

Marketing Savvy Begins with Sound Pricing Strategy

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How do you set rental rates? Do you throw darts at prices scribbled randomly on a dartboard? Or do you prefer the “me-too” pricing strategy, where you all up the competition and then set your rates relative to theirs? If either of these approaches to pricing sounds familiar, you are not alone. The fact is, most rental stores have no idea how to determine rental rates. Astonishing? Read on.

According to Kevin J. Clancy and Robert S. Shulman, authors of *Marketing Myths That are Killing Businesses*, fewer than 15 percent of major American businesses do much pricing research. So how much is going on in the average small business? But consider the power inside that little box you have on your desk – your computer. You have a research tool right there that can perform wonders for your business, including how to set profitable rental rates.

In this column, I want to help you to come to a better understanding of two things:

1. The factors that should be considered in determining a price;
2. How to use your computer system to do pricing research.

Importance of Pricing Strategy

Pricing strategies are important – they should be part of any business-marketing plan. The ultimate goal of any pricing strategy is to maximize profits. In most cases, this does not mean selecting the highest possible price, nor the lowest; but rather the price that generates the most sales at the highest profit.

According to *Decisions in Marketing*, a business textbook, the five basic components of pricing are (1) price objectives, (2) cost, (3) demand, and (4) competition and industry structure and (5) legal considerations. We will discuss items one through four. It would be best to discuss the fifth item with an attorney.

Pricing Objectives

Certain businesses have very clear pricing objectives that are a part of their promotional messages. One company’s objective might be to have the lowest price; another company may opt for a higher price, but also better quality. Some companies price their product low in order to discourage new stores from entering the market. Others want to match the current market price to create price stability. I would guess that the majority set their prices so that they seem reasonable to customers. Whatever your particular objective may be, it will have a major impact on pricing policy at your store.

The Second Component: Cost

The price of a product must recover all costs associated with it, including maintenance and overhead, and the price must also generate profit. In attempting to find the price that does these two things, many firms have established a price system that marks up the cost of each product.

According to *Hire and Rental Australia* (1995, Volume 16, Number 2, Page 8), the research committee of the California Rental Association determined a rate-setting formula for cost-plus pricing in 1977. I tried to get this committee report from the CRA, but it claims to have no knowledge of the report. In reviewing the magazine article in *Hire and Rental Australia*, I felt there were some inaccuracies in the detail of the formula. However, the general idea behind the formula is accurate. It says that rates should be established such that they recover these costs - (1) net cost of the item, which is the original cost minus the selling price, (2) maintenance costs over the life of the item, (3) operational costs, and (4) inflation – and produce profit.

Easy Solution? A Spreadsheet

Of course, putting these factors into a mathematical formula is difficult, if not impossible. However, it is very easy to create a spreadsheet that can be used to determine the right rate. A spreadsheet is better than trying to deal with specific formulas because it allows you to examine costs, rates, utilization, and profits interactively. By looking at all these factors using a spreadsheet, we can converge on the right price.

Figure 2 shows a spreadsheet that can be used to determine a rental rate. In this example, operating costs and profit were taken from the 1994 ARA Cost of Doing Business Survey (a summary of ARA data is in F16 1). You can all figure out your own costs and profits by using your financial reports. The inputs on the spreadsheet are (1) original equipment cost, (2) anticipated sales price of the equipment, (3) life – this is the number of years the rental store plans to rent this piece of equipment before selling it – and (4) average annual maintenance costs.

The spreadsheet shows the total cost and the total revenue for our assumed rate and the number of rental days. The right price is the rate, which makes these two numbers equal. (Variance goes to zero). This spreadsheet can also be used to better understand your competitors' strategic plans. By varying the inputs, it is easy to see how a competitor can be profitable with a pricing structure that will not work for your operation.

For example, let's assume that the numbers in Figure 2 are from a general rental store renting a Bobcat. Now let's look at the same spreadsheet for a store that is also a skid steer loader dealers – Figure 3. Because he is a dealer, he should be able to buy the machine at a lower cost and re-sell it at a higher price. So, let's say his cost is \$16,000 and he can sell it for \$15,500 after two years. Using the Cost of Doing Business Study, we will assume that operating costs per gross profit will be less. When we examine all of these factors and hold the price and utilization fixed, we can see that the dealer will earn in two years an accumulative profit on the unit, which is higher than the general rental store's cumulative profit after 5 years.

