Strategic Marketing - Contemporary Issues

Department of Industrial and Management Engineering
Prof. Jayanta Chatterjee
Indian Institute of Technology, Kanpur

Lecture – 5

In the last session on Strategic Marketing, we were discussing about the concept of strategy as a journey and in marketing terms it means it is about assessing our current market position using various tools like SWOT, Strength, Weakness, Opportunity, Threat analysis that we discussed, and going from that current market position strategy is all about getting to the target market position.

Now, what should be our target market position? How do we assess that whether that target is a feasible target or an achievable target? We have to look at various perspectives. Some of those we have discussed and some more we will be discussing that how do we know that our current position can lead to that intended position. There actually we have to look at concepts like the product life cycle and the growth rate, the industry position and so on. We will be discussing all of that, but in assessing this strategic journey as we discussed in the previous session that there can be various alternatives. It is never one clear cut linear plant the marketing strategy must be flexible it must be responsive to emerging situations to that extent it must be adaptive and therefore, we need to assess at various points during the execution of a Marketing Strategy. The cost versus benefit, the kind of budget that we will have to deploy to achieve our objectives and if we achieve those objectives then what kind of benefits will accrue to the organization as a whole and therefore, as I mentioned towards the end of the last session we need to be quite clear about that, what are costs in a strategic sense in the domain of marketing we need to have our concepts clear.

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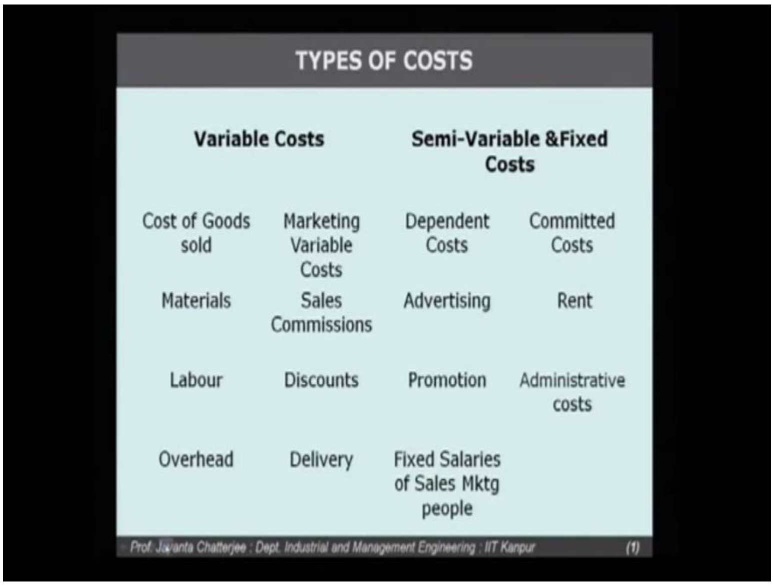

So, today's session will be about understanding some of these fundamental Finance Management Concepts, Accounting Concepts, as they apply to marketing so on. The left hand side as you see on your screen you have variable costs and on the right hand side you have semi variable and fixed costs. So, invariable costs thereare kind of 2 types the column, on the extreme left these are costs which can be connected to each unit of product or service delivered to the customer and so, we often call it as cost of goods sold. It can actually be equally applied to cost of service offered.

And in this therefore, there are issues like materials labour overhead and all of these therefore, we can often look at in terms of per unit which means if you sell five hundred thousand units the material consumption will relate to those five hundred thousand units, if you consume or if you offer four hundred thousand units then the material required will godown accordingly, the labour required per unit will go down accordingly, the total labour requirement will go down accordingly and similarly, overhead that means attribute able fixed costs per unit can therefore, go down or up accordingly to the volume that we are looking at. So, we often call these as costs which can be calculated per unit however some of the other costs under variable costs may not be entirely relating to exactly per unit. For example, say sales commission is often provided according.

If you sell or achieve 70 percent of your target and then when the sales commission kicks in 80 percent of your target and then you will achieve a certain amount of sales commission between 80 to 100, then you achieve another set up higher rate of sales commission may be when you go 100 to 120 and so on and so forth audit sometimes can be given to volume. That means if you sell 10 to 50 units, then there is certain commission; if you sell more than 50 units then maybe a higher rate of sales commission. So, these are costs which cannot be exactly or often not exactly attributed per unit but, could be for a block. Similarly, discounts and the delivery cost because often actually we cannot deliver 1 unit so, delivery costs are often calculated for a package which may contain 10 packets in a box, 50 packets in abox and therefore, those costs have to be calculated accordingly.

