Line Potential from a 1% Price Increase

Before you begin dreaming about how you'd use that extra money, let's do the same calculations for 3 percent, 5 percent and 10 percent price increases. Table 1-2 shows the results you could expect from each of these price increases.

Current Revenues	$1 million	$10 million	$100 million
After tax profit from a 3% price increase	$19,500	$195,000	$1,950,000
After tax profit from a 5% increase	$32,500	$325,000	$3,250,000
After tax profit from a 10% increase	$65,000	$650,000	$6,500,000

Table 1-2 Bottom Line Potential for 3%, 5% and 10% Price Increases

When you performed the 10 percent calculation, did you experience some queasiness? Was your heart was beating a little faster? Did you have visions of your customers racing to your competitors? That's natural. The reality is that a 10 percent higher price has little impact on a committed buyer. Here are some examples that demonstrate how I can make that statement with such confidence.

Let's say that you're a car aficionado and you really like the Lexus. How much more will you pay for that Lexus over a Camry? A Lexus sedan starts at $31,155; the Camry sedan is $19,145. The price of the Lexus is 62 percent higher than the Camry. That's a lot more than the 10 percent we've been talking about.

You're probably thinking, "That's fine for people who can afford the Lexus, but not everyone can." You're right – to a degree. People have to be able to afford what they're buying, but they'll find a way to afford what they want. I'm sure that you've driven by an old, weathered, and shabby mobile home only to be surprised by the presence of a brand new $30,000 pickup truck in the driveway. You've seen fifty-year- old, 900 square foot houses with a $100,000+ recreational vehicle parked in front. Those are examples of people paying premiums for what they truly want, and those premiums are well beyond 10 percent cited in the examples above.

What are you willing to pay a premium to get? Let's say that you want a new sweater. Where are you going to shop? Penney's, where you'll get an attractive, serviceable sweater for a modest price? Macy's, where you can get a designer brand, but pay about twice the price of the Penney's sweater? Nordstrom's, with its incredible ambience and exceptional personal service, where you'll pay four to six times (yes, that's 400 percent to 600 percent) more for your sweater than you would at Penney's? It depends on what you want – on how important image and service are to you.

You've got your new sweater and you're dying to show it off when a friend calls wanting to meet for a drink. "What'll you have?" asks the bartender. Indeed, what will you have? You order Jack Daniels bourbon. Did you know that Jack Daniels' bourbon whiskeys range in price from $18.98 to $49.99 for a 750ml bottle? The highest price is almost three times the lowest price offering.

The point is that people make trade-offs in their spending. They'll pay as little as possible for things they need, but don't want. Conversely, they'll pay extraordinary premiums for things they want, but don't need. As you've seen these premiums can be as high as 600 percent. Actually, it's higher if you're a technology junkie.

People who simply must have the latest greatest technology will pay as much as 12 times (1,200 percent) what they'd pay when market saturation has been achieved. If you doubt that, look at the history of VCR and DVD players. When they first came out, they were priced around $1,200; that's for a player; no recording capability. When virtually every household in America had multiple players, the price dropped to less than $100.

Have I convinced you that people will pay huge premiums for what they really want? My guess is that, while you can acknowledge the premiums we've just discussed, you can't quite see your offerings in those categories. We'll deal with that issue later in this chapter. Right now, we're considering the high cost of low prices to you and we've only scratched the surface.

So far we've determined how much revenue and bottom line loss you experience by foregoing a 1 percent to 10 percent price increase (Tables 1-1 and 1-2). Here are some of the less obvious costs.

Productivity Costs

McKinsey & Company, an international consulting firm, published a study entitled "The War for Talent."[1] Their research showed that an "A" player typically costs a company 20 percent more in direct compensation than a "B" player. The "A" players, however, produce two to three times as much as a "B" player. That's a 100 percent to 200 percent increase in productivity. What implications does that have?

Think of productivity in terms of revenue capacity. How much more revenue could you generate if you could afford all "A" players on your team? Theoretically, 200 percent to 300 percent. If you're currently generating $1 million in revenues, your sales could grow to $3 million without having to add staff.

Of course it isn't realistic to think that everyone in your organization is going to be an "A" player. So let's take a more realistic view. Let's see how much your revenue capacity and profits would increase if you could replace 10 percent of your workforce with "A" players.

Let's use the same three income levels ($1 million, $10 million, and $100 million) from our earlier examples to help us visualize what lost productivity costs us. Here's the logic behind the math we'll be using.

