How is markup used by the retailer, both within the store and in his relations with suppliers?

Consider the type of world facing a large department-store buyer. Few lines that he purchases are not subject to negotiation. In fact, price is usually negotiated on special purchases even in those departments where price on the basic line is fixed.

Markup is defined technically as the difference between cost and retail price, an amount usually expressed as a percentage of the retail price. Cost here usually means the invoice cost of the merchandise, minus trade discounts and plus inbound freight paid by the retailer.

There are additional important uses of markup by merchants: a negotiation tool with suppliers; a control and planning device by the buyer’s superiors; and a decision tool.

Negotiation Tool with Suppliers

One notable contribution of markup is as a negotiation tool with actual and potential suppliers. The retailer can gain significant benefits by using markup effectively; and the supplier may benefit by understanding the retailer’s use of markup to gain additional advantages.

Markup may be utilized as a commitment on the part of the management or buyer of a specific merchandise classification. Thus the buyer may bind himself to a specific markup policy.

The success of any commitment depends on the ability of the buyer to communicate it persuasively to the supplier. A buyer for a specific merchandise classification, therefore, might consider only vendor offers with a minimum markup of X%, for example, 34%. This minimum would be set at a realistic level after considering industry practices and those of competitors. If a vendor believes this markup constraint to be a commitment on the part of the retailer, he will meet these requirements if he hopes to sell merchandise to the department.

If a department store dominates a locality, a rigid markup used intelligently by the buyer provides another way to counteract the advantages held by a price-initiating supplier who enjoys substantial market acceptance. This means that the buyer may obtain a larger part of any additional joint profits resulting from the relationship between a vendor and the department than he would receive without using a rigid markup.

The price-initiator is the first to establish a price, usually the seller. "Joint profits" are the combined profits of the store and the vendor in a given relationship. Without a prior commitment by the buyer in the form of a markup constraint, a vendor in a strong market position has the advantage even over a store with an equally strong market position.

Since almost all department stores use markup as a tool and have similar expense structures and systems, their minimum markup requirements tend to be parallel for a given classification of merchandise. Therefore, their minimum commitments tend to be in the same range and in certain circumstances have the effect of a minimum commitment for the department-store industry as a whole. The greater the similarity and the more logical the basis for the commitment, the more probable is the success of the commitment.2

Any vendor wishing to develop a substantial volume of business through department-store outlets must consider these markup requirements when establishing prices through the various channels of distribution. This should result in greater profits accruing to department-store outlets as a group.

Markup is also an effective tool in negotiating with vendors for special merchandise. A buyer may ask a supplier for a mattress with features that, at a markup of 33%, will create an exciting value for the consumer. This gives the supplier some latitude, but puts pressure on him for low cost because both buyer and supplier generally know the retail price line that a promotional item with specific features must have to excite consumers.

In addition, when the buyer indicates his expected markup, he eliminates some price negotiation because the general range of the alternatives is pre-specified.

Markup also gives the buyer an opportunity to introduce a third party—his superior or the store—into the negotiating procedure at any time. He may do this by stating simply that the store requires X% on any promotion or item in a merchandise classification.

Since the vendor usually does not discuss the policies of the store with store management, and since he probably accepts this statement, two effects may occur. First, an effective commitment may be established since the third party cannot be approached easily. Second, the management or the buyer's superior may be a "common enemy," thus giving the buyer and the seller a point for agreement and commiseration. This permits the negotiating parties to release "hostilities" against the third party rather than against each other.3

Control and Planning Device

Another significant contribution made by markup is as a control and planning device used by the store management. By controlling the level of markup required in a given department, the store management can strongly influence buyer performance.

Although the management never has to state specifically that the buyer must secure lower prices and thus perhaps become involved in a violation of the Robinson-Patman Act, by demanding a higher markup the management can communicate clearly to the buyer that he is expected to obtain low prices from vendors.

If management applies pressure for higher markup to the point where requirements cannot be met by negotiating lower prices on existing items in the market, then the buyer is forced to change the physical product offered—that is, to create new products. In creating new products the buyer often offers his merchandise at a higher retail price in addition to purchasing it at a possible lower cost.

Actually, certain markup pressures may induce a buyer to violate the Robinson-Patman Act by obtaining cost concessions on regular merchandise; but severe markup pressure may induce a buyer to create new products which may be entirely beyond the control of the Robinson-Patman Act.4

Management pressure for increased markup also helps top management to protect the firm against an opportunistic approach to pricing that might be to the long-term detriment of the store's image and reputation.

A low-price policy or a continuous-sale policy may prove satisfactory for the short term, or even for a short period of years. However, if the general reputation of the store is eroded due to low prices, it is extremely difficult to rebuild to its former status. Pressure for high markup makes it more difficult than it would be otherwise for a buyer to use low price as a merchandise weapon to attain additional sales, at least without substantial analytical work to justify the long-range advantage of such a low price.

Pressure for higher markup also may help to increase the element of genuine vendor contributions to advertising because it helps to prevent buyer-

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2 Schelling, same reference as footnote 1, at pp. 68-69.


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Professor Lawrence Fouraker of Harvard University, and Professors Delbert Duncan and Louis Bucklin of the University of California, Berkeley, made valuable suggestions regarding this article.
vendor collaboration to raise the cost price of an item to develop funds to pay for advertising.

Pressure for higher markup may increase the accuracy of shortage figures (shortage may be regarded as the dollar amount indicated as missing from the department in retail dollars) because it discourages a buyer from artificially reducing his maintained markup. This may be done by selling merchandise on the floor at higher retail prices than are entered for the merchandise in the books of the store, by taking larger markdowns in the store records than actually taken on the selling floor, or by failing to record increases in price.

Decision Tool

Buyers sometimes use percentage markup multiplied by estimated sales, to select from among the merchandise offered by vendors. In situations where cost structures are anywhere nearly equal between two alternatives, this may be useful and accurate.

Even in situations where marginal systems are employed, markup multiplied by volume may be used in merchandise classifications where the cost of more precise tools, such as the application of marginal principles, is greater than the derived benefits.

Implications

The main point of this short article is not that department store retailing should be enslaved by arbitrary percentages nor that markup as a tool does not have its limitations. Nor is it argued that markup should be nearly inflexible.

Instead, markup should be thought of as a valuable retail tool—as a control and planning-device by the buyer’s superiors, as a negotiation-instrument with suppliers, and as a decision-tool by the buyer.

MARKETING MEMO

Is It a New Product? . . .

We define a “new” product as one that will contribute new revenue to the corporation—as opposed to one that takes revenue away from existing varieties. Under our rule of thumb, a product is considered “new” if 90% of its sales will bring new revenue. Here we have also given our definition of a new variety. Now, a new variety may energize an existing line, create new excitement and provide new uses or applications.
