“Outrageous” Profit Margins

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> “No one buys a quarter-inch drill bit because they need a quarter-inch drill bit. What they need is a quarter-inch hole.” –Ted Levitt, Marketing Myopia (1960)

When you buy a product you evaluate the reasonableness of the price based on two metrics 1) how valuable the product is to you personally and 2) your assumption of how much the product cost the seller. We generally only think much about the first metric. In general, we assume that the markup of what we pay vs what the seller paid must be reasonable since we live in a generally free market system. But when competition is limited, we sometimes perceive that we are being taken advantage of and that the markup in price is unreasonable.

Personally, I find myself extremely annoyed buying beer at a baseball game. Since I’m free to buy or not buy a beer, you would think that if I buy one then I must find the price reasonable. But due to the limited competition inside of a stadium, the price of a single beer at a San Francisco Giants game is more than the price of a six pack of the same beer outside of the park and for whatever reason, breaking that threshold causes me to simultaneously believe the price is outrageously inflated even as I make a purchase and thus validate that the price is less than what the beer is worth to me.

Interestingly, people tend to evaluate the price of services differently. Adding a new subscriber to Netflix for instance has near zero cost to the company. Yet few people think that means they should allow new subscribers to sign up for free. Services don’t have the same type of visible cost of goods sold and therefore super high gross margins don’t tend to bother their customers.

Sometimes a company that appears to be selling a product is actually selling a service and in these cases a superficial analysis of the profit margins can make them look unsustainably high or even exploitative.

Here’s an example from my own life:

My dishwasher kept breaking. The washing mechanism worked just fine but every six months or so, the little plastic piece that stops the top shelf when you pull it out kept breaking. This made the dishwasher essentially unusable as one side of the top shelf would hang down. It is an older model that came with the house and is no longer in production.

But guess what? While a new dishwasher would cost me around $400, after googling around for a bit I found a company that sells parts for out of production consumer appliances. I ordered a couple of these and now my dishwasher works great with a very simple one minute replacement of the plastic part when it breaks.

The part cost me $7.56. What would you guess it costs to make the product? It is a small piece of injection mold plastic. We're talking pennies to make. But I was thrilled when I found the part. Why is this? The part saved me from needing to buy a $400 dishwasher (and finding a new one that fits the built in space under the kitchen counter).

The gross margin on the part is likely over 99%. Or in the language sometimes used by government accountability agencies, the "profit percentage" (or mark up over cost) is around 15,000%.

Is this an outrageous profit margin? As a consumer, I was excited when I found the product and realized I could fix my dishwasher so cheaply. I didn't feel taken advantage of. I felt glad to have found this random online part seller of out of production appliance parts.

The $7.56 isn't what I'm paying to obtain a part that costs pennies to make. $7.56 is the price I'm paying the company for the service it is providing me of keeping in stock out of production aftermarket parts that are very low cost but mission critical to the functioning of a much more valuable item.

Would it be good if there was more competition and I could have picked from a range of providers and gotten a cheaper price? Sure. But as a consumer I don't really expect that there is going to be a vibrant market for aftermarket appliance parts. Seems like a super boring business. I can't imagine many startups wanting to get into the business of producing these.

If I found out that an apartment complex manager was able to bulk order 100 of these units for $189.00 or a unit price of $1.89, I wouldn't think that because I was paying $7.56 a unit that meant the company was jacking up prices by an outrageous amount. It also makes perfect sense that I would pay $7.56 for one aftermarket part even while the maker of the dishwasher was able to obtain these parts for pennies.

A couple years ago we wrote about how we seek out competitively advantaged companies that delight their customers rather than those who use their competitive advantage to exploit their customers through overcharging. I can't say I was "delighted" by paying $7.56 for a piece of plastic that cost pennies to make. But I was delighted to have paid $7.56 to avoid needing to buy a new dishwasher.

When people not party to a transaction examine it, they sometimes misunderstand the nature of the transaction. The company that sold me the part for my dishwasher isn't in the business of selling expensive parts, they are in the business of selling super cheap fixes for older appliances. As we described in a post earlier this year, understanding what a business really sells is critical to investment analysis. Nike doesn't sell shoes, they sell self-identity. First Republic doesn't sell banking services, they sell reduced time and frustration spent dealing with your money. TransDigm doesn't sell airplane parts, they sell airlines on-time departures and thus happy passengers.

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