We're going to assume that we're only going to get the increased productivity from the new "A" players – the new 10 percent of your workforce. We're going to assume that they have no impact at all on their co-workers' productivity. That's an unrealistic assumption because "A" players raise the bar, making it necessary for all other player to elevate their performance as well. It is, however, a conservative assumption, which means that you can expect even better results than those calculated below.

We're also going to assume that your labor costs, prior to hiring the "A" players, is 25 percent of your total revenues. We're going to use the study's statistics and say that the "A" players are going to cost 20 percent more and that they'll produce 100 percent more (the low end of the range cited). Finally, we're going to assume that labor has been the limiting factor in growing sales – that demand exists for your offerings.

Table 1-3 shows the increased revenue and bottom line benefit you could expect by replacing just 10 percent of your workforce with "A" players.

Current Revenues	**$1 million**	**$10 million**	**$100 million**
10% of revenues (portion associated with workforce being replaced)	$100,000	$1,000,000	$10,000,000
Increased revenue potential (previous line x 100%)	$100,000	$1,000,000	$10,000,000

[1] McKinsey & Company, *The War for Talent*, Harvard Business School Press, 2001

Labor costs prior to adding "A" players (current revenues x 25% current labor cost)	$250,000	$2,500,000	$25,000,000
Additional labor costs (previous line x 10% of workforce replaced with "A" players x 20% higher wage cost)	$5,000	$50,000	$500,000
Additional pretax profits (additional revenues less additional labor costs)	$95,000	$950,000	$9,500,000
Federal corporate income tax rate	35%	35%	35%
Federal income tax	$33,250	$332.500	$3,325,000
Increase in after-tax profits from having 10% of workforce staffed with "A" players)	$61,750	$617,500	$6,175,000

Table 1-3 Bottom Line Impact From "A" Players

As you can see, there are significant profits to be gained from having the money to hire the best and brightest for your organization. How do you get the money? By charging prices that compensate you for the value you provide. I do not believe in gouging the customer, but most business people err on the side of giving the customer much more value than the price they're paying would warrant. We want to narrow that gap. The price you charge must always be less than the value you provide. If the customer isn't going to gain anything from making a purchase, she doesn't have a reason to buy.

This is still only part of the story, though. There's more to be gained. Let's see how much you can add to your bottom line by ridding yourself of those customers who drive you nuts – the ones who don't value what you offer.

Wrong Customers

There is a variation of Pareto's principle (the 80/20 rule) that says 80 percent of your customers produce 120 percent of your profits. The other 20 percent cost you money. Why does this happen? Why do we hang onto customers who cost us money?

Many accounting systems, especially in small to mid-sized businesses, are not designed to measure profitability by customer. This leaves you, the business owner, with the ill-conceived measure "average profit per customer." Averages mask the fact that some of your customers (all too often, those who account for the greatest portion of your revenues) are costing you money. If you're one of these business owners, set this book aside. Walk to your finance person's office. Instruct them to make a customer-profitability tracking system their number one priority. Then resume reading.

Lack of information regarding customer profitability, combined with the perceived constraint of "industry" pricing, creates a scarcity mentality in business owners. The fear of not being able to replace lost revenues causes many business owners to continue their unsuccessful attempts to satisfy customers who simply can't be satisfied.

How much does this fear cost you? Based on the Pareto variation mentioned above, 20 percent of your profits. Table 1-4 gives us a sense for how expensive that can be. The only assumption in this example is that your *pretax* profit is 12 percent of revenues.

Current Revenues	$1 million	$10 million	$100 million
Pretax profits at 12% of revenues	$120,000	$1,200,000	$12,000.000
20% of profits lost on unprofitable customers	$24,000	$240,000	$2,400,000
Federal corporate income tax rate	35%	35%	35%
Federal income tax on additional profits	$8,400	$84,000	$840,000
After tax profits	$15,600	$156,000	$1,560,000

Table 1-4 Bottom Line Impact of Firing Unprofitable Customers

These are the kinds of profit increases you could experience by walking away from the customers from hell--the ones who don't value what you offer, who are never pleased with the deal they got, and who constantly waste huge chunks of your and your staff's time trying to appease them. I'd like to reiterate that the reasons why you're not walking away is that (1) you feel locked into industry pricing and (2) you "know" what it takes to replace business, even bad business, so you stay with customers that you should be cutting loose.

