

Pricing Optical Products to Maximize Gross Profit

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Summary of a Webinar Presented by Review of Optometric Business and Sponsored by CareCredit

INTRODUCTION

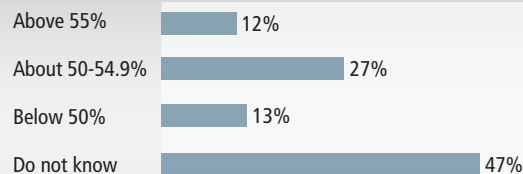
Retail pricing is one of the most important elements in any retailer's marketing mix. Among independent optometric practices, retail sales of vision devices account for nearly two-thirds of gross revenue. So the effectiveness of pricing strategies has a huge impact on practice profitability.

In a practice with \$500,000 in annual gross revenue — near the median for ODs in solo independent practices — \$195,000 of total revenue typically comes from professional fees. The remaining \$305,000 in revenue comes from product sales of eyewear and contact lenses. Cost-of-goods is typically \$145,000 in this size of practice, yielding a gross profit from product sales of \$160,000. That produces a typical gross profit margin of 52.5 percent on product sales.

Small changes in gross profit margin have a big impact on gross profit and net income. Increasing gross profit margin just five points — from the median of 52.5 to 57.5 percent — yields over \$15,000 in additional annual profit to a \$500,000 practice. Because staff, overhead and other expenses do not increase as profit margin grows, all the extra gross profit from device sales drops to the bottom line and net income also grows by more than \$15,000.

MARKETPLACE REALITIES

ROB Pricing Webinar Quick Poll Is Your Gross Profit Margin for All of the Products You Sell, Including Eyewear and Contact Lenses:



NOTE: Approximately 500 participants in the Pricing Webinar, held March 8, 2012, cast votes in the ROB Quick Polls.

The stakes are high in making good pricing decisions and adopting a disciplined pricing methodology. If prices are set *too low*, gross margin and net income suffer. If prices are *too high*, capture rate may decline as patients seek lower prices elsewhere.

In a highly competitive optical marketplace with Internet providers, patients have an ability to compare prices of identical eyewear and contact lens products. There is a limit to what independent ECPs can charge without causing patient defection.

ABOUT CareCredit™

One way to increase the likelihood that your patients will walk out of your practice happy with their purchase is to offer a variety of payment options. CareCredit, a part of GE Capital, is a healthcare credit card that offers special financing through 150,000 enrolled healthcare providers nationwide.

With monthly payment options, patients can get the care and optical products they need and want including contact lenses, multiple pairs of eyeglasses, sunwear, premium frames, lens treatments, eye exams and more. By offering CareCredit you can help increase sell-through and provide your patients with flexible payment options to fit their budget.

Not only can CareCredit help you increase patient loyalty, it can help you attract new patients. CareCredit sends 30 million marketing messages to over 7 million active cardholders educating them on elective care that may enhance their lives. Enrolled practices receive a free listing on CareCredit's online provider locator which receives up to 560,000 searches each month by patients looking for practices that offer CareCredit.

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In my experience and that of other eye care consultants, more ECPs tend to underprice optical products than to overprice. The truth is that independent practice ECPs can command a retail price premium compared to optical chains and Internet providers, without much effect on their capture rate. That's true because independent ECPs often provide a higher level of personalized service than is available in typical optical chain locations. Patients place a high value on this personalized care. It's appropriate that you are compensated for a higher level of care in the prices you charge for devices you recommend. It's impossible to offer both a higher level of service and low prices on the products you sell, and still achieve an adequate return.

Patients of independent ECPs are more often patients-for-life, and their loyalty to the practice is more intense than that of patients of optical chains. This occurs in part because of the lower turnover of personnel at independent ECPs. The peace of mind patients feel when they have an enduring relationship with a trusted eye doctor is worth a lot. Patients know that their eye doctor's income depends in part on product sales. To the extent that strong loyalty exists and device prices are not excessive, patients are reluctant to shop elsewhere for optical products.

