CHAPTER 1

Employers Can Fail or Go Broke—And Yours Can, Too

> Our basic problem has been our 14 quarters of losses. And that's because the price of the equipment we build has been less than the cost.
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> —Norman J. Ryker

It is, indeed, an unfortunate fact: *Most* businesses fail. They start off, expand a lot or a little, and then they die. Statistically, 16 out of 17 businesses that start in the United States will fail and/or go out-of-business—most of them in the first two years of their existence. The average life expectancy of all businesses in the United States is estimated at 7.5 years. In fact, one of the headlines used to promote a series of highly successful business management seminars has been, *If your business is not 8 years old, the odds are it never will be!* No less a business giant than Thomas J. Watson, the builder of IBM, in the very first paragraph of his book, *A Business and Its Beliefs,*[1] wrote:

> Of the top twenty-five industrial corporations in the United States in 1900, only two remain in that select company today. One retains its original identity; the other is a merger of seven corporations on that original list. Two of those twenty-five failed. Three others merged and dropped behind. The remaining twelve have continued in business, but each has fallen substantially in its standing.
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> Figures like these help to remind us that corporations are expendable and that success, at best, is an impermanent achievement which can always slip out of hand.

Watson wrote that in the middle of the last century. As we enter a new century, the situation is potentially far worse.

It is a statistical reality that most businesses do sooner or later fail. For us to state that most businesses fail is just as true as it is for us to tell you that if you are not 80 years old, the odds are you never will be. The average life expectancy for people in our society is just short of 80 years: For women it's just at 80 years and for men it's 74 to 75. But on average, we will all be dead by the time we're 80. And, on the average, most businesses will be dead before they are 8 years old.

So Most Businesses Fail—What's That Got to Do with Making My Prices Stick?

Most businesses end up in bankruptcy court and are liquidated or sold off because they aren't making any money. But why should we talk about failure? This book is about success—about how to sell at a premium price and how to make a profit for yourself and your employer. Right? Not necessarily. However, we would argue strongly that one of the first things you need to recognize is that the fundamental problem in making your prices stick is that you're competing with many people and businesses who are actually going broke. And when businesses start losing money, *they cut their prices.* In a desperate attempt to try to stay alive, they slash their prices because they've always been told that they can make it up in volume. They think if they can just sell more, then surely they will come out on top. But that doesn't work. When was the last time you saw a business that had a going-out-of-business price *increase?*

Most people have no idea how many businesses actually do fail in the United States. It is estimated that there are 800,000 new businesses started in the United States each year, yet there are only about 11,000,000 businesses existing in the country at any given time. Let's relate that number to another relevant statistic. According to the U.S. Census Bureau, there are approximately 293,000,000 Americans. That means that there is roughly one business for every 27 people. Roughly, only about 40 percent of our population work outside of the home. That means that we have approximately one business for every 11 people employed outside the home. Therefore, if we have 800,000 new businesses starting each year, and we have only 11,000,000 businesses, the failure rate *has* to be rather extensive. If it were not, we would eventually have more businesses than we have people to run them.

Maybe we should say that *fortunately,* half of those 800,000 businesses that start fail the first year. And that *fortunately,* half of the remaining half fail the second year. This means that roughly three out of four businesses that start fail in the first two years of their existence. And you need to keep that in mind when you come home from a hard day of selling, with your nose bloodied, and your knuckles skinned up, and you say to yourself, "We are getting killed; we are getting hammered out there. How can those guys sell at that price? If they can sell at that price, we can, too."

Well, Mr. or Ms. Sales Professional, you have only part of that right. *They* can sell at that price—and go broke and *you can, too!* If you base your price on your competitor's price—and they are going broke—you will, too. Typically, someone among your competition is going broke and usually is cutting prices on the way out. Owen Young, who is credited with having built General Electric, once said, "It's not the crook we fear in modern business; rather it's the honest guy who doesn't know what he is doing."

