

DELLMART PERSPECTIVE

– PRICING PRIVATE LABEL

Retail pricing is the least understood of all retailing functions, yet has significant sales and profit impact. Retailer nirvana is high gross margin while projecting a low price image. Optimizing Private Label pricing represents one of the greatest opportunities for all retailers. The straight discounting off National Brand approach simply does not make sense, it is ineffective and a contributor to both lost sales and profits. Dellmart studies have uncovered many examples of 50% or more discounting off National Brands, yet achieving less than a 10% market share. Our objectives are to provide a rational understanding of the issues and a more intelligent approach to pricing Private Label.

Most retail pricing is based on competitive comparison. Chain A compares and prices off Chain B, which does the same with Chain C, which prices off Chain A. This process is not unlike a dog chasing its tail. The process keeps going in a circle with no one really in control, although the market leader does set the tone. This comparison approach is losing its effectiveness due to retailers stocking different products, thereby reducing the number of items that can be price compared. Private Label items price comparison is limited to some basic items. There are simply too many differences for direct comparison. Many retailers use a minimum and maximum gross margin to control price development. While this is a reasonable control mechanism, there is no pricing theory to support this approach. We can find nothing wrong with a 60% or greater gross margin as long as it does not inhibit sales.

The most common approach for pricing Private Label is to discount off the leading National Brand. Discount pricing is relatively easy to execute, but there is no theory to support this approach either. This contributes to lower Private Label sales and profits. Advances in Private Label product render this approach useless when there is no comparable National Brand.

The foundation for retail pricing is the Elasticity of Demand economic theory. This theory states that if prices are lowered then sales will increase and if prices are increased then sales will decline. A second economic theory that affects retail pricing is the Supply Demand economic theory. This theory states that if supplies are plentiful then prices will decline and increase when supply is limited.

Economic theories are useful, but they require adjustments for the real world. The first adjustment is for the retailers target consumer. A basic item for some consumers is a luxury item for others. Many higher income consumers are somewhat less price sensitive than lower income groups. Therefore the elasticity curve for higher income consumers is shallow in shape. The second adjustment is for extremely low prices. Consumers perceive there is something wrong with the product when the price is extremely low and will not purchase. Extreme low prices will not increase sales past market saturation. Consumers will only buy over time what they can use or consume. Low prices will cannibalize sales within a category, but will not significantly increase overall category sales. When Private Label prices are too low the result is lost revenue and profit dollars. Some refer to this as a large a gap with the National Brand.

Computer software to support pricing falls into two groups. First is execution. After the retail price has been determined, there is the process of getting the correct price on the shelf tag and into the POS system. This is no simple task with daily perishable price changes and weekly promotions. Accurate pricing is an important factor in consumer store selection. Second is price development. The common approach here is a spread sheet or price book. A new price is plugged in and new sales and gross margin are calculated. Newer retail pricing systems expedite this process by bringing together all the data elements. Some systems have the user input a new unit forecast; others attempt to forecast this based on a new price. The accuracy of either method is typically low. In the real world elasticity of demand is not limited to just an item.

Years of research have confirmed a clean store is the number one reason given for selection. Price ranks between numbers two and four in their decision process, which correlates with consumers economic confidence. American consumers are trending towards the European model of daily buying for immediate consumption and weekend shopping for pantry loading. Different shopping trips require different pricing tactics.

Research tells us consumers recall up to 200 item prices. These are primarily highly consumable and frequently purchased items. It is from these items that consumers create their price image for the store. Combining customers recall items results in one to two thousand items creating

a store's price image. These may include some Private Label items.

What we do know about consumers is price by itself is not the deciding factor. Value is the ratio of price and perceived product quality/performance. Low price with low quality equates to low value and low sales. Improvement in Private Label quality has increased the value proposition for consumers and thus sales and share.

Pricing Private Label requires a different approach than either fresh or National Brand products. It includes the four factors of strategy, product type, pricing rules and profitability confirmation. To attempt Private Label pricing without a clearly defined strategy is foolish. In our Dellmart Perspective on Private Label Strategy we identified the key elements required for strategy. The difference between objective and current status is an important element in Private Label pricing.

Private Label products are classified into one of four types for pricing. The factors determining type are product quality/performance and competition. Premium or super-premium type is defined as having superior quality/performance than the leading National Brand. Unique type is defined as items for which there is no direct National Brand equivalent. An important point when working with unique items is to identify their substitution item. All items have a substitution. This is the item consumers would purchase should the preferred item be out-of-stock. Competitive or equivalent type is the category or sub-category where the Private Label item is in direct competition with the National Brand. Here intellectual honesty is critical when comparing the Private Label's quality/performance characteristics with the National Brand product. Commodity or basic is our last product type. These products have minimum value added. Examples include sugar, flour and salt.

Price determination is accomplished by combining the Private Label strategy, product type matrix and pricing rules. Premium types are priced in a range of 0 to +10 percent greater than the National Brand dependent on strategic achievement. The closer an item is to its strategic objective the greater the price premium. Unique types are priced in a range of +5 to +15 percent of their substitute item dependent on their strategic achievement. The closer a unique item is to achieving its strategic objective the greater the price premium.

Competitive type products are priced off the National Brand in a range of -5 to -15 percent. The closer an item is to achieving its strategic objective the smaller the discount. An important, additional consideration is the Private Label item's quality/performance ratio compared to the National Brand. Too small a discount on an inferior product can have a lasting negative impact on the whole store brand. Commodity types are priced in a range of -5 to -20 percent of the National Brand. The closer an item is to achieving its strategic objective the smaller the discount. Larger commodity categories are candidates for Private Label competitor price comparison.

The standard pricing rules apply to Private Label. The velocity rule states faster selling items are priced lower than slower ones. The size rule states larger size products are priced lower than smaller ones. The flavor/pattern rule states items whose only difference is flavor or pattern are priced as a group. The 9's rule says the last digit in the price should be a nine. The final step in Private Label pricing is to validate net profit contribution. Only in very rare circumstances should Private Label items not be contributing a profit.

By linking Private Label strategy with price determination we have a rational approach. Implementation will result in significant sales and profit improvement by eliminating excessive Private Label discounting. Our Private Label pricing approach solves the problem, if you don't know where you are going you won't know when you have arrived.



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