We're not finished yet! Let's not forget that ridding yourself of the wrong customers frees 20 percent of your capacity. If you replace that 20 percent with your ideal customers, those who value what you offer, you can add even more to your bottom line. Table 1-5 gives us a sense for how much. For purposes of this example, I assumed that your new customers value

your offerings and that they, like your good customers, are paying the 10 percent price premium suggested earlier.

Current Revenues	$1 million	$10 million	$100 million
Pretax profits at 12% of revenues	$120,000	$1,200,000	$12,000.000
20% of profits lost on unprofitable customers	$24,000	$240,000	$2,400,000
Federal corporate income tax rate	35%	35%	35%
Federal income tax on additional profits	$8,400	$84,000	$840,000
After tax profits	$15,600	$156,000	$1,560,000

Table 1-5 Bottom Line Impact of Replacing Unprofitable Customers

If we combine the profit potential from Table 1-4 (eliminating unprofitable customers) with the profits potential of Table 1-5 (replacing unprofitable customers), we get a true sense for how costly the wrong customers are. The math has been done for you in Table 1-6.

Current Revenues	$1 million	$10 million	$100 million
Table 1-4 after tax profit	$15,600	$156,000	$1,560,000
Table 1-5 after tax profits	$13,000	$130,000	$1,300,000
Profits from replacing wrong customers	$28,600	$286,000	$2,860,000

Table 1-6 Profit Potential of Replacing Wrong Customers

You've added almost 3 percent (2.86 percent) to your bottom line; that's 37 percent more than you were earning previously. How did I arrive at that? I used our earlier assumptions of 12 percent *pretax* profits and a 35 percent Federal corporate tax rate and performed the following calculation:

Before replacing wrong customers:

Pre-tax profit (as % of revenue)	12.0%
Federal corporate tax (12% x 35%)	4.2%
After tax profit (as % of revenue)	7.8%
Additional profit from replacing wrong customers	2.9%
Percentage improvement (2.9%/7.8%)	37%

By replacing the wrong customers with people who value your offerings you increase your "take home" pay by 37% percent 2.9 percent divided by 7.8 percent. We're not finished yet. There are more hidden costs.

Other Hidden Costs

Here are some of the more common costs companies incur and the reasons why they incur them:

- Interest costs (easy payment terms)
- Delivery costs (quick turnaround)
- Staffing costs (additional services)
- Quality (distinguishing your offerings)

All of these, and many more, are absorbed by your company in its efforts to distinguish your offerings from your competitors'. Why? Your price isn't doing that job for you; it's the same price everyone else is using.

I won't calculate these costs here, because they vary so widely from industry to industry. Instead, I'm going to provide you with the formulae for performing the calculations yourself.

Interest Costs

If you're providing favorable payment terms, the average age of your accounts receivable is going up. To determine how costly this is:

1. Calculate your average days' sales (annual revenue/365 days or annual revenue/264 days, if you're only open Monday through Friday
2. Multiply the solution in #1 by the number of additional days you allow your customers' on their payment terms. This is the dollar amount of additional accounts receivable that you're carrying.
3. Multiply #2 by the interest rate on your line of credit or whatever financing source you're using. If your cash flows are adequate to fund these receivables without borrowing money, use the interest rate that you could get from investing this cash in money market accounts, savings accounts or short-term CDs. This is what your favorable payment terms are costing you. Are they being recouped in your pricing?

Delivery Costs

If your claim to fame is that you're much more responsive than your competitors - that you provide quicker turnaround - how often do you incur extra delivery costs because the system fails and you have to overnight or special deliver to your customers? What do these system failures cost you? Here's an easy approach to calculating that cost:

1. For a one month period, track every special delivery you make, how much it cost you, and how much you recouped from the customer.. Total the unrecovered costs. This total will tell you what cost you incurred during the month by using quick turnaround time as your competitive advantage.
2. Calculate the total the number of orders on which you ate delivery these costs.
3. Divide that number by the total number of orders for the month. This tells you what percentage of your orders are costing you money.
4. Multiply the percentage from #3 by the total number of deliveries you make in a year to get a sense for what your annual costs are.
5. Take the total dollar amount of delivery costs you ate during the month and divide by the number of orders on which you incurred those costs. This gives you and average cost per order.
6. Multiply the average cost per order in #5 by the solution to #4, the estimated total number of orders per year on which you absorb delivery costs. This is how much your quick turnaround time strategy is costing you.

