The Conundrum of Price Cut

What You Will Discover?

CEO: “Sales is declining! What do we do?”
VP Sales: “Let’s decrease price to recoup some sales!”

Does it ring a bell? It is how companies act in reality. Whenever there is a sales crisis, managers feel pressured to decrease price, pretty much as a knee-jerk reaction. This can be a self-destructive form of behavior. When does price cut pay off, when doesn’t? Are there better alternatives to price cut in the face of a sales crisis?

The case of empty parking houses is among my favorite examples in order to illustrate the relationship between price and demand in my pricing lectures for entrepreneurs and executives. It looks like follows:

Parking houses have limited capacity. Every single unused parking slot at any time represents a lost sales opportunity and profit foregone. We have this parking house operator which finds that the utilization rate of one of its properties in a central business district is extremely low on the weekends. So there is potentially a lot of money left on the table. Now what can you do to boost utilization and increase revenue? A knee jerk reaction would be to reduce prices to stimulate demand. Will it work?

When I put the question to the audience, the majority said No. Why is that? Presumably because I had before unduly framed them by showing them the impact of pricing on the bottom line with the help of the following mental exercise.

Suppose you find yourself in a deteriorating market situation, which of the following two options would you prefer?
1. *Cut price by 10% to keep sales volume from declining?*
2. *Keep price unchanged and accept 10% decline in sales volume?*

I don’t know why a 10% decrease in sales should be more painful than a 10% decrease in price to many companies. They will prefer the second option, i.e., lowering price in favor of the sales volume, without really understanding the consequences. For the sake of simplicity, I set the scene as follows. In the starting situation, we have a product whose price = $10, sales volume = 1 million units, and revenue = $10 million. Assuming cost is equal to $8 million, we make a profit equal to $2 million. Further, we assume all cost is variable, which means cost is perfectly correlated with sales volume. See Fig. 1.

The impact of Option 1 is visualized below in Fig. 2a. In order to protect sales volume, we go down from $10 to $9 in price. What happens then?

Take a look at the green area, which represents the profit. A 10% price reduction would slash profit by half. Would you reconsider your decision? Wait, you have heard about price elasticity. Isn’t it logical that we would have more volume coming in, if we decrease price? Fair enough. Let’s see how much volume boost we need to make at least as much as profit as before? Check out Fig. 2b.

In a nutshell, it will be almost a mission impossible to be profit-neutral given even the seemingly harmless 10% price decrease. In order to bring in at least $2 million in profits with the reduced price, you would have to double the sales volume. It translates into a price elasticity of \(-10\)! Where should the massive increase in volume come from? Would you suddenly double the

![Fig. 1 Starting situation. (Source: Author’s own figure)](image-url)
customer base, because new customers would get so excited about the 10% price cut? Or would existing customers suddenly double their purchase orders? Neither of these scenarios seems realistic. We are also ignoring another possible negative impact, evident when we ask what would happen if competitors follow suit and decrease their prices, too. Unfortunately, a 10% price decrease would bleed you dry without bringing about any benefits.

Price decrease is often seen as the default action in a downturn. This was the case in the 2008/2009 financial crisis, and it is happening again right now in the middle of the COVID-19 pandemic 2019/2020. But past experience

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**Fig. 2** (a) Option 1–10% price decrease without volume change. (b) Option 1–10% price decrease with profit-neutral volume change. (Source: Author’s own figure)
shows that it is more often than not the best decision to make. Do not get me wrong. I am not blind to the other forces that urge price decreases such as the need to support clients in trouble and maintain adequate market exposure, the pressure from work unions to keep workers employed, the fear of losing supply chain partners, etc. All in all, I am not against price decreases but encourage managers and business owners to be wary of the possible consequences to and ask themselves three questions before implementing the price cut. These questions are:

1. Will I win new customers?
2. Will existing customers buy more?
3. Will competitors follow suit?

If you don’t have clear answers to the questions above, you’d better think them through and refrain from a price decrease till you figure out the answers. A piece of popular wisdom has it that doing nothing is also an option, and sometimes it is the better one. Maintaining price integrity in difficult times, i.e., not hurrying into price reductions, will prove to be a superior tactic in many cases.

So far we have seen what damages price decreases can do to the bottom line. It is only fair to take a moment to look at the flip side. What will happen if we increase the price by 10%? See Fig. 3a.