Most patients prefer to have an exam and purchase their optical devices at the same time and at the same location. This is a real convenience with real value, because patients place a high value on their time. It's a nuisance to get a prescription from one doctor then take it to another place to be filled.

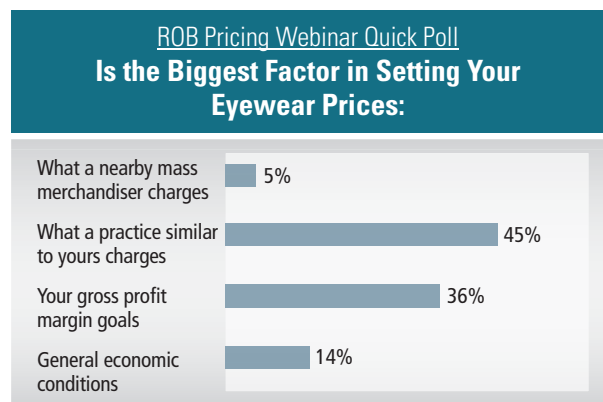
Finally, few patients take the time to learn about optical product prices. Except among patients of some optical chains, few people choose providers based on product prices. For eyewear, because of the great complexity of choices, it can be very difficult to determine prices for identical combinations of frames and lenses. For contact lenses, it's relatively easy to compare prices on the Internet, but most patients do not bother. That gives independent ECPs some latitude in pricing.

Some ECPs obsess with optical product prices of the mass merchandisers like Walmart, Costco and Target. But in most market areas, it is not necessary to set prices based on what these retailers charge. Doing so is a formula for low gross margins and inadequate net income. With their superior buying power, these large retailers will always be able to offer lower prices. But only a minority of patients choose these stores for eyecare, because most people prefer the personalized, ongoing care they receive from their independent doctor. There is no great surge in the optical market share of mass merchandisers.

It's a mistake for an independent eyecare practice to gear its product pricing on what a small segment of price shoppers demand. In most cases it's better to let the price shoppers, who do not embrace a high service value proposition, to shop elsewhere, rather than to accept margins that are too low to sustain the business.

COMMON PRICING PITFALLS

Many ECPs don't bother to calculate the gross margin they achieve on product sales. Depending on the software system a practice uses, it can be a complicated process. But it is a mandatory first step in any pricing overhaul to know your starting point.



Many practices do not use a standard methodology to set prices. They may have a set of mark-up formulas but apply them inconsistently. They may listen to what sales reps recommend. They may be influenced by prices they have seen advertised. They may express all prices at price points divisible by \$5. The best approach is to identify gross margin targets for major product categories then set prices consistently to achieve them.

While wholesale prices do not change frequently during the year, manufacturers, distributors and labs occasionally change prices. If wholesale price increases are not monitored—and when they occur, if immediate changes are not made in retail prices—then gross margin suffers.

It is difficult to measure capture rate, and many ECPs simply ignore this important ratio. But there are some good indicators of capture rate both for contact lenses and eyewear that should be regularly monitored. A low capture rate is often an indicator of retail pricing that is too high.

EYEWEAR PRICING BENCHMARKS AND GUIDELINES

According to the Management & Business Academy (MBA), the current median gross profit margin ODs earn on eyewear sales is 61 percent. That's equivalent to a mark-up of 2.6 times cost-of-goods. The 20 percent of practices who achieve "somewhat above average" gross margin, have a gross profit yield of 65 percent, or 2.9 times cost-of-goods. At the high end, the 20 percent of practices with eyewear pricing "well above average" achieve a gross profit margin of 72 percent.

It's quite likely that most practices could achieve a gross profit margin on eyewear sales in the 65 percent range with no significant negative impact on capture rate. This depends on many considerations, including the dependence on managed care income of the practice, but as a general rule a 65 percent gross profit margin is attainable.

Independent ODs apply higher mark-ups to lower cost, basic spectacle lens types, and lower mark-ups on higher performance lenses, presumably to minimize sticker shock. Similarly, ODs apply higher mark-ups to low-cost frames than to high-end frames.

