

Product Pricing and Margin:

THEIR IMPACT ON DIRECT MARKETING STRATEGY



1215 4th Avenue Suite 2100
Seattle, Washington 98161-1018
t 206.805.1500 f 206.805.1599
<http://www.hackergroup.com>

Product Pricing and Margin:

THEIR IMPACT ON DIRECT MARKETING STRATEGY

Failure to understand how product prices and margin affect strategy is one of the biggest mistakes marketers make when planning direct marketing campaigns. When the strategy is wrong, the best offers, list selection and creative in the world often can't save the program.

To demonstrate the effects of price and margin on program planning, let's look at three scenarios for the same basic software product (*Fig. A*).

FIG. A

Price/Margin	Low Cost/ Low Margin	High Cost/ High Margin	High Cost/ Low Margin
Product	Software	Software	Software
Price	\$69.95	\$4,495.00	\$4,495.00
Margin	\$64.95	\$4,000.00	\$2,000.00
Direct Marketing Cost/Sale Target	\$20.00	\$2,000.00	\$1,000.00

The higher the price and margin, the less impact these factors have on direct marketing planning, so these scenarios should be enough to make the point.

To run pro formas for the Low-Price Option, we'll use the cost assumptions in *Fig. B*.

FIG. B

Direct Mail Cost Assumptions	
Package Cost	\$750/M
Inbound Call	\$2.00
Outbound Call	\$6.00
Fulfillment	Covered by Handling Fee

LOW-PRICE PRODUCT OPTIONS

Look at the Low/Low scenario. The first question often is: “Should this be a one-step or two-step sales program?” To find out, let’s run two models, one assuming a one-step sale with 50% of orders coming in by mail and 50% coming in by phone. The two-step program generates leads 50% by phone and 50% by mail. There is, on average, one follow-up call with a closing rate between 30% and 60%. The two models are shown in *Fig. C*.

Clearly, the one-step program is the only one that has a chance of success. And even then, the purchase rate must hit 3% or more to achieve the cost-per-sale target. Mailing an upgrade offer to house files should exceed this by a large margin; cross-selling to house files should work too. But 3% is quite aggressive for a one-step package mailed to prospecting files at this price point.

FIG. C

One-Step		Two-Step				
Cost Per Package	\$0.60	Cost Per Package	\$0.60			
Inbound Call Cost	\$2.00	Inbound Call Cost	\$2.00			
Outbound Call Cost	\$6.00	Outbound Call Cost	\$6.00			
Phone Response %	50%	Phone Response %	50%			
One-Step Cost/Sale		Two-Step Cost/Sale At Various Closing Rates				
Buy Rate		Lead Response Rate	30%	40%	50%	60%
1.00%	\$61.00	1.00%	\$223.33	\$167.50	\$134.00	\$111.67
1.50%	\$41.00	1.50%	\$156.67	\$117.50	\$94.00	\$78.33
2.00%	\$31.00	2.00%	\$123.33	\$92.50	\$74.00	\$61.67
2.50%	\$25.00	2.50%	\$103.33	\$77.50	\$62.00	\$51.67
3.00%	\$21.00	3.00%	\$90.00	\$67.50	\$54.00	\$45.00
3.50%	\$18.14	3.50%	\$80.48	\$60.36	\$48.29	\$40.24
4.00%	\$16.00	4.00%	\$73.33	\$55.00	\$44.00	\$36.67
4.50%	\$14.33	4.50%	\$67.78	\$50.83	\$40.67	\$33.89
5.00%	\$13.00	5.00%	\$63.33	\$47.50	\$38.00	\$31.67
5.50%	\$11.91	5.50%	\$59.70	\$44.77	\$35.82	\$29.85
6.00%	\$11.00	6.00%	\$56.67	\$42.50	\$34.00	\$28.33

With aggressive new customer acquisition goals, the next question would often be, “Should we test media to prospect for new customers?”

Let’s run a pro forma based on the media cost drivers in *Fig D*. This time we’ll only model a one-step sale to simplify the example.

FIG. D

Media Cost Assumptions	
Media Cost.....	\$25,000
Circulation	200,000
Inbound Call.....	\$2.00
Fulfillment	Covered by Handling Fee

It’s clear from the pro forma in *Fig. E* that prospecting with an insertion in this publication requires a response rate of about .7% (1,400 orders) to hit the \$20.00 cost-per-sale target. (You can’t just divide 25,000 by 20 and get the answer; you have to add the telemarketing and fulfillment expense to the model.)

FIG. E

Media Cost Assumptions	
Media Cost	\$25,000
Circulation	200,000
Inbound Call Cost	\$2.00
Response Rate	
0.20%	\$64.50
0.30%	\$43.67
0.40%	\$33.25
0.50%	\$27.00
0.60%	\$22.83
0.70%	\$19.86
0.80%	\$17.63
0.90%	\$15.89
1.00%	\$14.50

You now have enough reliable information to make reasonable judgments based on solid economic reality.

- 1** Do you have a better chance of prospecting with direct mail and hitting a rate of 3% or more, or
- 2** Should you prospect with media and be forced to hit .7% response and 1,400 orders, or
- 3** Should you go back to senior management and get them to reduce profit expectations for prospecting?

The answer to #3 is probably yes!

When we change the profit expectation to break-even, look what happens! With a cost-per-sale target of \$64.95, you break even at less than a 1% response rate with direct mail and a .2% rate with this media insertion! Doesn't it make sense to reduce the cost-per-sale target for new customer acquisition when you can add a new customer to your database FREE? The answer is yes if you have multiple up-sell and cross-sell opportunities. And it's probably no if you have a one-product company with no upgrades, service contracts or supplies to sell.