It May Be Illegal to Be Crooked, But It Isn't Illegal to Be Stupid

Whom would you rather compete against, a crook or an idiot? If you think about it, you'll no doubt decide in favor of a crook. Have you ever seen a crook sell below cost? Have you ever heard anybody call the Mafia *poor business people*? You may not approve of the Mafia and their "business," but you have never heard anybody say they don't know how to make money. And lots of it!

Now, let's address the idiots. Have you ever seen an idiot sell below cost? Which idiot? And on what day do you want to talk about? You see, Owen Young was right. Fundamentally, it is not the crook we fear in business, but rather it is the honest idiot. The people (or organizations) who don't know what they are doing are the ones who foul up the works. And fundamentally, they are the ones giving away their products and services by cutting their prices.

Causes of Business Failure

Typically, when a business does go bust, especially if it gets into enough trouble to file bankruptcy, three things occur:

1. They experience a period of declining gross margin;
2. Wages, as a percentage of sales, begin to increase; and
3. Sales volume begins to increase.

In this book—because we are dealing with the subject of how to make your prices stick—we are going to deal in depth with only two of those three things: declining gross margin and increasing sales volume. Wages are a whole different issue, deserving its own book.

Declining Gross Margin

A declining gross margin indicates that there is a pricing problem. The way to calculate gross margin (GM) is by subtracting the cost of goods sold (COGS) from sales:

$$\begin{aligned} \text{Gross margin} &= \text{Sales - Cost of goods sold} \\ \$35 &= \$100 - \$65 \\ 35\% &= 100\% - 65\% \end{aligned}$$

The only way that gross margin (as a percentage of sales) can go down is if a business cuts its prices or fails to raise its prices when its costs rise. That's it. Even though that can occur three different ways, the bottom line is the same: The sales price is too low relative to the cost of goods sold. These three ways are shown in the box titled, "The Three Ways Gross Margin Can Decline."

Declining gross margin should inevitably send a signal to an organization that it is experiencing a pricing problem that will ultimately result in trouble. It clearly signals either an inability or an unwillingness to sell its products or services at a high enough price in comparison to the costs. Most organizations that file for bankruptcy due to operational reasons have had a clear history of declining gross margin for a significant time before they ever filed. They often will blame it on "cost increases," but the real culprit is a declining gross margin: Their selling price was too low relative to their cost.

In fact, one of your authors recently had a conversation with the CEO of a firm that had to sell out before bankruptcy. And sell out he did. What did the former owner say? Here it is: "If I had increased price and cut capacity to half, we'd be in business today." His error, which he now sees, was that he did the exact opposite.

Wages, as a Percentage of Sales, Begin to Increase

A second condition that normally prevails when any entity fails financially is that wages, as a percentage of sales, begin to increase. This normally occurs because the organization just has too many people on the payroll or too many people making too much money. There often are too many people sitting around on their hands, watching other people who are also sit-

The Three Ways Gross Margin Can Decline

A. If you *cut* price $5 to sell something, situation A transpires:

Situation A

	Dollars	**Percent**	**Dollars**	**Percent**
Sales	$100	100%	$ 95	100%
COGS	65	65%	65	68%
GM	$ 35	35%	$ 30	32%

B. If you don't cut price to get a sale, but *fail* to raise price when your costs go up $5, situation B transpires:

Situation B

	Dollars	**Percent**	**Dollars**	**Percent**
Sales	$100	100%	$100	100%
COGS	65	65%	70	70%
GM	$ 35	35%	$ 30	30%

C. If you find your costs are going up $5 and raise your price only by the amount of your cost increase, situation C transpires:

Situation C

	Dollars	**Percent**	**Dollars**	**Percent**
Sales	$100	100%	$105	100%
COGS	65	65%	70	67%
GM	$ 35	35%	$ 35	33%*

**Note:* Your dollar gross margin stays at $35, but your gross margin as a percentage of your sales goes down from 35% to 33%. In short, raising your price the same dollar amount as your cost increase is a de facto price cut. You must raise your selling price the same percent as your percent increase in costs if you are to maintain your gross margin percent in the face of rising costs.

ting around on their hands. However, as we've suggested, that's a subject that falls into another area of business management and not what we want to talk about here. However, for the decision-making executive, that is certainly an area that should be monitored constantly. Why is that? Because it often proves difficult to downsize a work force even if people don't have anything to do. Executives must never allow wages as a percentage of sales to increase above a point where they have good profitability, or their organizations will likely go broke—even if they don't have a problem in making prices stick.