There is no one right way to set gross margin goals or mark-up formulas. Theoretically, the goal should be to set eyewear prices at a point just below where the capture rate declines sharply. That point can vary depending on the service level of the practice, the loyalty of patients and the competitive environment.

I recommend applying higher mark-ups at the low end of spectacle lenses and frames. It takes an office about the same amount of time to dispense a pair of eyeglasses with a \$30 cost-of-goods as it does a pair with a \$200 cost-of-goods. You should determine the minimum amount of gross profit you will accept on any pair of eyeglasses, taking into account your investment in inventory and your allocation of office space to the dispensary, your opticians' time and your general office overhead. A point of reference is that the average eyeglass sale in optometric practice yields \$138 in gross profit. If your minimum gross profit goal was \$100 on a low end pair of eyeglasses, and the low-end pair had a \$30 cost of goods, your retail price would be \$130 and your mark-up would be 4.3 times cost-of-goods.

There is a nearly limitless array of permutations of spectacle lens features that can be incorporated into a pair of eyeglasses. In presenting spectacle lens options to patients, it's most effective to streamline options to simplify decision making and to encourage patients to purchase higher performance lenses. When advanced

features such as high-index materials or anti-reflective treatments are presented as a series of add-ons, each with an added cost, there is more price resistance than when these features are presented as part of a bundled package.

An effective approach is to offer three bundled packages for both single vision and progressive lenses. The top tier includes lenses with the latest technology offering top performance. The middle tier includes advanced technology with premium features. And the third tier offers basic, mature technology lenses, at a lower cost. Use a structure like this as you construct your own bundled packages that reflect your product preferences.

Patient presentations should always begin with the top tier. It's also recommended that all packages, even the basic package, include lenses with anti-reflective treatments. Many ECPs find that 80 percent or more of their patients will purchase anti-reflective lenses when they are recommended by the doctor, and that most patients who buy AR lenses want them again the next time they buy glasses.

Because discounting is not an effective means for independent ECPs to attract new patients, it makes little sense to continuously offer discounts to stimulate eyewear purchases. Discounts only reduce gross profit margins, and there is no evidence they cause patients to buy.

The most important exception to this guideline is a discount on purchase of second or third pairs of eyewear. Surveys show that only 10 percent of eyeglass-wearing patients of independent ECPs purchase more than a single pair during their exam visit.

These surveys also indicate that nearly all ECPs offer some discount on a second pair, usually just 20-25 percent off. Increasing the discount to 40-50 percent, and routinely presenting it to eyeglass buyers can raise the second pair purchase rate to 20 percent of patients. Even though gross profit margin percentage declines with such a discount, the dollar return to the practice is significantly higher.

Five-Step Eyewear Pricing Review

1. Calculate current eyewear gross profits and gross profit margin.

- Use the practice software system to determine collected revenue from eyewear sales. Examine at least six months of history to smooth out any short term aberrations in the sales mix.
- Calculate cost-of-goods, adding up all orders from lens labs, frames purchases and the costs of any in-office lab. If unusual inventory adjustments were made during the time period, adjust the cost-of-goods estimate to simulate a normal level of purchases.
- Subtract cost of goods from gross eyewear sales to calculate gross profit from eyewear.
- Divide eyewear gross profit by eyewear revenue to calculate gross profit margin. A spreadsheet has been developed by Review of Optometric Business to assist in calculating gross profit margin for eyewear. The formulas for calculating gross profit margin are imbedded in the spreadsheet.

2. Compare your gross profit margin to industry norms.

- Appraise the practice's eyewear margin and establish an overall eyewear gross margin goal for the practice.

3. Examine gross profit margin for the major categories and products that you sell.

- ROB has developed a spreadsheet to assist in calculating current gross profit margin for individual eyewear items and product categories. The formulas for calculating gross profit margin are embedded in the spreadsheet.

4. Establish gross margin goals for the major categories of eyewear you sell.

- Start with the category that accounts for the largest percentage of sales. Establish a gross margin goal for this category that is close to your overall eyewear gross margin goal.
- Establish a higher gross margin goal for low end products.
- Decide whether or not to accept a lower margin on high end goods.