HIGH-PRICE PRODUCT OPTIONS

The key price and margin assumptions that will drive modeling for products with the high-price are again found in *Fig.A*. The main differential is the amount of gross margin available for marketing and contribution to overhead and profit.

The selling strategy for a \$4,495 product is usually two-step, rather than one-step. Direct mail or media are used to generate leads, then the “back end” — telemarketing and fulfillment — takes over. Two-step pro formas will be driven with the cost and performance assumptions in *Fig. F*. Compared with our first example, the primary differences here are a significant increase in direct mail and fulfillment expense and an aggressive lead qualification process. In this case, it is assumed that only 30% of all gross leads survive qualifying and are allowed into the selling process.

FIG. F

Direct Mail Cost Assumptions	
Package Cost	\$1.00 or \$3.00 each
Inbound Call	\$2.00
Outbound Call	\$6.00
Fulfillment	\$15.00
Qualifying Rate	30%

To survive the qualifying process, responders must usually meet four tests:

- 1 The responder has **buying authority**.
- 2 There is a **need** and **desire** to buy.
- 3 There is sufficient **budget** to make the purchase.
- 4 They are willing to make a decision within a reasonable period of **time**.

Responders who don't pass these tests are usually allowed to escape the selling system.

One of the biggest mistakes made in the lead generation planning and budgeting process is spending too much on lead generation. An argument is often made that you have to spend more money to sell an expensive product. Often the opposite is true. The amount of money you can spend on a lead generation package is often severely constrained by available margin and conversion rates.

Let's look at two cost-per-sale models in *Fig. G* — one built on a \$1.00 package, the other on a \$3.00 package.

FIG. G

\$1.00 Package Cost/Sale				
Package Cost	\$1.00			
Inbound Call Cost	\$2.00			
Outbound Call Cost	\$6.00			
Number of Outbound Calls	1			
Fulfillment Cost	\$15.00			
Qualified %	30%			
Marketing Cost/Sale Closing Rate				
Response Rate	10%	20%	30%	40%
1.5%	\$2,848.89	\$1,424.44	\$949.63	\$712.22
2.0%	\$2,293.33	\$1,146.67	\$764.44	\$573.33
2.5%	\$1,960.00	\$980.00	\$653.33	\$490.00
3.0%	\$1,737.78	\$868.89	\$579.26	\$434.44
3.5%	\$1,579.05	\$789.52	\$526.35	\$394.76
4.0%	\$1,460.00	\$730.00	\$486.67	\$365.00

\$3.00 Package Cost/Sale				
Package Cost	\$3.00			
Inbound Call Cost	\$2.00			
Outbound Call Cost	\$6.00			
Number of Outbound Calls	1			
Fulfillment Cost	\$15.00			
Qualified %	30%			
Marketing Cost/Sale Closing Rate				
Response Rate	10%	20%	30%	40%
1.5%	\$7,293.33	\$3,646.67	\$2,431.11	\$1,823.33
2.0%	\$5,626.67	\$2,813.33	\$1,875.56	\$1,406.67
2.5%	\$4,626.67	\$2,313.33	\$1,542.22	\$1,156.67
3.0%	\$3,960.00	\$1,980.00	\$1,320.00	\$990.00
3.5%	\$3,483.81	\$1,741.90	\$1,161.27	\$870.95
4.0%	\$3,126.67	\$1,563.33	\$1,042.22	\$781.67

As you can see, the \$1.00 package makes it relatively easy to hit the \$2,000 cost-per-sale target and possible to hit the \$1,000 cost-per-sale target. By increasing the cost per package to \$3.00, it will be difficult to hit the \$2,000 target and virtually impossible to cross the \$1,000 hurdle.

Typically, it makes more sense to shift investment from the front end to the back end in multi-step selling situations. Let's look at the \$1.00 package scenario again. This time we'll invest more in the telemarketing function in an attempt to increase closing rates. See *Fig. H* for an example.

FIG. H

\$1.00 Package Cost/Sale				
Package Cost	\$1.00			
Inbound Call Cost	\$2.00			
Outbound Call Cost	\$6.00			
Number of Outbound Calls	6			
Fulfillment Cost	\$15.00			
Qualified %	30%			
Marketing Cost/Sale Closing Rate				
Response Rate	10%	20%	30%	40%
1.5%	\$3,148.89	\$1,574.44	\$1,049.63	\$787.22
2.0%	\$2,593.33	\$1,296.67	\$864.44	\$648.33
2.5%	\$2,260.00	\$1,130.00	\$753.33	\$565.00
3.0%	\$2,037.78	\$1,018.89	\$679.26	\$509.44
3.5%	\$1,879.05	\$939.52	\$626.35	\$469.76
4.0%	\$1,760.00	\$880.00	\$586.67	\$440.00

As you can see, it makes much more sense to invest in telemarketing than it does to increase the cost of the mail package. By increasing the cost per package from \$1.00 to \$3.00, the cost per sale at a 1.5% response rate and a 10% close increases from \$2,849 to \$7,293 — an increase of \$4,444!

By investing in telemarketing, cost only increases from \$2,849 to \$3,149 assuming there is no increase in closing rate. If the closing rate goes up to only 20%, the cost per sale would fall to \$1,574, saving \$1,275 per sale. Since telemarketing would have a much greater influence on buying behavior than a lead generation package, the telemarketing investment looks like a better bet to make.

As you can see in some of these examples, if the investment strategy is wrong, you may never recover. Product price and available margin define both opportunity and constraint, so you must run the numbers before you commit budget to any direct marketing program.