On the right hand side we have semivariable and fixed cost that means these are costs. Some of these are dependent dependent on decisions that we can take, some of these are kind of dependent on our discretion to that extent therefore, for how much we are going to spend on advertising is not entirely fixed on it. We do have some control on it or how much we are going to, what will be ourpromotion cost or for example, fixed salaries of sales and marketing people. Again here it is somewhat variable because you could have some control on the total number of such people you will deploy. And then there are some costs which we call committed costs like for example, rent of sales offices or warehouses or administrative costs as these are again not entirely not completely fixed but, again they are committed for 6 months 1 year and so on depending on the terms of business.

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Then there are some other marketing costs,these areexpenditure that are expected to occurin the future as a result of some marketing action that you are taking today and obviously marketing costs differ depending on which alternative you are choosing are in your this going from position current position to your intended position. So, there can be plan a, plan b, plan c and each one will have certain type of marketing cost.

As we had discussed in some earlier session that the marketing effort changes across the product life cycle so, while in the initial stage of the product life cycle it is far more explanatory information and knowledge transmitting activity between the company and the customer and lot of direct sailing expenses may be involved at that stage, lot of exhibition promotional seminars road shows may be involved. So, marketing costs can be higher on those counts in the initial phase. Whereas, at that later stage in the product life cycle the marketing costs could be related more towards service or customer relationship building and so on. So, different plans at different points of time at different points of the product life cycle depending on the company's current position all these marketing costs the composition of the marketing costs would differ. And then of course, we should never forget sometimes we tend to ignore this that by adopting plan a, we are giving up certain opportunities which may be enshrined in plan band therefore, some of those opportunities costs also must be counted acceptance when it is very significant.

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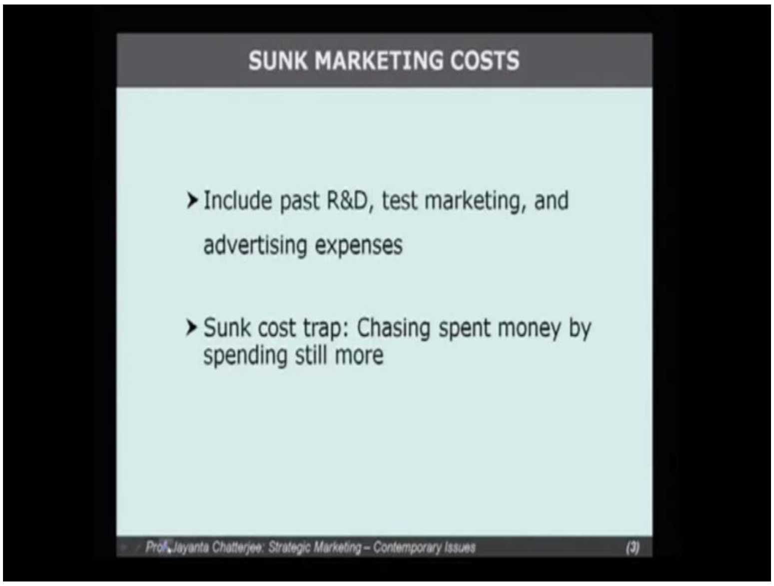

Then, there are costs which we often called a sunk cost that means once committed it is gone. That means saywhat has gone into as we research and a development for developing a particular product that is already innovates. It is a marketing cost because it is a cost of bringing that product into the market. But, to that extent you know it is not per unit it is not controllable today because it is a cost that we have already incurred. Similarly, all new product launches need some kind of testing in the market place before we go for a full-fledged launch and therefore, test marketing costs are often considered a sunk cost.

Similarly, certain pre-launch advertising expenses may also be counted in this category. The sunk cost often is seen as a fallacy or a trap because in a way you first spend money to develop a product, to promote that product, the pre-launch promotion and so on. And to recover that money you actually have to spend more money by way of your post launch promotion, your product life cycle based marketing expenses and so on. So, often actually some costs are they kind of breed more costs in terms of marketing efforts.

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Now, we will like to discuss few of the fundamental concepts. I expect most of youalready know these concepts and but, it is good to recap them before we go along to more deeper and complex topics. So, margin as you all know it is the difference between the selling price and the cost of the offering which means we have used the word deliberately as offering that means, it can equally applies to unit of product or unitof service. It is expressed on a total volume on individual basis in rupee terms or as percentages we will see therest now. So, a short quick quiz for you; so Gross Margin we have question mark, Trade Margin, Profit Margin right. So, what are the, what should we put at this. So, obviously I am suremost of you will be able to answer this. Yes, Gross Margin is equal to, and this is plus. So, Gross Margin, Gross Margin is a Trade Margin plus Profit Margin.