5. Calculate your retail prices for eyewear.

- ROB has developed a spreadsheet to quickly perform these calculations. The formulas for calculating gross profit margin are embedded in the spreadsheet.

CONTACT LENS PRICING BENCHMARKS AND GUIDELINES

ECPs achieve somewhat lower profit margins for contact lenses than they do for eyewear. This is no doubt because it's much easier for patients to compare prices for branded and advertised contact lenses, which are universally available at chain optical locations and many Internet sites. ECPs must keep their soft contact lens pricing at an acceptable premium to avoid patient defection.

Based on ongoing audits of the retail soft lens prices of independent ECPs, the median gross profit margin being achieved today is 47 percent. The soft lens profit margin has been stable in recent years. The 20 percent of practices with somewhat above average margins realize a 50 percent gross profit. That's a realistic goal for many practices, with little risk of reducing the capture rate of soft lens sales.

It's doubtful that practices achieving lower than the median profit margin are forced to do so by local competitive conditions. More likely it merely reflects a judgment by some ECPs that it's necessary to compete on price with the big box retailers and Internet providers. As with eyewear, the reality is that patients will pay a modest premium out of loyalty and for the convenience of one-stop shopping.

Although the spread in profit margin by lens type is not great, ECPs today earn somewhat higher margins on soft torics and lower margins on colored lenses and daily disposables.

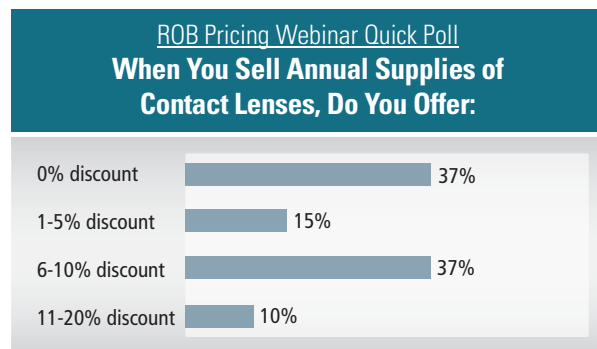
In general, it should be possible to earn somewhat higher profit margins on both soft torics and multifocals than on clear spherical lenses, which are much more likely to be price promoted by commercial providers. There is no good rationale to accept a lower profit margin on colored lenses. Inasmuch as daily disposable 90-packs command a higher retail price than sphere six-packs, it's in a practice's interest to accept a somewhat lower margin on these products to keep the annual cost in line and reduce patient price resistance.

New silicone hydrogel materials have somewhat higher wholesale prices than the earlier generation of lens materials. It's a mistake to accept a lower gross margin on silicone hydrogels to presumably make it easier for patients to agree to be upgraded. There's no evidence that a lower profit margin makes any difference.

A majority of soft contact lens patients today buy just two six-packs of lenses during their exam visit. When patients leave the office with a small supply of lenses, they are much more likely to stretch lens usage beyond

the recommended replacement frequency. The result is lost sales. When patients run out of lenses before their next exam is scheduled, they are also more likely to buy replacement lenses from alternative providers to avoid a return to the office.

It's in your interest to encourage annual supply sales to all soft lens patients, using manufacturer rebates as incentives. Many ECPs also discount their per box price by 5-10 percent when an annual supply is purchased to further sweeten the deal. When patients see they can save 20 percent or more per box by purchasing a year's supply, many choose to do so. You should be able to double your current annual supply sales ratio if these savings are consistently presented to every soft lens patient.



Six-Step Contact Lens Pricing Review

1. Calculate current soft contact lens gross profits and gross profit margin.

- Go to your software system and determine collected revenue from contact lens sales. Examine at least six months of history to smooth out any short-term aberrations in the sales mix.
- Calculate cost-of-goods, adding up all purchases from contact lens manufacturers and distributors. If any unusual inventory adjustments were made during this time period, adjust the cost-of-goods estimate to simulate a normal level of purchases.
- Subtract cost-of-goods from gross soft lens sales to calculate gross profit from contact lenses. Divide soft lens gross profit by soft lens revenue to calculate gross profit margin.
- ROB had developed a spreadsheet to assist in calculating gross profit margin for soft lenses. The formulas for calculating gross profit margin are embedded in the spreadsheet.