Sales Volume Increases

Surprisingly, most entities that go broke do it during a period of an increase in sales volume. This statement shocks most people (especially those involved with sales) because most everyone mistakenly believes that a business fails as a result of a lack of sales volume. The facts are, however, that business is *not* a game of volume. *Business is always a game of margin.* If a business doesn't maintain gross margin at an adequate level, it is going to go bust, *regardless* of its sales volume. Cheap seats, cheap products or services, and giveaway prices really do have a way of attracting more and more customers. Have you ever seen a yard sale go wanting for customers? We don't think so. Lots and lots of items for sale and all at very low prices.

Business Is a Game of Margin, Not Volume. Many large company leaders seem to sincerely believe, albeit blindly, that volume and market share are the secrets to business success. If that is the case, then why are multiple billion-dollar corporations filing bankruptcy every year in the United States? In the years between 2000 and 2004, 23 of the 40 biggest bankruptcies of all time occurred.

The year 2001 was a record year for big dollar bankruptcies—there were 257 major organizations that filed in the United States in that year alone. Since then, we've seen even more high-profile bankruptcy filings such as Enron, Kmart, and WorldCom—the record holder with assets worth more than $103 billion on the day before its default and credited with a bankruptcy worth $11 billion.

Westpoint Stevens, once one of the largest home fashion manufacturers in the United States, filed for Chapter 11 protection before agreeing to be bought by an investor group, WL Ross & Co., which had already purchased failed textile companies Cone Mills and Burlington Industries. The Fleming Companies, which not only was a supplier to Kmart, but owned IGA and Piggly Wiggly grocery stores, filed for bankruptcy in 2003 with revenues of $15.6 billion.

Delta Air Lines filed a report with the Securities and Exchange Commission that it would likely incur a net loss for 2005, and as we go to press in October, the airline has filed for bankruptcy. (Like many airlines, Delta narrowly avoided bankruptcy once in 2004 when its pilots agreed to concessions.) The same day, Northwest Airlines also filed for bankruptcy protection, negatively affected by union troubles, an out-of-date "hub-and-spoke" model, and increasing fuel costs.

"As goes General Motors, so goes the nation," was a famous expression of the 1960s. But as we write this, there is speculation in some very prestigious business journals that General Motors itself may be bankrupt by the year 2020 or before.

Even these few examples should provide a fairly graphic picture that business is, indeed, not just a game of volume and market share. A business must maintain an adequately high price against its costs (a high gross margin), or it is going to follow these well-known predecessors down the well-traveled path to bankruptcy court.

But We Can Make It Up in Volume. When businesses get into financial difficulty, it's inevitably because some genius gets the bright idea that one can cut price and make it up in volume—to at least be "competitive." Most people get that idea when they take a course in economics. In fact, if you have anything to do with selling or pricing, one of the *worst* things that may have ever happened to you was taking Econ 101 when you went to college.

Just to emphasize the point that the bulk of our population thinks that the only way to do business is to cut price and make it up in volume, consider what happened as a result of airline deregulation. Way back in 1978, then-President Jimmy Carter deregulated the airline industry. This meant that the airlines were free to charge any price they wanted. How many raised prices? Answer: None. How many kept the same prices? Answer: Virtually none. They all, in varying degrees, began to *cut* their prices. How many airlines have filed for bankruptcy since deregulation? Answer: Hundreds. And some predict that the twenty-first century will see a further culling of the airline industry so that just a few airlines survive.