Moreover, if the dealer drops his price to \$155 and gets an additional rental day per month, his two year accumulative profit is only slightly less than the rental store's 5 year profit (see Figure

4). If he further drops his price to \$45 and the number of rental days stays the same, his annual profit is still 50% greater than the general store owner (see Figure 5). In other words, the dealer's rate is \$40 dollars *less* than the general rental store's, yet the dealer is 50% more profitable. This example should illustrate the need to understand how the factor of competition can affect your business.

Your Computer Knows the Story

The spreadsheets we've been looking at are examples of computer modeling. In order to do this modeling; you must have accurate cost data. Your computer system can provide this information.

Modeling with spreadsheets is an inexpensive way to increase your industry knowledge and vision. Many costly business decisions can be avoided by using the lessons learned through computer modeling. Additionally, this type of modeling is a good way to test gut-feelings and to learn to understand different strategic plans.

Build the spreadsheet in Figure 2 for your rental store. It is a simple process. Play with it. Use different factors and see how they relate to each other. The end results will be a better understanding of the relationship between price, utilization, operating costs, net cost, maintenance costs, and profit.

The one factor missing in our analysis so far is volume. Figure 6 is a spreadsheet, which looks at volume versus profit. Again, this spreadsheet is built upon the ARA 1994 Cost of Doing Business Survey. The variable in this example is fixed costs. Figure 7 shows a graph of these values, calculated with a 30% fixed cost and an 80% fixed cost.

Using the ARA data, one would conclude that the rental industry is probably closer to an 80% fixed cost than a 30%. When fixed costs are high, the business is volume sensitive, as opposed to price sensitive. Looking at Figure 6, we can see that if we increase volume by 25%, profits almost tripled. Figure 7 illustrates graphically this relationship between profits and volume.

Thus it is clear that volume is an important factor to be considered in pricing strategies. The problem with our simplified cost plus profit pricing system is the fact that it doesn't take volume into account. In order to incorporate volume into a pricing strategy, we need the third component of pricing, which is demand.

The Ups and Downs of Demand

If demand for a product is very responsive to changes in price, demand is elastic. If demand is independent of price, it is inelastic. Knowing the elasticity of demand is key to determining the price that will maximize profit. Products that are hard to differentiate and exist in marketplaces where everyone knows the price tend to have high elasticity of demand. An example of this is an intersection with several gas stations. It would be unusual to find rental stores bunched together like that, of course, and I have not yet come up with anything certain about overall demand elasticity in the rental industry.

But to see how inelastic demand works in rental consider this example: the prices of trenchers in Colorado. Once the ground freezes in the winter, rental stores tend to raise the prices of trenchers because of the high maintenance costs associated with underground work this time of year. Such a price increase would be justified with our cost-plus-pricing model, since costs have increased.

One store I know charges more than twice as much in winter as in summer. Last spring the store was so busy that it forgot to lower the price. But as far as it can determine, the high price had no effect on demand. Demand was inelastic. Now, if the competition had realized that this price difference existed, it might have been able to affect demand. But without any competitive influence, price did not change demand. This is just one example, but I think it is generally true. Today rental is driven by a very defined need. The alternatives to renting a piece of equipment, assuming you cannot borrow it, are buying it or doing without.

The Competition Factor

My last example brings us to the fourth component of price – competition. But first, I want to stress how important a good computer system is in determining the relationship between price and demand. Since this relationship is so mysterious, it is crucial to have a computer that can measure changes in demand – a computer that can compare previous years' demand levels against current demand. When looking at changes in demand, we need to analyze in terms of prices and competitive pressures. As prices are raised, you should check the change in demand.

To understand the relationship between prices, demand and competition, let us modify Figure 6 to show what happens in the following cases: (A) prices are increased by 10 percent and volume drops by 10 percent; (B) prices are decreased by 10 percent and volume increased by 10 percent; (C) prices stay the same and volume decreased by 10 percent; (D) prices decrease by 10 percent and volume increases by 20 percent, and (E) price decreases by 10 percent and volume increases by 30 percent. Figure 8 (back page) is the result.

The Problem with Raising Rates

For years, rental storeowners have been told over and over again the advantages of raising rates – even if it means losing some volume. Columns 2 and 3, which show Cases A and B, support this theory. In Case A, even though the sales volume of dollars decreased, profits increased. In Case B, volume increased but profits decreased.