2. Compare the practice's gross profit margin to industry norms.

- Appraise the practice's contact lens gross profit margin and establish an overall soft lens gross margin goal.

3. Calculate gross profit margin for best-selling lens brands

- Identify margin inconsistencies and sub-optimal margins across all products dispensed.

4. Establish gross margin goals for the major categories of soft lenses.

- Start with the category that accounts for the largest percentage of sales. Establish a gross margin goal for this category that is close to the overall eyewear gross margin goal.

5. Calculate retail prices for soft lenses.

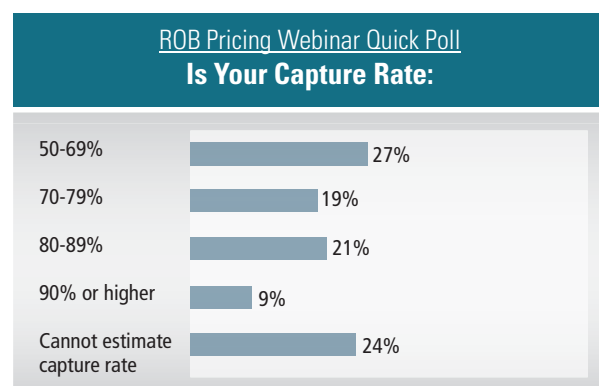
- ROB has developed a spreadsheet to quickly perform these calculations. The formulas for calculating gross profit margin are embedded in the spreadsheet.
- Establish a single price point for categories of lenses with similar wholesale costs to simplify presentation to patients.
- Take current sales mix into account as category prices are established to be sure it will yield the desired profit margin.

6. Calculate annual supply prices.

- Establish per box prices for each lens brand when patients purchase an annual supply. A 10 percent discount is typical among independent ODs. When combined with a manufacturer rebate, this will provide a compelling incentive.

MONITORING EYEWEAR CAPTURE RATE

It's estimated that a typical capture rate of patients' eyewear purchases among independent ECPs is about 70 percent, and about 80 percent for soft lens purchases. Capture rate is influenced by factors other than pricing. But a low capture rate can be an indicator that prices are too high, and it should be regularly monitored. It's difficult to accurately measure capture rate because patients are unlikely to reveal the other places they buy their eyewear or contact lenses.



To monitor eyewear capture rate, a simple method is to keep a count of the number of patients who request their eyeglass Rx to take to another provider or who have a changed Rx but don't purchase eyeglasses. Call them walk-outs. At the end of each month, divide the number of walk-outs by the number of eyeglass Rxes you dispensed that month. A walk-out ratio above 25 percent is indicative of a problem that requires further investigation.

For soft contact lenses, use a similar approach. Keep a monthly count on the number of patients receiving a contact lens exam who do not purchase any contact lenses on exam day. At the end of each month divide the number of walk-outs by the number of contact lens exams performed. A walk-out ratio above 10 percent indicates a problem.

Every six months, it's also useful to divide the number of soft lens boxes dispensed by the number of contact lens exams performed. A ratio below three is sub-optimal. It may indicate that prices are too high and that few annual supplies are being sold.

CONCLUSION

It's not necessary for ECPs to match chain optical or Internet prices to compete in today's eyecare market. But to maximize gross revenue, gross profits and net return from eyewear and contact lenses, it is necessary to use a disciplined, consistent approach to establishing retail prices, as outlined in this whitepaper.

Sometimes, patients don't buy eyewear or contacts on exam day because they don't have the funds that day, not because they think your prices are too high. It can be embarrassing for patients to admit they're short on cash, and when asked to commit to purchase, they may say, "I need more time to think about it," or, "That's more than I am prepared to spend."

When patients push back when faced with a buying decision, it can be effective to remind them that they do not need to pay the entire amount today, but can do so in installments.

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