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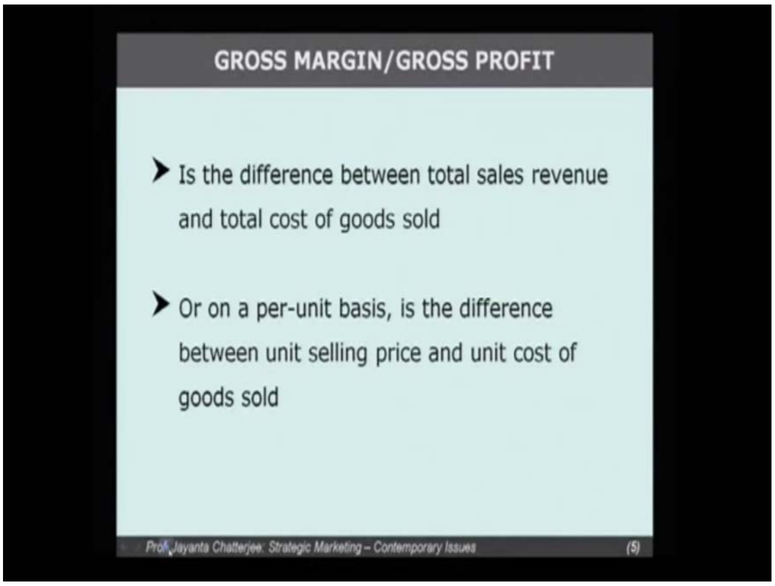

What is Gross Margin? Is the difference between the total sales revenue and total cost of goods sold and that means, we are not considering at this stage often, costs like the cost of money or what we call interest cost and tax and so on. And the Gross Profit can be per unit basis, in which case it is the difference between the unit selling price and theunit c o g sor cost of goods sold. I am sure you are already familiar with these terms from your previous understanding.

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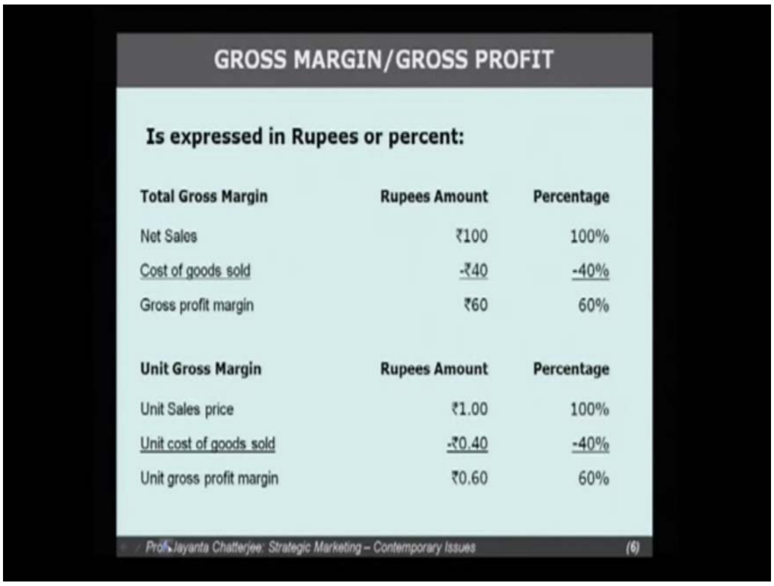

Let us take some quick understanding of numbers. If the next sales is 100 and cost of goods sold is 40 then, the gross profit margin is 60 and it represents in percentage 60 percent. Unit sales price 1, if the unit cost of its 40 paisa. Then, we have 60 paisa per unit as Unit Gross Profit Margin, again that same 60 percent ok. Now, this is an important point that the decrease in gross margin can adversely affect profit and often actually, we when we look at this for example, that suppose you give a 10 percent discount, on your unit sales price, then your new sales price will become 90 paisa 0.9, this does not change because you have given a discount your cost is not going to change.

So, this becomes 0.5 then, you see the difference between 0.6 and 0.5 is almost 20 percent, depends on how you look at it. If you look at from this side, now that means the difference of 10 percent can lead to a 20 percent difference when youlook at your Profit Margin. So, this is a very important point to understand that, that the discount at the sales price level and can look innocuous but, it can be significantly magnified as a reduction in a Gross Profit Margin. Alsoobviously, if there is a fluctuation in unit volume our change in unit price, unit cost of goods sold, modification in the sales mix, all of these can change at the Gross Margin, Gross Profit.