The problem with this analysis is that it does not take into account the competition factor. Let us assume a competitor decreases prices by 10 percent and takes 10 percent of your business. The competitor becomes Case B and you become Case C. The competitor loses some profit but is still profitable. You, however, are now unprofitable.

Let's further assume that there are other competitors who hold their prices the same and lose the similar volume to the competitor. If there is another competitor, Case D results. If two competitors exist, then it becomes Case E. In both Cases D and E, the competitor is generating

significantly more profits than before. He is growing as he makes the competition weak. Many experts consider price-cutting a zero-sum game in which there is one winner and one loser. In this example, if you do nothing, the competition wins and you lose.

What is the proper response to price-cutting? Let's look at Figure 9. Doing nothing, which is shown in Case C, is clearly not the answer. Matching the competitor's price, as in Case D, is a slightly better response because you will at least maintain your current level of volume, even though you lose money – as will your competitor (Case D versus Case C). Unfortunately, you will lose more money than if you did nothing. The winner will be the financially strongest competitor.

The Best Solution: Marketing

Marketing offers you several positive alternatives to these scenarios. With marketing, you can hope to increase your share of the market. If you match the competitor's price and take 10 percent of his business away, you will be the profitable one and he will be unprofitable. The winner, then, is the best marketer. All of these examples are based on the assumption that competition can take your business away by price-cutting. In other words, it assumes that your business is price-sensitive.

But earlier we showed that the rental industry is *volume*-sensitive, not price-sensitive. That means that through marketing, you can reach the customer before the competition does and price may never have to be an issue. Remember: demand elasticity depends upon market knowledge and product differentiation. So if you can inform prospective customers about rental opportunities and differentiate your product, you may be able to keep *all* your customers *and* the higher price. You win and the competition loses. This is called target marketing.

A third alternative: *both* you and your competitor begin marketing actively. What happens then is that the overall market grows and both of you increase rentals. With an expanded market, you maintain your price, so does your competition, and both of you are profitable. But if you have the higher price, you should be the more profitable store.

Marketing offers the only positive response to price-cutting. But marketing is very dependent upon good management and information, and that's where your computer comes in. Computers are the ideal tools to develop, implement, and track a marketing plan.

What is the Right Price?

Having analyzed the four components of price, again let's ask, What is the right price? Earlier we said that the right price maximizes profits. In reviewing the rental industry, we saw that if demand increases by 25 percent, profits can triple.

Price-cutting gets the rental industry focused on the wrong industry. If the industry focuses on building rental awareness and increasing rental demand, everyone wins. In my seminars, I have tried to calculate the rental potential and I've concluded that currently, rental stores are

capitalizing on only half of the existing rental opportunities. Marketing will enable you to increase this number and leave the price-cutter behind.

Missed Opportunities

The next question to consider is whether or not the current pricing structure at rental stores has any effect on the number of missed rental opportunities. Does the standard rate set of four hours, a day, a week, or four weeks help *build* demand? Or *limit* the appeal of the rental?

A follow-up question is whether or not prorated rental rates are effective. Do you know the cost of prorating a rental rate? Let's examine an item with a daily rate of \$25, a weekly rate of \$100, and a four-week rate of \$300. Figure 10 shows the differences in revenue between fixed rates and prorating for this item.

In the five examples, the amount of revenue varies from 3 percent to 16 percent. Since costs are independent of rate, the differences between prorating and using fixed rates goes directly to the bottom. If you prorate, be sure this difference in revenue achieves some benefit for you. The trend is always from prorating, it is extremely costly and many rental centers today simply don't do it.

Another question is whether the same price-setting strategy applies to all items. In competitive retail situations, the same markup is not applied to all items. Each item's price is determined by evaluating the four pricing components – price objective, cost, demand, and competition. As a result, one item may have a very small markup and another a standard markup. The right price is determined differently for each item.

Rental Operators Need Better Pricing Strategies to Maximize Profits

The rental industry is not as price-sensitive as mass merchandisers are. But today rental store operators need better pricing strategies to maximize profits. Pricing should not be a dart game or a "me-too" policy.

Pricing should be proactive instead of reactive. Prices should be determined by analyzing the four pricing components. And it's not enough to determine what you believe to be the right price – you must also monitor the effect of price changes, to verify your judgement. The computer can keep track of all this information. Given the competitive environment today, you can't manage without it.