DISCOUNT FALLACY

Walking through a shopping centre today you are bombarded by 30%, 40% and 50% Sales signs which are starting to appear as a permanent fixture. This is numbing customers into expecting this kind of pricing as being the norm and this will eventually come back to haunt retailers. Discounting is a select marketing strategy to capture new clients, introduce a new product or enter a new market. It is not a business model to operate by. There is only one guarantee when you continually discount at normal retail margins. Failure!

Discount stores are not Discounts stores. They buy cheaper product and have good margins on them. If you buy an item for 50cents and sell it for $2.99 then you are a high margin store. Whereas if you buy an item for $5 and sell it for $10 then offer a 20% discount you are selling at a loss. Keep it up and you will go broke. Retailers are not the only losers in this fallacy as small manufacturers, wholesalers and service providers get caught up in it also. Table 1 illustrates the increase in turnover necessary to meet the same gross profit before discounting.

Discount % to Turnover increase					
Discount	**10%**	**15%**	**20%**	**25%**	**30%**
Increase Turnover	11.11%	17.65%	25.00%	33.33%	42.86%

Table1 Discount % to Turnover increase

A quick glance shows the massive turnover increases necessary to achieve the same Gross Profit as you offer higher discounts. Many justify this strategy with claims that it is better to have some cashflow coming in than none at all. Table 2 shows the result of discounting on the net profit of a business with a Net Profit of 10%. We have assumed no other changes.

Discount	**10%**	**15%**	**20%**	**25%**	**30%**
Net Profit	$100,000	$100,000	$100,000	$100,000	$100,000
Adjusted Net Profit	Nil	$-50,000	$-100,000	$-150,000	$-200,000

Table 2 Adjusted Net Profit

This summation is backed by anecdotal and academic evidence. Mr Gerry Harvey of Harvey Norman is quoted as saying that discounting is killing retail and sending businesses to the wall. (ABC News, 2010) and this is not a new problem. Back in 2005 Harvey Norman's Finance director John

Skippen claimed department store strategies send false messages to shoppers. Harvey Norman has also criticised the pre and post-Christmas sales strategies adopted by Myer and David Jones, although it claims they mostly hurt smaller retailers. (Frew W, 2005) Cornell University's research paper "Why Discounting does not work" backs the premise with facts from their study of 6,000 motels. Indeed their conclusion confirms that discounting increases turnover at the expense of profit. Canina and Enz (2004) warn that you may be at the mercy of the dumbest competitor in a race to the bottom if you follow a path of price discounting.

The results of the paper answered 4 important questions:

1) Offering prices lower than your competitor does increase turnover but not profit.
2) Pricing above your competitor reduces turnover yet increases profit.
3) Higher turnover incurs additional costs which impact on profit.
4) High end clients are less sensitive to discounting whilst low end retail clients are discount sensitive.

So those that price themselves 2% higher than their competitors can expect a better profit result on less sales. (Canina and Enz, 2006). People understand that prices are a market mechanism. If you start playing the discount card too much, you're sending a signal that you don't believe your product or service is worth it. And if you don't believe it, who will?

In conclusion Discount sparingly and within a strategy. Do not follow your opposition down the path to oblivion.

References

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