



Margin or Markup?

As operators we are constantly trying to figure out how to price our products and services. In part, how our clientele perceives us as a business is related to how expensive we are or are not. We don't want to be the least expensive, but we also don't want to be the most expensive among our competition. So, what is a fair price for our products and services?

We exist in a competitive market. For services, the first place we look to determine what to price our services at is our competition. What are they charging? If they are charging \$85 for a facial, how do we What should we charge? Let's figure it out. We are in business for two reasons; fun and profit. It is difficult to have one without the other. When pricing services, we need to make sure we have an adequate gross margin. To determine Gross margin, we need to determine what is costs us to provide the service. Don't make it complicated.

What goes into the service? Direct Costs Direct Costs (also called Variable Costs, Cost of Goods and Cost of Sales) are labor, payroll taxes, subcontractor costs, professional supplies, room supplies and any other costs that are used to provide the service. Add them up. Let's look at an example where we sell the service for \$75.

	Hourly		Subcontractor	
Selling Price	75.00	100.0%	75.00	100.0%
Direct Costs:				
Labor for 1 hour	25.00	33.3%	30.00	40.0%
Payroll Tax	3.75	5.0%		0.0%
Room Supplies	1.50	2.0%	1.50	2.0%
Professional Supplies	12.00	16.0%	12.00	16.0%
Total Direct Costs	42.25	56.3%	43.50	58.0%
Gross Margin	32.75	43.7%	31.50	42.0%

Gross Margin equals Selling Price minus Direct Costs. This is different than markup. Some operators take their direct costs and mark them up 40%. In this case, marking up the \$42.25 by multiplying them by 140% would translate to a selling price of approximately \$60. In this case, Gross Margin would only be 30%. \$60 minus \$42.25 equals \$17.75. \$17.75 divided by \$60 equals 30%. Clearly, there is more profit when we target a Gross Margin of 40% than if the Direct Costs are market up 40%. Are operators who use mark-up rather than margin leaving money on the table or does this help them competitively? If the market pricing will bear it, I recommend that services be priced on a targeted Gross Margin of at least 40% rather than a mark-up of Direct Costs.

Opportunity for pricing product that is to be sold for retail is a little more limited. Although we would like to use Gross Margin, it is difficult to do so and sell at competitive prices. Typically, MSRP is a 100% mark-up which nets a 50% Gross margin. Commissions that are paid on retail sales are also part of Gross Margin. When the cost of retail product and retail commissions are added to service cost in the above example, the overall Gross Margin drops to 43.2%.

	Hourly		Subcontractor	
Selling Price				
Service	75.00	87.0%	75.00	87.0%
Retail	11.25	13.0%	11.25	13.0%
Total Selling Price	86.25	100.0%	86.25	100.0%
Direct Costs:				
Labor for 1 hour	25.00	29.0%	30.00	34.8%
Payroll Tax	3.75	4.3%		0.0%
Room Supplies	1.50	1.7%	1.50	1.7%
Professional Supplies	12.00	13.9%	12.00	13.9%
Retail Product	5.63	6.5%	5.63	6.5%
Retail Commission	1.13	1.3%	1.13	1.3%
Total Direct Costs	49.00	56.8%	50.25	58.3%
Gross Margin	37.25	43.2%	36.00	41.7%

In this situation, I would recommend that the service price be increased so that the Gross margin is closer to 40%. As long as the costs are managed as they appear above and the retail to service ratio remains constant, increasing the service price to \$85 will increase the Gross Margin to 50.7% as shown below. The decision to do this must be made after considering what your competition is charging for comparable service and whether the pricing of this service at this rate fits within the pricing and marketing structure of other service items on your menu. Please remember that this is merely a guideline for determining how to price your services. Gross Margin of your entire business needs to include front desk labor, related payroll taxes and employee benefits. Front desk labor should be budgeted at no more than 10% of Service plus Retail Sales. For the entire spa business, Gross Margin should not be less than 35% of Service plus Retail Sales.

	Hourly		Subcontractor	
Selling Price				
Service	85.00	87.0%	85.00	87.0%
Retail	12.75	14.8%	12.75	14.8%
Total Selling Price	97.75	101.7%	97.75	101.7%
Direct Costs:				
Labor for 1 hour	25.00	25.6%	30.00	30.7%
Payroll Tax	3.75	3.8%		0.0%
Room Supplies	1.50	1.5%	1.50	1.5%
Professional Supplies	12.00	12.3%	12.00	12.3%
Retail Product	6.38	6.5%	6.38	6.5%
Retail Commission	1.28	1.3%	1.28	1.3%
Total Direct Costs	49.90	51.0%	51.15	52.3%
Gross Margin	47.85	50.7%	46.60	49.4%

Profitability is attainable if it is managed by viewing your business as a system of interconnected parts. Create a picture of what it should be as a whole. Analyze it by tearing into the most popular items you sell. By focusing on the major pieces, the overall puzzle will begin to take shape.



Monte Zwang is a principal of Wellness Capital Management, providing cash flow and financial strategies to businesses in the wellness industry including medical practices, wellness practitioners and day spas. Monte has been a consultant for more than 25 years, teaching entrepreneurs and company leaders in health care, spa, and hospitality industries the strategies of business planning and cash flow management. For more information visit: www.WellnessCapital.com



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