It could be argued that the first airline to really figure this out was Southwest. Here was an airline that intelligently attacked key issues head-on and won. However, it took them a long time after deregulation to enter the scene and become competitive. Perhaps they learned from the losers. Some of the traditional airlines have (and are) going broke, because they are cloned knockoffs of the model. Southwest keeps labor costs down by hiring younger, non-union employees and sustains margin with a series of maneuvers that cut costs. For example, flying a limited number of aircraft models eliminates training redundancy, a huge parts inventory, specialized tools, and other costs. In addition, they eliminated the wasteful hub concept and, instead, fly from point to point. The result? They *can* sell cheaper seats, but keep labor costs in line, control other expenses, and still sell more seats. However, they are a minority player, and it took many years for someone to discover the formula. We cannot help but wonder what the future holds for them as costs, labor demands, and all the rest potentially escalate. There are other airlines merging and following suit as well—making the terrain even more competitive.

Some airlines that have filed for bankruptcy since deregulation include:

Air Florida Systems
America West Airlines
Braniff International (twice)
Capitol Air, Inc.
Conquest Industries, Inc.
Continental Airlines (twice)
Crescent Airways Corp.
Delta Airlines
Eastern Air Lines, Inc.
Fine Air Services Corp.
Frontier Holdings (twice)
HAL, Inc.
Hawaiian Airlines, Inc. (twice)
Kitty Hawk, Inc.
Metro Airlines
Midway Airlines, Inc.
Northwest Airlines
Pan Am Corp.
People Express
Provincetown Boston Airlines
StatesWest Airlines, Inc
Tower Air, Inc
Trans World Airlines (three times)
UAL Corp. (United Airlines)
US Airways, Inc.
Vanguard Airlines
Western Pacific Airlines

The ability to fail creatively is widely documented. The depths have not as yet been plumbed as to the new, novel ways somebody is going to figure out how to mess up a business. *But they all go back to one common pattern: They cut the price (to make it up in volume).* If you think you can match (or sell below) your competitor's prices, you need to understand that you will have an on-going, lifetime battle for survival that, sooner or later, you are going to lose.

Why Companies Cut Price When They Get into Trouble

Perhaps you've heard the story of the industrious entrepreneurs who set out to make their fortune by buying watermelons for a buck each and selling them for $10 a dozen. And, like any good joke, it is readily adaptable to anything. Just change the subject—watermelons, exit signs, carpeting, hammers—and make the local meathead the butt of the joke. The way we originally heard it ran as follows:

> There were these two guys from Texas who had a little money and an old pick-up truck. They heard they could buy these watermelons in Mexico for $1 each and they decided that they could sell them for $10 per dozen.

> So, they went to Mexico, loaded the truck with watermelons and headed toward Dallas, selling off these watermelons for that $10/dozen. They did a great business and sold out of watermelons before they even got halfway to Dallas. But, while sitting on the side of the road, counting their money, they noticed they were a little short of the amount they had started with. They wondered what the problem was since they had done a brisk business and it finally dawned on them—what they needed was a bigger truck.

Although you may have thought this was a new story, there is clear evidence that it has been around for over a century. Paul Nathan,[2] who wrote *How to Make Money in the Printing Business,* published the following in 1900:

> If there is any one thing in the business management of a printing office that particularly commands the utter disapproval of successful printers as being worse than other evils that beset the trade, it is the cutting of prices. The method of getting work by lowering the price has absolutely nothing to recommend it, and it is contrary to common sense. The practice is absolutely wrong in principle, and the reasoning advanced in its support, stripped of its verbiage, is the equivalent of that of the old apple-woman who bought apples at a cent each and was selling them at ten cents a dozen, and when asked how she could make any money at that replied: "By doing a very large business."

When a business gets into trouble, it has a cash-flow problem and a margin problem—not a profitability problem. For example, let's consider the following:

Question: Do the vendors to your company care whether: (A) you're profitable or (B) pay your bills?

Answer: (B) pay your bills.

Question: Do an organization's employees care whether: (A) their employer is profitable or (B) meets its payroll?

Answer: (B) meets its payroll.