Staffing Costs

When you provide additional services, whether it's phone support, free installation, or a myriad of other services, you have to add staff. The question is "What does it cost to provide these services?" Here's one way of answering that question:

1. Calculate the number of people it takes to provide these services; it's okay to have fractions, as some people split their time between other duties and these additional service offerings.
2. Calculate the annual rate of pay for these individuals (to make the math simple I typically multiply their hourly rate by 2,000 hours).
3. Divide your total benefit package costs by your total labor dollars to determine what percentage your benefit costs are to labor dollars; don't forget to include your matching social security costs, worker's compensation insurance, and similar costs, along with the health care and retirement plan costs
4. Multiple the annual pay calculated in #2 above by 1 plus the percentage from #3 (if your benefit cost is 20 percent, multiply by 1.2 to get the combined labor and benefit costs). This is what you're paying for providing these additional services.

Quality Costs

A printer taught me this lesson very early in my career. He asked me whether I thought that his customers wanted a good print job or a great print job. Great print job! I said. He gave me one of those gotcha' grins and said, "Most people can't tell the difference between a good print job and a great print job. Plus a great print job is very expensive. My customers want a good print job."

Are there aspects of quality that you've built into your offerings that your customers don't value – that they wouldn't be willing to pay extra to get? If so, here's how you can calculate the cost:

1. Determine what equipment is involved in adding the quality; then calculate the acquisition and operating equipment costs associated with that equipment. Acquisition cost is the purchase price of the equipment plus installation costs and financing costs over the life of the equipment. Operating costs include regular maintenance, major overhauls, utility costs, insurance, etc.
2. Convert the acquisition cost to an hourly cost by dividing the total acquisition cost by the anticipated hours of life the equipment has. Equipment lives are typically stated in some measure of time--such as years or hours of operation--that make it easy to determine the number of hours of you can expect from the equipment.
3. Convert the equipment operating costs to an hourly cost.
4. Use the staffing cost formula above to calculate the hourly rate your employees are spending on quality development (design), production, and assurance (testing).
5. Add the hourly rates for equipment acquisition cost, equipment operating costs, and staffing costs.
6. Multiply #5 by the number of hours of operation of the equipment. This will give you a reasonable estimate of the cost of quality you're incurring, but not recovering, in your pricing.

Once you've calculated these hidden costs, you can add them to the results in Table 1-7, which shows the bottom line benefit that can be gained by:

1. Increasing prices by 10 percent
2. Replacing 10 percent of your workforce with "A" players
3. Replacing the wrong customers with those who value your offerings.

As you can see, we're simply summarizing the data from earlier tables.

	$1 million	$10 million	$100 million
Profits from a 10% price increase (Table 1-2)	$65,000	$650,000	$6,500,000
Profit from "A" player productivity (Table 1-3)	$61,750	$617,500	$6,175,000
Profits from replacing wrong customers with ideal customers (Table 1-6)	$28,600	$286,000	$2,860,000
Total profit improvement	$155,350	$1,553,500	$15,535,000
profit improvement as a % of revenues	15.5%	15.5%	15.5%

Table 1-7 Total Profit Improvement Potential

That's right! Given even the modest assumptions we've made in the exercises above, you would gain 15.5 percent more of every revenue dollar falling to your bottom. That's huge. How would you use the money? Increase your competitive advantage? Diversify your portfolio? Spend more time with your family?

Now that you have a sense for the payback that raising prices can have for you and your organization, let's deal with that nagging fear that's still hanging out there – the fear of losing revenues. Here's an extreme example of what can occur when you learn how to price and bundle your offerings more effectively.

A horse trainer was referred to me by a client. When she finally got around to calling, she had a 95 percent vacancy in her barn. Despite providing incredible service, she was charging *below-market* rates. She was taking a double hit to her bottom line. Her costs were higher costs than her competitors' because she was providing higher levels of service. Her revenues were lower because she was charging below-market prices.

We raised the price of her core offering – the boarding service – by 33 percent, making it 10 percent higher than the market. We also bundled the boarding with training and show services and developed her sales script to help customers understand the value they were getting. Within sixty days, her vacancy went from 95 percent to 5 percent. She picked up twenty-five new weekly riding lessons and had so many horses for a show that she had to build temporary stalls.

How can this be? How could she raise prices by 33 percent and generate more business? She was able to convert the value she was providing into dollars and cents and communicate that monetary value to her customers. Customers pay for value when they understand what that value is. They, like you, haven't been trained to make those calculations.

You and your company aren't the only ones to suffer from low prices. Your customers do as well. How? Let's take a look.

