



Bundling and Loss Leaders

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Pricing Strategy—Class 7

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Why Bundle?

- Strategic:
 - Entry deterrence
 - Mitigation of competition
 - Price obfuscation
- Product Quality and Customer Experience:
 - Manufacturer can assemble bundle better than consumer (e.g., cars)
 - Common commands across programs, guaranteed compatibility. e.g., software suites
 - Restrict Choice: Behavioral choice theory says offering too many options leads to fewer sales
- Margin:
 - Cost: Cheaper to offer fewer options, more efficient to produce
 - Price optimization: capture more consumer surplus and make more profit!

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Chips and Salsa

	Chips		Salsa	
	WTP			WTP
Adam	6		Adam	1
Betsy	5		Betsy	2
Charlie	4		Charlie	3
Daphne	3		Daphne	4
Edgar	2		Edgar	5
Fran	1		Fran	6

Price Chips individually? $6 * 1$ or $5 * 2$ or... $3 * 4$ or $4 * 3 = \$12$

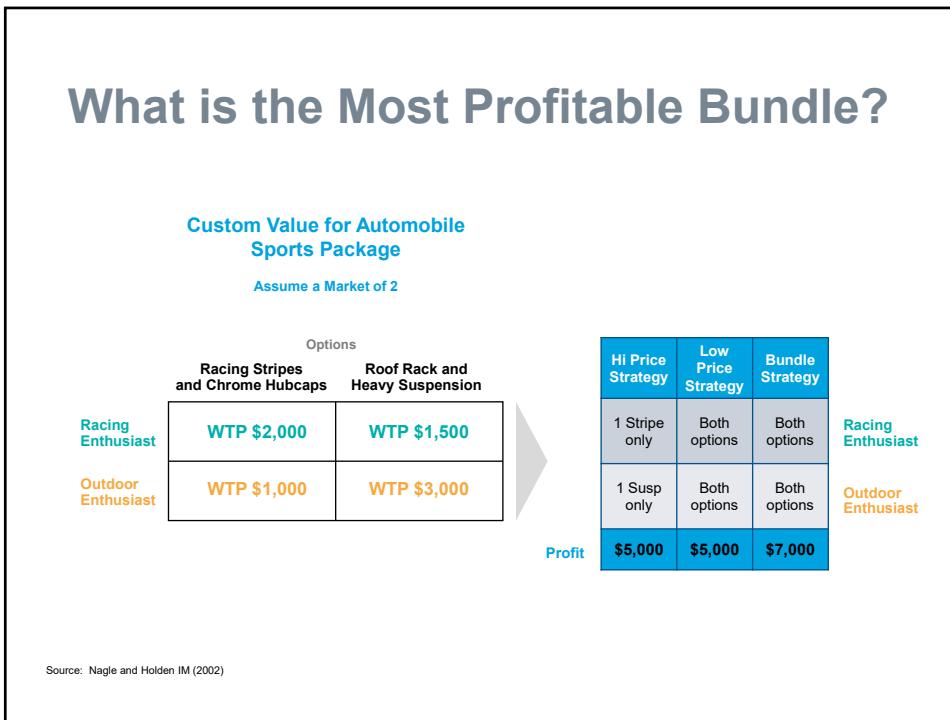
Price Salsa individually? Same →

Total Revenue: $\$12 + \$12 = \$24$

Price Chips + Salsa bundle? $6 * 7 = \$42$

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For BE Sales Change, Adjust CM

- Break-even calculations for complementary products need to reflect the contribution margin for the complementary products that are sold when the product being priced is sold

**Adjusted \$CM = Unadjusted \$CM + (Change in Sales of Complement *
\$CM of Complement)**

- Break-even calculations for substitute products need to reflect the contribution that is lost on substitute products when the product being priced is sold

**Adjusted \$CM = Unadjusted \$CM - (Change in Sales of Substitute *
\$CM of Substitute)**

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Not Products, But Value Bundles . . .

Smithsonian Mobile sells Zebra smartphones and provides wireless service throughout North America. Smithsonian sources the popular “Zebra” smartphone from Samsung for \$170, and sells the Zebra to consumers for \$200. To drive sales and profits, management is contemplating a 10% price cut. Should it proceed with the price cut?

10% Price Cut:

% BE Sales Change = _____ %

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Not Products, But Value Bundles . . .

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$$\text{CM: } \$200 - \$170 = \$30$$

$$\Delta P: -10\% * \$200 = -\$20$$

$$20 / (30 - 20) = 200\%$$

Sales would have to increase 3x to deliver same CM

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But Zebras Lead to Other Sales Too

But when consumers buy smartphones they purchase other add-on products and services too. By tracking past changes in sales of other accessories and services, management found that each smartphone sold is associated with the following changes:

Product	Dollar Change	%GM
Charger	\$12.70	65%
Case	\$28.40	55%
Screen protector	\$4.60	80%
3-Year Insurance Plan	\$480	95%

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The Complete Zebra Value Bundle

What is the gross margin (\$) of the broader “value bundle?”