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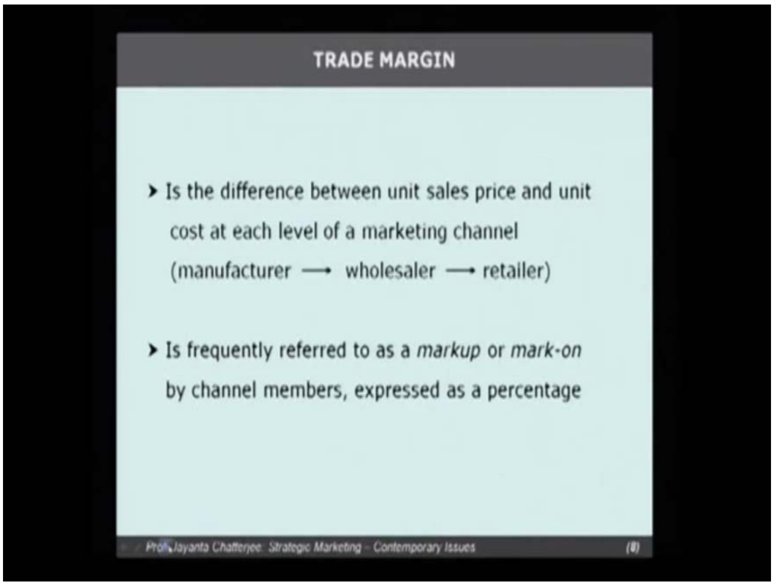

Trade Margin, the difference between the unit sales price and the unit cost at each level of a marketing channel say, as you know a most of the time if we look at most of the fast moving consumer goods like soap, toothpaste, or shampoo, some of the examples that we have been discussing. They go from manufacturer, to the wholesaler, to the retailer. At each stage there is some sharingof margin and this is often called as mark-up or mark-on by channel members, that means and it is expressed as a percentage.

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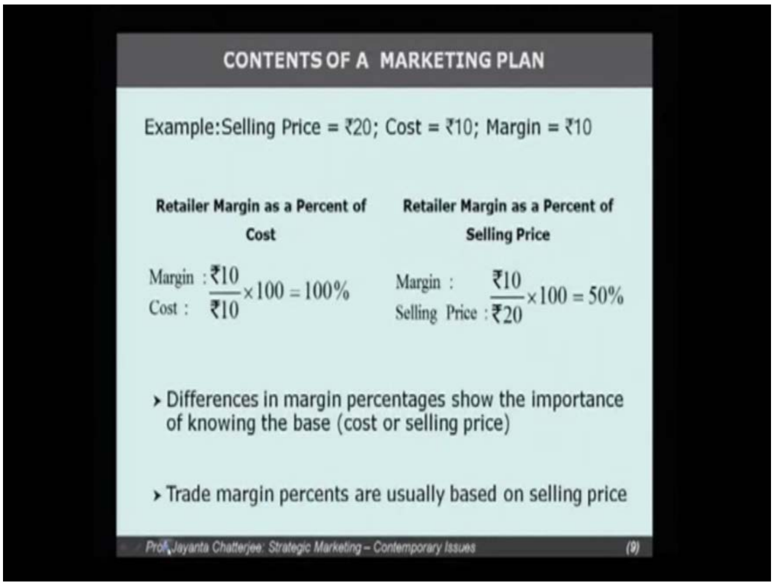

Let us, let us look at some example in this. Now, here you see that if the margin is 10 that means you are selling prices is 20 or cost is 10, your margin is 10, then the margin is 10 percent of the cost and margin is 50 percent of the selling price. Some of this concept should be absolutely clear, they look very simple but, we can get quite confused when we look at some of the financial reports that marketing manager often need to analyse. Trade Margin on the other hand is often based on selling price so, let us look at that. We often actually look at a product and it is MRP or the Maximum Retail Price and so, we look at a soap which is 45 rupees when you buy, the marked price or the MRP maybe 50 on that and the retailer may tell you that I am giving you 10 percent discount.

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But, in reality if that is 45, the retailer most probably might have got it at, you know 31.25 and he is selling at 45 so, his margin is something like 30 percent. Now, if the retailer has received it at 31.25, the wholesaler most probably would have got it at 25. And then, which means the wholesaler is actually keeping a 20 percent margin. If the wholesaler got it at 25, then the manufacturer perhaps, the manufacturing cost or what we often call the cost at the factory gate might be 20. So, you see here that the manufacturer actually gets only 20 percent and and is 50 percent. So, to get to the margin map, you have to start from the end that means, the price in the consumer's hand go from the price at which the retailer was able to get it from the wholesaler and the wholesaler, the at price at which they were able to get it from the manufacturer and as you can see therefore, because of this distribution chain, something that actually the manufacturer only gets 20 or other 25 at against that 20 and reaches you as consumer in your hand it becomes 45 and the marked price maybe 50. So, this understanding is very importantone may think that why not we therefore, jump and go from 25 to 45 or 25 to 50 you can and why do we have to share these margins, right.