Costly for Your Customers

The high cost of low prices isn't always obvious. Here are some of the ways consumers pay dearly for low prices, often without knowing it. By the way, let's not forget that we, too, are consumers who are paying these costs.

Subprime Mortgages

As I write this section, the United States Congress just passed a $750 billion bailout plan. This is on top of an $85 billion dollar bailout of American International Group (AIG), a global insurer of financial instruments to the banking and finance industry, as well as the estimated $25 billion cost of the government take over of Fannie Mae and Freddie Mac. This projected $860 billion doesn't take into consideration the failed businesses, home foreclosures, and stock market hit (over $8.4 trillion dollars over a seven-day period). [2]

Yes, I know that lax underwriting standards, inflated appraisals, failed regulatory oversight, and Wall Street greed contributed to this problem, but do you think that these home buyers would have applied for loans if the price of money hadn't been so cheap?
I doubt it. The vast majority of people don't want to risk their credit standings, their personal and retirement assets, or their good names by buying things they can't afford.

What, then, caused them to take the risks they did? Cheap mortgage money. Low interest rates reduce monthly payments. Lower payments allow buyers to purchase more house than they can typically afford. Buyers, recognizing the opportunity, rush to buy larger homes while they can afford them. In doing so, they drive up the price of the homes.

As sellers experience higher profits on their home sales, they begin to view homes as a great investment vehicle instead of as a place to live that has some upside potential. This change in attitude, coupled with an extended period of low interest rates and the high profits they triggered, cause home owners to become real estate "investors." Soon people were "flipping" homes – buying and selling them in a matter of months – to garner previously unheard of profits. The result is the subprime disaster that plagues the global economy.

The numbers are so huge that few, if any of us, can get wrap our minds around them. Let's see if we can make these numbers more relevant. There are approximately 305 million people in the United States, according to the Census Bureau projections.[3] The $860 billion in bailouts and $8.4 trillion stock market hit alone total $9.26 trillion dollars. That's $30,361 for every man, woman, and child in the United States.

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[2] Wall Street Journal, October 10, 2008

[3] www.census.gov/cgi-bin/popclock

The full impact of these losses may never be known. One thing is certain, though; they'll be borne by us as consumers. They'll appear in the form of higher taxes, more government regulation, and higher prices (some related to the higher cost of regulatory compliance; some resulting from inflation).

Isn't that interesting? We're going to pay higher prices in the future because we didn't pay them previously. Abnormally low prices, such as those experienced in the mortgage market, only postpone price increases. They don't eliminate them. Unfortunately, price increases, when postponed for extended periods of time, grow exponentially. We thus find ourselves paying much more than we would have if pricing had reflected true value.

Let's see what costs we incur when one of the world's most popular retailers enters the market. Yes, I'm speaking of WalMart.

WalMart

Whenever I counsel business owners against using a low-price strategy, I inevitably hear "But what about WalMart?" Indeed, WalMart is a huge success story and its success, to date, has been based on a low-price strategy. This isn't the whole story.

WalMart's success reflects a tireless commitment to cutting costs, which is something most business owners don't enjoy. In fact, when I ask business owners in my pricing and finance seminars and college finance classes "How many of you awaken in the morning thinking 'Wow, I get to cut costs today!'" no one raises their hand. None of them has a passion for cutting costs. Yet, that's been one of the keys to WalMart's success using its low-price strategy. They had a passion for doing what others abhor.

Unfortunately, those of us who buy from WalMart don't have a clear picture of the true cost we're paying. Many communities, in order to attract a WalMart store, have had to revamp their road systems and enhance their infrastructures *at taxpayer expense*.

Employee and labor department lawsuits against WalMart dealing with everything from discrimination, use of illegal aliens, and having employees work "off the clock" indicate that members of our community are paying a price in terms of employment and earnings. Some of these practices result in fewer workers being employed. Others limit employees' income, which means they have fewer dollars to spend. Fewer jobs and lower earnings reduce discretionary income, which in turn reduces demand for non-WalMart products and services. This limits the number of jobs and salary levels available to employees in businesses not serving WalMart. In essence, these practices serve to slow economic growth.

A similar effect is experienced by vendors serving WalMart. Many are not adept at cost cutting and have, consequently, been "eating" the price reductions required to keep their WalMart vendor status. Diminished profits in these vendor firms inevitably translate into lower business investment and slower job growth. I'm not blaming WalMart for its suppliers' inability to control costs, but the effect is there nonetheless.