An organization gets into trouble when it can't pay bills and/or can't meet payroll. It has a cash-flow problem (or more correctly, a cash-trickle problem). This creates an intolerable situation for the organization. If the bills aren't paid, it will be cut off from needed services and supplies; if payroll isn't met, there will be no one to do the work. So, the first thing executives start worrying about is, "How can we get some cash? . . . How can we get that cash in the fastest way?" You guessed it. It has got to *sell* something! How to sell that something? Use the old standby: *Cut the price.* Unfortunately, cutting the price immediately creates the three danger signs that signal the organization may soon become a bankruptcy statistic: (1) gross margin goes down, (2) wages as a percentage of sales go up, and (3) sales volume begins to increase.

Gross margin must go down when prices are cut. But do most organizations cut wages when they cut prices? No. So then, wages as a percentage of sales go up—and sales go up because of the lower prices. Again, remember that those are the three conditions that *virtually always prevail* when an organization really gets itself in trouble and ends up filing bankruptcy or having to sell off or merge because it isn't making any money.

Many salespeople have the feeling that when they're out in the marketplace, the only way to sell and compete is to cut price when the competition starts cutting its price. They think, "Hey, we're getting killed. We're getting hammered. Our competitors are selling at a lower price than we are. They keep cutting price. We can't compete on an unlevel playing field. And, if those guys can sell at that price, we can too." So they go back to the boss, and say, "Hey, boss, we're getting smashed out there. Those guys are selling at a lower price. And we need to do the same thing or we won't ever be competitive." Well, the bottom line is—*If those guys can sell at that price and go broke—you can, too.* Just because your competition is selling at a price or offering products or services at a price lower than you are, it doesn't mean you can—or should even try to—meet their price, because most of that competition is going broke.

Maybe you *still* don't believe that most businesses go broke. Perhaps you think it's only the little start-up companies that lose it—not the big boys that "really know what they're doing." Do you think that big businesses don't go broke? Let us give you another example. *Inc.* magazine, way back in May of 1988, reported that, "We should not expect that our large corporations somehow possess a corporate fountain of youth. We should not mourn the fact that, in the 11 years between 1970 and 1981, 29 percent of the 1970 *Fortune 500* companies vanished as companies . . ."[3] The article went on to say that the " 'vanishing rate' of a *Fortune 500* company is only two-and-a-half times less than the vanishing rate of a garage start-up today." Did that continue? Let's take a look.

Other notable bankruptcies ($100,000,000 or more in assets) in the early 2000s have included: Mirant Corporation; Spiegel, Inc.; Penn Traffic Company; NRG Energy, Inc.; Solutia, Inc.; Amerco; Alterra Healthcare Corporation; Pillowtex Corporation; Conseco, Inc.; Global Crossing, Ltd.;

NTL, Inc.; Adelphia Communications Corporation; Genuity, Inc.; Exide Technologies, Inc.; Viasystems Group, Inc.; Consolidated Freightways Corp.; Roadhouse Grill, Inc.; President Casinos, Inc.; Archibald Candy Corporation; Florsheim Group, Inc.; TransTexas Gas Corp.; Jacobsons Stores, Inc.; Kasper A.S.L, Ltd.; Geneva Steel Holdings Group; Guilford Mills, Inc.; Formica Corporation; Oakwood Homes Corporation; Consolidated Freightways Corporation; Globalstar, LP; Highlands Insurance Group Inc.; Farmland Industries; National Steel Corporation; Budget Group Inc.; XO Communications; Today's Man; Piccadilly Cafeterias; FAO, Inc.; iPCS Inc.; Neenah Foundry Company; Magellan Health Services; Congoleum Corporation; Eagle Food Centers Inc.; Cone Mills Corporation; Wherehouse Entertainment Inc.; . . . and the list goes on.

Notice that what we are talking about doesn't just involve an isolated segment of the business world. Failure occurs in all avenues—big and small, established and start-up. But there is a commonality that exists—most failing companies believe they can cut their prices and make it up in volume, but they fail to consider what happens to their gross margin when they try to compete that way. As the quote at the start of this chapter says, "The cause of our losses is that the *price* of the equipment we build *has been less than the cost.*"