Now, this is again at today, 30 years back, 50 years back, this was not a debate because to reach out from your manufacturing location to customers all across the geography you needed a vehicle, you needed a mechanism to get there and it has been well calculated that, if the manufacturer had to take the product or product basket by the company to the customer, the costs are often quite high.Whereas, a wholesaler or a retailer can distribute his or her overhead over a larger basket of products and therefore, it is more economical to use the distribution chain. Today however, because of the electronic market potential, the e-business or internet commerce it is possible, it is tempting, that one couldlook atreaching the customer directly from this point onwards.

Now, obviously that means that a company which is able to do that or products where this philosophy can be or this, this, this concept can be applied, the manufacturers ability to compete goes up. And often, with this respect one has to look at the great example of dell, they are the first PC personal computer vendor, who decided to do most of their business through the virtual distribution chain. That means, they they relied from the beginning heavily on telephone-based, internet-based, direct selling from their manufacturing or distribution location and they did not have distributors and retailers as wereused by many of their competitors at that time.

As a result, Dell had a greater competitive depth because they had lesser amount of sharing, lesser amount to share as margin with their channel partners because they had no channel partner the it was almost direct reaching out to the customerand for many years,it was a very significant advantage and so, gradually they were able to edge upwards and soon they became number one in that market and even though they had competitors like compact or HP or IBM and others, they saw that this was an obvious advantage which Dell had, they were not always able to emulate that example because they already had every significant distribution chain long term relation with their distributors. They needed their distributors for other products and therefore, they could not actually get into that situation which we call often channel conflict.

So, knowing fully well thatthe dell model gives a lesser sharing and elimination of Trade Margin almost entirely and and therefore, a more enhanced marketing power and the competitors are not able to emulate that because ofthe legacy they already had the structure. So, this was a short discussion about Trade Margin and what it does to your competitiveness or to your marketing strategy. So, Trade Margins are important considerations. There are costs. But, there are benefits if you can find an alternative route as Dell found then fine. But, in most in most cases particularly in a far-flung country or when you go into a global scenario, you often have to have a sharing of your Total Margin and there has to be an account for Trade Margin.

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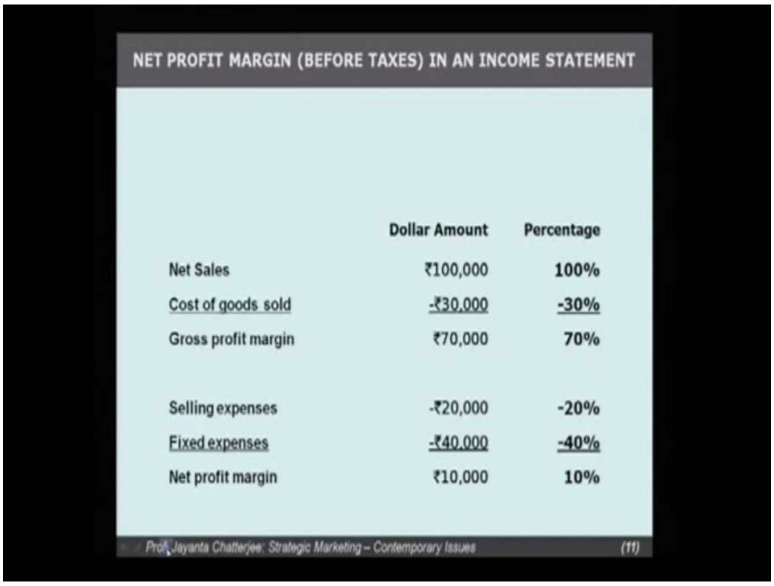

So, this is a typical income statement as you see here that, if the next sales are 100,000 rupees, cost of goods sold 30,000 rupees, Gross Profit Margin 70,000 or 70 percent, selling expenses 20,000 rupees, fixed expenses 40,000. These are some of the expenses that we saw and therefore, you have 10 percent or 10,000 rupees on 100,000 rupees as your net profit margin. This is very important this this margin, that if you are able to push this up and if you do which means that, if you are able to reduce your cost in cost of goods sold, that means you are able to work well as a marketing team with your operations team and therefore, you are able to bring the costs down, cut out the fills that are not truly appreciated by the customer or not that significant in the customer's perception. So, this continuous partnering between the marketing team and the operations team can lead to and if you are able to decrease this to say, even 25,000 right so, your costs are coming down just by 5,000 rupees. But, you see this will straight away push-up your final result to 15,000 which is 50 percent improvement right, because this is now becoming 75,000 and 75,000 minus 60,000 is 15,000. If you are selling expenses, like we were discussing about reduction of Trade Margin if you could utilize more of electronic distribution again can make it significant.