It's not my intent to bash WalMart. They, like all firms employing a low-price strategy, find it increasingly difficult to lower costs in order to maintain their low-price leadership. As they approach the floor (the point where costs can no longer fall, but must rise), they begin to

push the envelope. That's when we see the abuses that lead to lawsuits and community action like WalMart is experiencing.

To its credit, WalMart's leadership has recognized that it has reached the floor. The most obvious evidence of this is the change in its tagline from "Always low prices, always" to "Save money. Live Better." If WalMart is successful in making the transition, some of the hidden costs we've discussed will be converted to higher prices, which is where they should have been all along. Had these hidden costs been known, it's likely that we, as consumers, would have made some different buying decisions.

American Airlines

On April 8th and 9th, 2008, American Airlines cancelled over 1,500 flights, stranding roughly 150,000 passengers, due to wiring harness problems in its MD-80 planes. American paid a heavy price in lost revenues, but they were not the only ones to have suffered losses.

Companies whose employees were on those flights suffered lost revenues as well as productivity losses. To get a sense for how costly this was, simply take your average sales per day and multiple it by the number of salespeople you have traveling. That's what it would have cost you if all of your salespeople were scheduled to travel via American Airlines that day. Add to that the number of production people in your organization who weren't able to get to the customers they were supposed to serve. How many billable hours did that represent? You can't recover those billing days, so the revenue potential for those days was completely lost.

Passengers who were vacationing lost those vacation days – a heavy price given that Americans typically don't use all of their vacation time. Imagine having your employees returning tired, frustrated, and still exhausted from an extended period without a vacation. What is that going to do to their productivity in the next six months to a year? Will their productivity drop 10 percent, 20 percent, more? What about the lost productivity when they weren't able to report back to work on time?

For those hoping to visit family and friends, the time lost is irreplaceable. Imagine that you were scheduled to visit your grandkids and these were your last two vacation days you had available to make this trip. There isn't enough money in the world to compensate you for the loss of time with your grandchildren.

The "Big Three" Automakers

I want to include this example because it demonstrates a common mistake made with pricing. For decades, GM, Ford, and Chrysler have taught us to wait for a deal. Wait for 0 percent financing, wait for rebates, wait for both 0 percent financing *and* a rebate, wait for employee pricing. They have, in essence, trained us to not to buy from them unless we get a deal.

So what's the problem? They've dug a deep hole for themselves. Instead of dealing with the labor issues, the lack of inspiring designs, quality control issues, and fuel efficiency issues

they've faced for decades, they've chosen to use low prices to accelerate future sales into current periods.

As of this writing, these automakers asked for $50 billion in loans to help them develop the technology for alternative fuels. In the face of congressional dismay, they quickly reduced the request to only $25 billion. To make matters worse, those of us whose retirement plans include investment in GM and Ford stock have seen the value of our investment decline by more than 50 percent in the past 5 years.[4] These costs certainly weren't reflected in the sticker price of the automobiles we bought.

As you can see, there are many costs we don't see that are the directly related to low prices. Costs that, had we been aware of them, could have altered our buying decisions – could have helped us make more informed decisions.

Now that we've had an opportunity to see how expensive low prices can be for us and our customers, let's revisit those "reasons" for not raising prices outlined at the beginning of the chapter. They're listed below for your convenience.

"Reasons" For Not Raising Prices

The most common reasons for not raising prices are:

- We don't have the name awareness of the big boys
- Our customers only care about price
- Our competitors won't raise prices, so we can't
- We'll lose sales (market share)

As I mentioned earlier, these reasons are just smoke and mirrors clouding the real issue – the fact that we don't know how to calculate the monetary value of the intrinsic value our offerings provide. Let's begin with name awareness or the lack thereof.

Our Lack of Name Awareness

A residential homebuilder client told me that he couldn't raise prices because he didn't have the name awareness of the big builders. This, after he'd just spent forty-five minutes telling me why his quality was better than "the big boys."

Upon hearing this, I asked him if he advertised in the local paper. He did. Then I asked him to envision that he and two of the top builders in town all had subdivisions in the same area, with similar size homes and elevations (styles), and that they all advertised on the same page in the real estate section of the paper. The only difference between his homes and those of his competitors was that his price was 10 percent lower. What would he, as a buyer, think upon seeing that ad?