	Dollar Change	%GM	\$GM
Charger	\$12.70	65%	\$8.26
Case	\$28.40	55%	\$15.62
Screen Protector	\$4.60	80%	\$3.68
3-Year Insurance Plan	\$480.00	95%	\$ 456.00
Incremental Gross Profit			\$483.56
Basic Smartphone	\$200.00	15%	\$30.00
Total			\$513.56

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Smithsonian Mobile Sells Zebras

So . . . to drive sales and profits, management is contemplating a 10% price cut on the Zebra. Should it proceed with the price cut . . . [in light of the broader Zebra value bundle]?

10% Price Cut:

% BE Sales Change = _____ %

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Smithsonian Mobile Sells Zebras

So . . . to drive sales and profits, management is contemplating a 10% price cut on the Zebra. Should it proceed with the price cut . . . [in light of the broader Zebra value bundle]?

CM: \$513.56 (previous page)

$\Delta P: -10\% * \$200 = -\20

→

BE Sales Change: $20/(513.56-20)$
 $= 20/493.56$
% BE Sales Change = 4.1%

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Is Chicken a Good Loss Leader?

As a pricing analyst for the Value Supreme grocery chain, you are asked to prepare the analysis of a proposal to price whole frying chickens low in order to attract shoppers to VALUE SUPREME stores.

The current price for whole chickens is \$.89 per pound. The proposal is to set a promotional price of \$.59 per pound. The wholesale cost of the chickens, prepackaged and ready for sale, is \$.55 per pound.

By tracking past changes in sales of chicken with changes in sales of other grocery products (how would you do this?), you discover that each one pound of sales of whole chickens is associated with the following changes in the sales of other products:

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Chicken – 2

Product	Dollar Change With One Pound of Chicken	\$CM
Fruits and Vegetables	+.154	50%
Packaged Groceries	+.692	20%
Frozen Foods	+.114	33%
Other meat incl. chicken parts	-.250	40%

1. If this past relationship between sales of whole chickens and increased sales of other goods holds, by how much must chicken sales increase to make this price promotion profitable?
2. How might you structure the promotion to increase the likelihood that additional chicken sales will in fact result in a corresponding high level of sales for other products?
3. Could this store have profitably promoted whole chickens at \$.49 per pound?

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Chicken – 3

Calculate contribution for the chicken and its complementary and substitute products:

Product	\$ Change	%CM	\$CM
Fruits and Vegetables	.154	.50	.077
Packaged Groceries	.692	.20	.138
Frozen Foods	.114	.33	.038
Other meat	-.250	.40	-.100

Contribution margin for chicken is $\$.89 - \$.55 = \$.34$

The resulting contribution margin is:

$$\$.34 + \$.077 + \$.138 + \$.038 - \$.100 = \$.493$$

Use BE Sales Change with price change and adjusted CM:

$$\frac{-\Delta P}{0.493} = \frac{.30}{0.193} = \frac{.3}{0.193} \quad \boxed{= 155\%}$$

Sales would have to increase by 155% just to reach break even

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Chicken

$$P \ .89 \rightarrow .59$$

$$\Delta P = .30$$

$$VC \ .55$$

$$CM_{old} = .89 - .55 = .34$$

$$Fruit \ + .154 \ C \ 50\% = .077$$

$$Groc \ + .692 \ C \ 20\% = 0.1384$$

$$Frozen \ + .114 \ C \ 33\% = 0.0376$$

$$Meat \ - .250 \ C \ 40\% = -0.1$$

No Complements/ Subs:

$$\frac{.30}{.34 - .30} = \frac{.3}{.04} = 7.5$$

$-\Delta P$

$$\frac{.30}{0.493 - .3} = \frac{.3}{0.193} \quad \boxed{= 155\%}$$

$$Adj. CM = \boxed{0.493}$$

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What makes a good loss leader?

What makes a good loss leader?

- Frequently purchased products because shoppers are likely to remember their prices and use them as a proxy for judging the stores overall price level
- Products purchased by the more price-sensitive segments

Where would you expect to see especially low prices on some products to attract customers into the store?

- High-margin stores: the adjusted contribution margin for the loss leader is greater because of the high margins on all the complementary products
- Full-size supermarkets (that is, not small convenience stores): larger store has more complementary products to sell, so the adjusted contribution margin is higher

What are the risks of a loss leader promotion?

- *Inventory or stock-up effect*
- Purchase complements in lower-than-historical ratios

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