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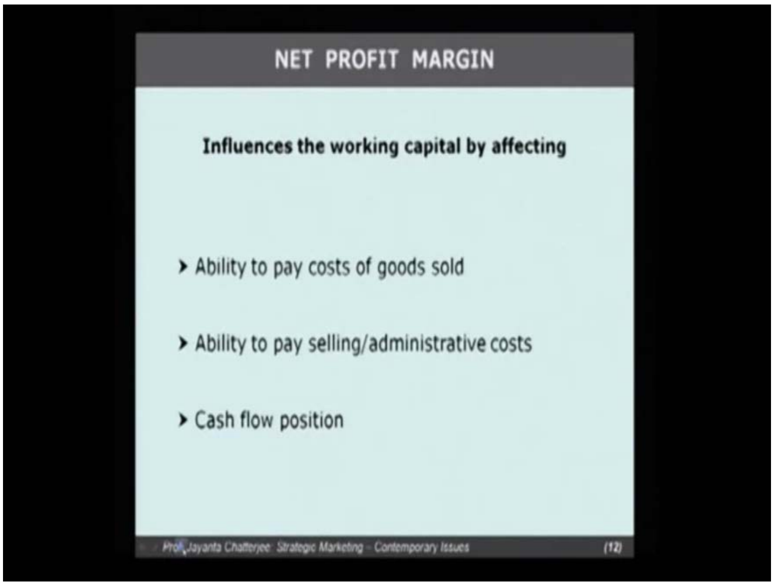

So, 5,000 rupees decrease in COG Scan lead to 50 percent increase in your Profit Margin and if you have higher Profit Margin you are able to improve your working capital because you have a better ability to pay COGS, if you have better ability you can get better terms from your vendors. So, it creates a virtuous cycle here because the higher ability you have to pay your sales people you get better sales people and overall your cash flow position in groups. So, important profit is the life blood, the margin is the life blood of the business in in this scenario.

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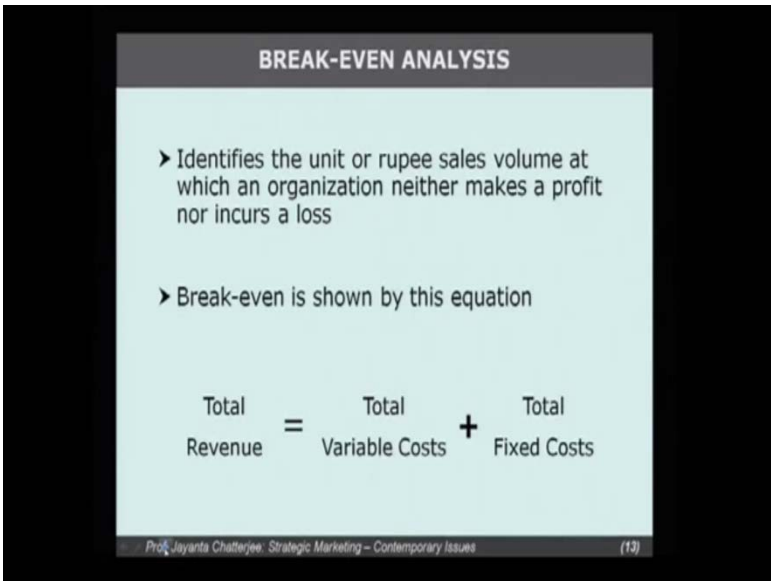

The next important concept that we will discuss will be break-even and break-even is derived from this total revenue is obviously, total variable cost plus total fixed cost and again I am sure that you all know about this how to calculate the break-even volume or break-even price and so on.

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But before that you need to have good estimate ofunit variable costs and an estimate ofthe total fixed cost which is relevant and the selling price for each offering unit.