If we increase price by 10% while losing no sales volume, profit will climb up to $3 million vs. $2 million in the starting situation. How nice is that! Price is the most effective profit lever. Price increase usually pays off, unless you have zero bargaining power against your customers. By the way, if you have to pray the night before you raise prices by 10%, you are in a horrible business, according to Warren Buffet.

Then a valid and sensible question presents itself, which is: How much volume loss should we expect, if we increase the price? So let’s do the math to see how resilient the profit potential from price increase is in case of volume loss. See the result in Fig. 3b.

Whenever we increase the price, volume reacts in a negative way (under normal circumstances)—less customers will be buying or existing customers will be buying less, or a combination of the two. All in all, we can afford to lose a third of the total volume if we thereby earn at least as much profit as before. We are looking at a price elasticity of \( -3.3 \), a moderate to high price elasticity. If managed well, price elasticity should be less in many industries. I am of the opinion that making a price increase is the safer choice if you are not sure whether to pick price decrease or price increase. The numbers are
more revealing than plain speculation. Do the math to be prepared or to be shocked!

Now, let's return to the empty parking house case, I believe that offering deep discounts on weekends is most likely not the right answer to improving occupancy. On the contrary, it could make things even worse for the parking house operator. Why is that? Because the drivers who have to park in the parking house on the weekends will definitely be pleased if they have to pay less than they were willing and expecting to pay; on the other hand, the central business district on the weekend is meant to be empty. Pricing is no magic wand. Price decrease will not create additional demand in this case. If I were

![Fig. 3](a) Option 2–10% price increase without volume change. (b) Option 2–10% price increase with profit-neutral volume decrease. (Source: Author’s own figure)
the operator, I would probably consider increasing the prices on the weekends in the face of constant demand. For those that need to come over to the place on the weekend, the demand curve is extremely inelastic. In simplified words, it does not matter how much you charge, they will come and park on the weekend. It is a different story during the week, where you can use pricing to manage capacity in a more dynamic way. The technological foundation for dynamical pricing is generally in place these days. Nevertheless, common sense about the relation between price and demand is still much needed and valuable. Another possible solution would be a loyalty program which grants frequent parkers free parking hours on the weekend similar to and based on free night awards offered by many hotel chains to guests that come often.

There is a strikingly similar project example where price decrease fails to do what we want it to do. The client of mine, in this example, is a B2B retailer for miscellaneous factory supplies, keeping in stock a large number of items. The market landscape is highly competitive, as the customers usually have two to three competing suppliers in most product categories. At the same time, it is also a business with a very fat long-tail, meaning that the offerings of different suppliers have limited areas of overlap (there are overlaps, though sourcing through different channels could lead to significant price differentials at the end customer) and customers generally have little knowledge concerning prevailing market prices (because there is none in many cases, when it comes to industrial long-tail products).

It is not uncommon for salespeople to be closer to their clients than to their own organization, and they are tempted to give discounts to please their clients. In the meantime, the management also wishfully hopes to boost sales through price promotions. When conversing with the CEO of the B2B retailer for the first time, I told him about my gut feelings on the spot: price decreases are futile, as there will be probably no effect on volume at all. After having made this strong statement, I had to prove it. Among others, the project team looked into the instances of price changes in the last quarter. To my relief, the data proved me right. See Fig. 4.

In the last quarter, there were about the same number of price increases and decreases. As the business was growing fast, we were seeing growth in sales volume regardless of the direction price changes were taking. In the case of price increases, the retail price went up by 7.1% on average; when there were price decreases, the retail price went down by 3.0% on average. Interestingly, we saw a stronger sales increase, where the prices were increased. In the meantime, price decreases failed to boost growth, while destroying margins. In the price decrease cases, profit margins dropped by 5.5 percentage points. Price decrease is guaranteed to be a bad choice when demand is inelastic. For our
client in this case, the price elasticity in all product categories is generally low. We also noticed during the project that if clients are complaining about the price, there is oftentimes something else that they are not happy with, be it product- or service-related. Price cut is obviously not the remedy.

The CEO was so convinced of the results of our analysis that he soon hired a dedicated pricing manager as a conclusion of the pricing project. This is why we can proudly say that we are on the sunny side of consulting.

Remember This!

- Price has a huge impact on the bottom line.
- Do the math before enacting any price actions, especially when you are about to decrease price.
- Before decreasing price, you need to ask yourselves this:
  - Will I win new customers?
  - Will existing customers buy more?
  - Will competitors follow suit?

Don’t decrease price unless you have clear answers to the questions above.