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[4] I didn't include Chrysler stock, because Chrysler was owned by DaimlerChrysler during this period

"I'd think that the low-price builder was cutting corners!" he replied. Indeed, the message his pricing was sending was exactly the opposite of what he believed. *He believed that his product was better, but his pricing indicated that it was inferior.*

Pricing is not the tool to use to create name awareness. That's what your marketing messages should be doing. Marketing is the tool for shouting your competitive advantage - advantage that people value and are willing to pay premium prices to get. We're talking about the advantages that Lexus has over Camry; Nordstrom has over Penney's; Jack Daniel's single barrel bourbon whiskey has over its Old No. 7 brand.

A Lesson from Retailers

If you feel that you absolutely must lower your price to get in the door, take a lesson from retailers. Preface your offer with "This time only…" There are times when a prospect is happy with his or her current vendor, doesn't want to change, and the only way that you're going to get a shot at that business is to offer an incentive to try your offerings. That's when you make it clear that you're extending a one time offer.

Language that works well for me, and my clients, is:

> *"I know that you're happy with your current vendor and you need a reason to give me a try, so I'm going to extend this offer only on the first order. (State the offer.) I'm sure that you're going to be so delighted with our (quality, service, speed) that you want to use us again and again."*

This approach is especially helpful for those of you who have recently gone into business and are trying to land that first customer/client. Buyers appreciate the business acumen you demonstrate in acknowledging the fact that they're "taking a risk" by going with a vendor with a limited track record. They appreciate being compensated for taking that risk. Add these factors to the confidence demonstrated by your statement, "I'm sure that you're going to be so delighted…", and you'll find that your odds of closing the sale go up dramatically.

A Final Point on Name Awareness

Whenever you feel tempted to lower your price because you don't have a well-established reputation, ask yourself the following question: Would I rather have the prospect walk away saying "I wish I could afford his offerings" or "His price is low; I wonder if his offerings are any good?"

Remember that name awareness is the goal of marketing, not pricing. Your price should reflect the value you provide. That brings us to the second reason for not raising prices: customers' sole focus on price.

Our Customers Only Care about Price

Did I mention "The Big Three" automakers? Do you think that they might have felt that way? Was it true? Of course not! People have been buying Toyotas and Hondas even though they are priced higher than their GM, Ford, and Chrysler counterparts. Why? Because buyers value other aspects of the offerings more than they value low prices.

In the case of Toyota and Honda, buyers value the reliability and convenience that their cars engender over a lower price. Buyers understand that besides spending $1,000 to repair their American-made cars at 50,000 miles, they'd have to jockey schedules to make sure the kids got to school on time, that the car got to the shop before work, that Mom and Dad got to work on time, that the kids got to band or soccer practice in the evening, and that the car got picked up before the repair shop closed. These are some of the reasons why people have paid higher prices for Toyotas and Hondas.

Another reason business owners think that buyers only care about price is that buyers bring up the subject so early in the discussion. Why do buyers do that? In many cases it's because they can't tell the difference between your offerings and your competitors'. Couple this lack of differentiation with their inability to quantify value (remember, you're not the only one suffering this malady) and price becomes the only yardstick by which they feel they can measure it.

If it appears that your customers only care about price, revisit your sales and marketing messages. You're probably not doing a very good job of communicating the advantages your offerings provide or reflecting that in the prices you charge.

Our Competitors' Won't Raise Prices

Of course not! Their offerings are inferior to yours. My clients know when that's true and you do as well.

This, the third reason for not raising prices, doesn't hold water if your products and services are, indeed, better than your competitors', *and* your customers value the difference. You should get compensated for that value regardless of whether or not your competitors are willing to raise prices. People expect to pay more to get more, but only if it has value to them.

Your ability to get higher prices than your competitors lies squarely on your ability to demonstrate greater value and monetize that value for the customer. If you can do that, you can get higher pricing. It won't matter that your competitors refuse to raise their prices. If you're still skeptical, let's look at a fairly common occurrence. You've probably done this yourself.

You drive a greater distance *and* pay a slightly higher price for what you want because the people are friendlier or they'd previously gone above and beyond the call to help you with a problem. Whatever the reason you paid extra in the forms of drive time and cash to get the experience you wanted. The fact that their competitors were closer and had lower prices didn't prevent you from spending more.

Now for our final "reason" for not raising prices– we'll lose market share.

We'll Lose Market Share

Unfortunately, the financial press often speaks of market share as if all customers are equally valuable. As we saw in our discussion of the wrong customers above, there are tremendous costs involved in dealing with people who don't value what you offer.