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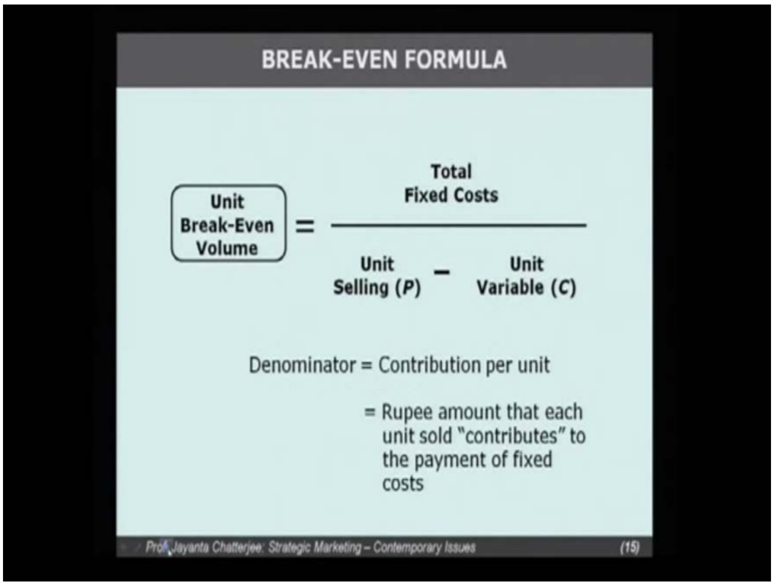

So, then what happen this is how we calculated the total fixed cost divided by unit selling price minus unit variable cost, unit variable cost. So, that gives us the denominator is the contribution per unit, unit selling price minus unit variable cost and this is equal to rupee amount that each unit sold contributes the payment of fixed cost this contribution, that is why we call it contribution because it contributes to the payment of fixed costs.

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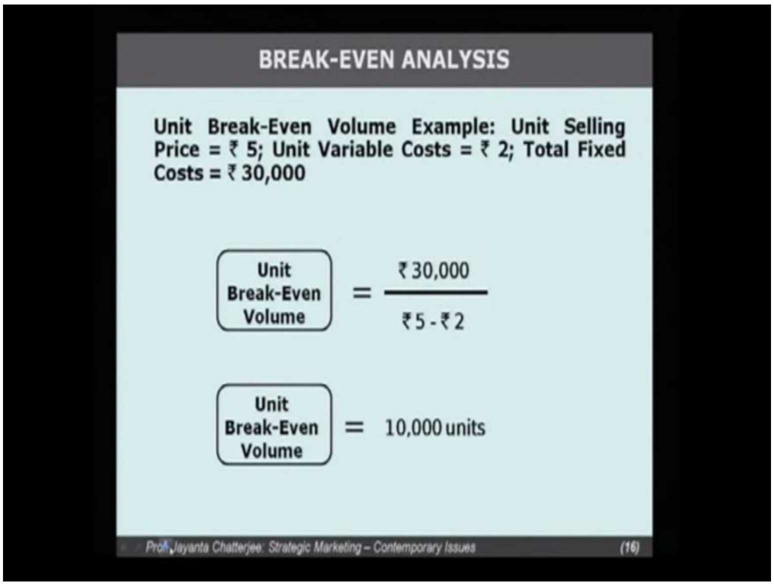

And then, we can apply some numbers that suppose your unit selling price is 5, unit variable cost is 2 rupees and total fixed cost is 30,000. So, 30,000 divided by 5 minus 2 it means equal to 3 so,10,000 units you need to sell to recover your 30,000 rupees fixed cost 10,000 units at the rate of rupees 3 per unit of recovery. In the same way we can look at this, actually we looked at this in terms of numbers units so, this we call break-even volume in units and the break-even volume in rupees will be unit selling price multiplied by the unit break-even volume. So, that means 5,000 is the selling price multiplied by a 10,000 that we just obtained. So, 5 rupees is the so 5 into 10,000 that will give you 50,000 rupees which is your break-even volume in rupees.

So, contribution margin as we discuss whileback is unit selling price minus unit variable cost upon unit selling price so, that kind of gives you as a percentage. So, 5 minus 2 you remember the 5 rupees was your selling price 2 rupees and therefore, your contribution margin is 60 percent 3 upon 5. And rupee break-even volume is often equal tocanalso obtained by total fixed cost divided by contribution margin in percentage. So, 30,000 divided by 0.60 gets you that same 50,000 that we obtained by the other method. 50,000 this we got from unit selling price multiplied by the break-even volume and same 50,000.

