Beware Of Outsized Gross Profits

Sometime around 2009, Guitar Center launched the proprietary line of Laguna guitars with the stated goal of improving its gross profit. By purchasing direct from an Asian factory, cutting out the middleman, and having an exclusive on the line, Bain Capital, Guitar Center's owners at the time, projected that they could "significantly" enhance gross profits. The guitars were supported with an ads in all major enthusiast magazines and GC flyers that carried the headline, "We asked guitar players what they wanted…"implying that Laguna guitars filled some long unmet need. One bystander caustically noted, "Who knew all these years that what players really wanted was an Indonesian guitar with a lot of shell inlay at an F.O.B. price of $98." We're not privy to Laguna sales data, but the fact that GC is no longer promoting the line suggests that results fell short of projections. Search the GC and Musician's Friend websites today and you'll find a single Laguna model that was initially offered for $699 now priced at $99. We're guessing that the improved margins never materialized, the victim of heavy discounts, sales spiffs, and customer indifference.

This case study sheds light on the changing dynamics of the marketplace. Setting aside the relative merits of Laguna guitars, or the accompanying promotional strategies, any product created primarily to pad a retailer's gross margin is unlikely to find favor with the buying public. Even one backed by Guitar Center's considerable promotional muscle. Consumers have always been pretty good at picking out the best price/value proposition. The internet has only sharpened this aptitude, enabling them to make these judgments faster and more accurately. The collective wisdom of the market is also widely shared through product forums, social media, and blog posts. The result is transformative. A 1989 consumer study, conducted by the Nielsen organization, concluded that a contented customer would tell three others about his experience, while a disgruntled one would tell twenty-six. Today, that unhappy customer has the ability share even the smallest complaint with the world in an instant.

Online giants like Amazon.com and China's Alibaba loudly proclaim a "customer is always first," policy. While not impugning their motives, we suspect this stance is driven more by market realities than altruism. Unhappy customers are prone to going viral. As a result, the consumer has the ability to dictate the terms of sale like never before. Trying to get them to subjugate their interests to aid retail or manufacturer profits—by purchasing an overpriced private label guitar—is a losing game. In 1861, Abraham Lincoln cautioned, "You can fool all the people some of the time, and some of the people all the time, but you cannot fool all the people all the time." To the 16th President's wisdom we would add, "Trying to fool anyone, anytime, is increasingly difficult today and also represents a serious reputational risk."

We're not denying the importance of maintaining gross margins, or the basic arithmetic of retail finance. We just think that Amazon and Alibaba are on to something with their emphasis on giving the customer what they want. Gross margins remain important, but can't be the primary consideration when it comes to making purchasing decisions. Lackluster products, priced to provide a big margin, present two potential risks: they may not sell on a timely basis, needlessly tying up inventory dollars, or they might sell and create a disappointed customer. Either way, we're not sure the extra margin points are enough to offset the potential downsides.

Putting the customer first carries over to the application of minimum advertised price policies as well. In theory, MAP is a useful tool. Just as auto makers require dealers to maintain inventory, showroom, and service levels, music products manufacturers are justified in limiting loss leader advertising to ensure retailers have adequate incentive to stock and service a product line. However, MAP policies don't give manufacturers carte blanche to set prices and maximize retail margins.

The retailers we talk to understand this. Ultimately, it's the customer who sets the price. In an ideal world, retailers would like to see higher MAP prices. But they also recognize that overly generous MAP prices can adversely impact sales. If the value proposition isn't there in the eyes of the consumer, the product won't sell.

In a pre-internet era, when local retailers had more ability to dictate price, selecting product lines strictly on the basis of gross profit potential might have been a viable strategy. No longer. Viability starts with offering best in class products at prevailing market prices. The challenge is to create a structure that can be sustained by available margins. As the Laguna guitar case study illustrates, attempts to add margin points without delivering real perceived value are unlikely to succeed.

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