The first thing to understand about market share is that there are a limited number of people (it could be a large number, but it is a finite number) who value what you provide. Market share should be calculated in light of this number, not, as is often done, in light of the total number of buyers who *might* use your product or service. Why use the smaller number?

Let's say that your market, the people who will pay significantly more for your offering because they value what you provide, is 100,000 buyers. Let's further assume that you've saturated your market, which, to me, means that you've achieved about 70 percent market share (70,000 customers from this group).

Some of you are wondering "Why 70 percent?" I don't have any hard data, but most of us abhor a monopoly. We understand that monopolies put us at the mercy of the seller. To avoid that, we begin shifting our business to other companies when we feel that one company is gaining too much market share. We're going to err on the side of shifting business early in case others don't see the trend as quickly as we do. That, I believe, occurs around 70 percent market saturation. I know I'm dating myself with this example, but monopoly avoidance is one of the reasons that, in the early days of the Internet, people used Netscape instead of the Microsoft browser. They wanted a choice. Hopefully, this minor digression will help make this example more relevant for you.

In this example, we're assuming a market of 100,000 buyers with you having a 70 percent market share. You decide to increase "market share" by expanding the market to include people who have an interest in your offering, but who don't really value it enough to pay your price. How do you attract them?

Typically you're going to offer a lower price. It could be in the form of a lower cash price, more favorable payment or delivery terms, or higher quality or additional service. Whatever the form, you have, in essence, lowered your price.

In order to handle this additional volume, your infrastructure has to grow with the following results; you will:

1. Spend more to attract these customers and the sales cycle will be more protracted, driving up both your marketing and sales costs
2. Invest more in inventory if you're a manufacturer/assembler
3. Typically experience slower pay because these buyers don't really value what you offer
4. Pay more interest to finance larger inventories and older receivables
5. Experience more bad debt losses, because buyers don't value your offerings
6. Incur more in customer service costs dealing with customer complaints; people who don't value what they buy are easily disappointed

Attracting that second tier customer is expensive. It's one reason why so many businesses end up with 20 percent of their customers being the wrong customers.

What's the solution? Instead of trying to "expand" your market to disinterested buyers, expand geographically, keeping clearly in mind the profile of your ideal customer or, better yet, identify unsatisfied needs of your existing customer base and fill the gap with new offerings. There are always unsatisfied needs. The company that identifies and fills those needs first can charge whatever they like because there is no alternative.

As you can see, the four "reasons" for not raising prices, have little, if any, validity. In the following chapters, you'll learn how to set aside these excuses and enjoy the compensation you so richly deserve.

Before we get to the methodology for calculating value (Chapter 3), there is something you need to know. Not every seller is capable of demanding and gaining higher prices even when they know how to quantify value. In Chapter 2, we're going to find out why, and what you can do if you happen to fall into that category.

Executive Summary

1. There are four "reasons" why business owners don't feel that they can raise prices:

   - We don't have the name awareness of the big boys
   - Our customers only care about price
   - Our competitors won't raise prices, so we can't
   - We'll lose sales (market share)

   None of them are valid.

2. The real reason that business owners don't raise prices is that they don't know how to monetize the intrinsic value of their offerings.
3. The cost of low prices to you, the business owner, is huge. The combined cost of lost revenues, productivity losses, and retaining customers who don't value your offerings can easily reach 15.5 percent of your revenues.
4. Low prices cost your customers, too. The subprime mortgage debacle, which could have been prevented if the price of money hadn't been held artificially low, cost every U.S. citizen at least $30,361. That's a conservative estimate.
5. WalMart, the icon of low prices, is tempering its low-price strategy. Communities, employees, and vendors are no longer willing to bear the high costs of WalMart's low price strategy.
6. The "Big Three" automakers have taught us to wait for a deal before buying. Are you doing that with your customers?
7. Creating name awareness is the function of your marketing message, not your pricing. Using low prices to "market" your offerings ends up sending the wrong message to the market – a message of poor quality/service.
8. The perception that "customers only care about price" demonstrates the customers' aren't any more adept at monetizing value than you are.

9. “My competitors won’t raise prices” is simply an indication that they don’t know how to quantify value either. If they could, and their offerings were superior, they would be charging higher prices.
10. The fear of loss of “market share” implies that all customers are equally valuable. The examples above show that the wrong customers can conservatively cost you 1.5 percent on your bottom line (that’s after-tax dollars). You can double that, 3 percent, if you can replace the wrong customers with those who value your offerings.