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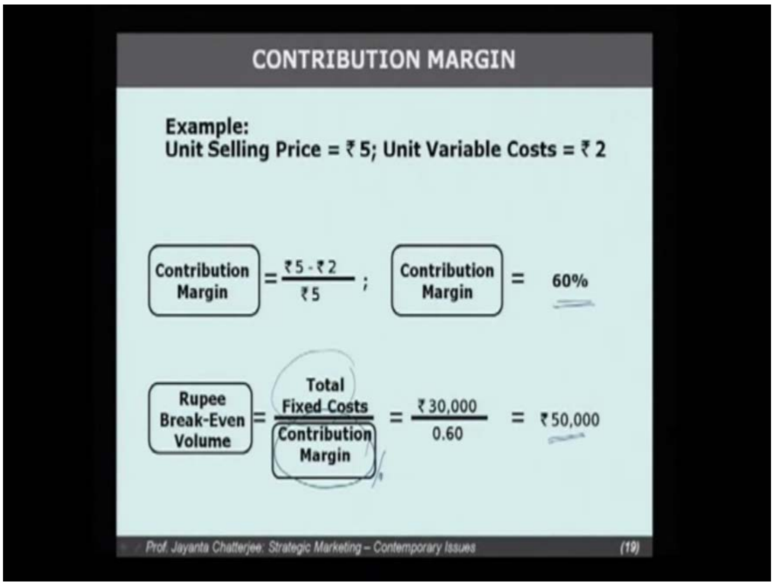

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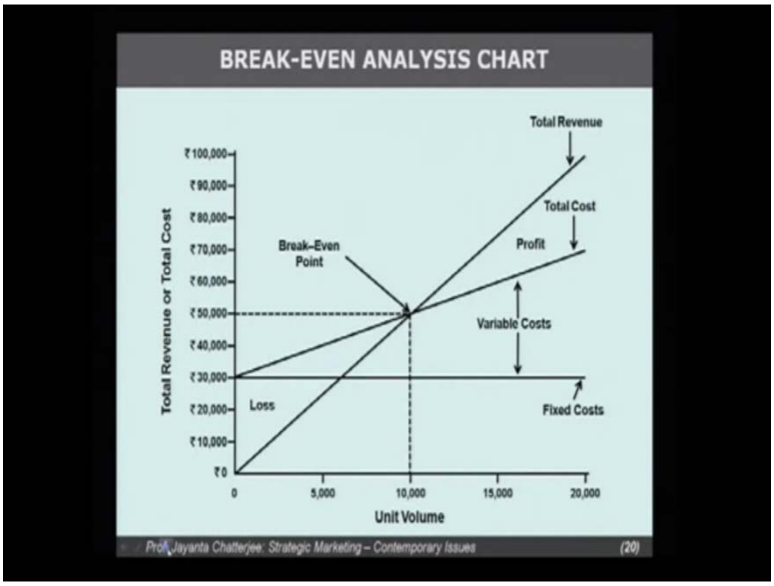

Therefore, we can also look at it graphically and that is this is the fixed cost line it does not change, is not dependent on unit volume. The variable cost right, it changes it comes obviously, after the fixed cost because the fixed cost is there whether you produce 1 unit or you do not produce anything or you produce 500,000 units. Of course, within the limits because there is a, there is a concept of capacity. So, as long as that you would you are within the production capacity of the capacity operational capacity so, fixed cost does not change so, it comes on top of that right.

So, the variable cost and this together can therefore, create this total cost line and we often say that this break-even point is where we reach this either 10,000 and the unit volume or the total revenue. And as you see here, this is the point where total revenue and total cost, these two graphs they intersect. So, break-even means that is where your total revenue has just about met your total cost. What is very interesting is after you cross this point, why we are we so bothered with this point at is that a after this point everything every bit is actually your profit.

So, your contribution at that point onwards goes totally to the profit before that the contribution goes towards meeting your fixed cost. The other very important point is, that if we are able to bring this down that means if our break-even volume instead of 10,000 unit becomes 5,000 unit then, we are able to gain significant marketing flexibility which means that, we can preserve our resources, we are able to then the risks come down significantly and therefore, we can also plan our marketing budget so, we can get a bigger bang for our buck.

So, whenever we look at a new product or any new marketing plan this is very important to bevery clear about that, what is the impact of that marketing plan on your break-even volume because as you can see some of those costs will increase your fixed cost. If you open new offices, if you hire more number of marketing or sales people, if you actually commit yourself to a big campaign, all of that in a way have already created costs which are not attributable to each unit. In a way that means, whether if you go for a big promotion, whether you sell 100,000 units or you sell only 50,000 units it is going to be the cost that is already committed and therefore, you need to sell more to recover that committed cost and that is the fallacy of the trap of the sunk cost. And that is why it is very important to always plan for a break-even volume which is as low as possible which means if we can keep our fixed costs low or if we can improve our margin or contribution per unit, our marketing plan will have strategic advantage. We will continue this discussiononce we look at few other concepts.

Thank you.