Helping You to Develop Your Business with Free Hints and Tips...

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Pricing

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Pricing

⇨ An essential pillar of profitability

Overview

Pricing is a surprisingly complex, important and yet neglected area of business. At first glance it appears a straightforward, almost mundane activity: either charge cost plus an arbitrary mark-up, or else simply charge what you believe the market will bear. If in doubt, glance at what your competitors are doing, before making your decision.

However, the truth is much more involved for many reasons, both direct and indirect; for example, pricing:

- Influences perceptions of the product and brand. A premium price may actually stimulate sales if it reinforces a customer perception of quality, prestige or other intangible factors (such as reliability).
- Directly affects sales growth and customer loyalty.
- Is a critical determinant of profitability.
- Is very difficult to change once fixed.

However, despite its significance, leaders can be unprepared when making decisions about pricing.

Benefits of effective pricing

Pricing is a major source of competitive advantage – firms can compete directly and overtly on price and take market share. It also provides a way to increase loyalty to a brand or product, to enable firms to enter new markets, to sustain the life of an established product or to provide a vehicle for special offers and supporting other sales techniques. Viewed another way, if the price is wrong then the business can collapse – and at best, an opportunity is wasted.

The issue of pricing is relevant whether you are looking to enter a new market, launch a new product, sustain an established product or simply increase sales. Pricing underpins other business issues – from brand building to competitiveness.

Action checklist: pricing

Understand the issues affecting pricing

Economic forces. Anti-trust legislation aims to stop abuses of market power by big companies and to prevent mergers or acquisitions that would create a monopoly. Supply and demand affects pricing; generally, when supply is high relative to demand, prices will fall. The converse is also true: when demand is high relative to supply, prices will rise – one sales technique is to stimulate demand by creating a perception of scarcity. Linked to this concept is price elasticity of demand that highlights how the volume of demand is influenced by changes in price. When demand is elastic, a change in price (whether a rise or fall) causes a relatively greater change in the quantity demanded. Conversely, when demand is price inelastic, a change in price (again, whether a rise or fall) leads to a relatively smaller change in the quantity demanded.

Elasticity of demand can be calculated with the following equation:

Percentage change in volume of demand ÷ Percentage change in price

The negative or positive sign in the answer only tells you about the relationship between demand and price; it does not tell you about the level of elasticity. If demand and price move in opposite directions, the answer will be negative. If demand and price move in the same direction, the answer will be positive.

When price elasticity of demand is negative, as with the majority of tradable goods and services, then a rise in price leads to a fall in demand, as fewer are willing or able to purchase a given quantity at the higher price.

If price elasticity of demand is positive this means that a rise in the price will lead to a rise in demand, meaning that it is a 'snob' good – people may prefer diamonds they perceive as 'expensive' rather than cheaper ones. In this instance, a rise in earnings can happen when the price rises – but this lucky situation is quite rare!

The value of the number reveals the level of elasticity.

When the answer is greater than one

If the % change in demand is greater than the change in price, then demand is elastic. By using the equation, when the answer is greater than one (ignore the sign) demand is elastic, as price changes lead to relatively larger changes in demand. Here, price changes will have a considerable impact on the volume of sales.

When the answer is less than one

If the % change in demand is less than the % change in price, then demand is inelastic. If your answer to the equation is less then one (ignore the sign) price changes lead to relatively smaller changes in demand. In this case, price changes will have a relatively smaller impact on the volume of sales than for elastic goods.

Market issues. Customer perceptions and behaviour – what the customer wants and expects – are among the biggest issues underlying pricing. Successful pricing is based on a clear understanding of the specific needs and nature of the target market. The culture of the market also affects pricing decisions, so if there is an acceptance of a particular type of pricing structure or approach then strategies will often follow this. The maturity of the market also affects pricing: if the market is mature with relatively few new customers, then pricing needs to concentrate on taking customers from competitors as well as retaining market share. However, if the market is new and growing then the aim is to build and gain market share as rapidly as possible. These two approaches may lead to the same result or they may not. Finally, if the market is in decline then prices may need to be cut simply to compete for a dwindling number of available customers.

Competitive issues. The competitiveness of the market clearly affects pricing decisions. Where few direct competitors exist then there may often be a greater degree of latitude for pricing decisions.

The nature of the competition also influences pricing, as some competitors may be vulnerable to lower prices, chiefly if their costs prevent them lowering prices any further. Other competitors may be open to claims of poor value or quality. In this situation, a higher price accompanied by appropriate advertising could reinforce perceptions of premium value and quality. A useful rule is to target one competitor or a group of competitors, attacking them with the most appropriate pricing strategy.

Product issues. A product's costs are fundamentally significant when setting prices. It may be desirable for products to be sold at a loss to establish market-share or drive out competitors. In any event, break-even analysis is a valuable method for setting prices (see below). Finally, and frequently of greatest significance, are the product's benefits and the value it provides customers, although this needs to be closely related to other factors such as costs and competition.

Review costs and understand cost structures

This stage involves checking all of the direct costs of sales. In particular, it is also worth *understanding what comprises those costs*. For example, a publisher may price a series of books on the basis of a quote given by a printing company that is valid for six months. Ten months later when a new book in the series is published (at the fixed series price) its profitability may be eroded by a price increase from the printer.

As well as checking direct costs to external suppliers, it is also important to take account of other, less obvious costs that are directly attributable to the product. These may include marketing and sales expenses, distribution costs or professional fees. There is a tendency to categorise as many costs as possible as overheads and remove these from calculations of gross profit (which of course relies simply on revenue less directly attributable costs of sales). When calculating gross profit, it is sensible to include any cost whose size is in direct proportion to the level of sale. However, given the complexity of most business situations the best approach is often to check with the management accountant about their views of direct and indirect costs. This will certainly highlight the importance, when pricing, of going all the way to the bottom line (meaning net profit) to see what is the minimum price needed to break even for a given sales volume.

Apply break-even analysis (cost-volume-profit or CVP analysis)

Break-even point is when sales cover costs – where neither a profit nor a loss results. It is calculated by dividing the costs of the project by the gross profit at specific dates, making sure to make an allowance for overhead costs. Break-even analysis is used to decide whether to continue development of a product, alter the price, provide or adjust a discount or whether to change suppliers in order to reduce costs. It also helps with managing the sales mix, cost structure and production capacity, as well as forecasting and budgeting.

For break-even analysis to be reliable, the sales price per unit should be constant, as should the sales mix, and stock levels should not vary significantly.

Understand the market and the firm's competitive position

Once the costs of the business are clearly understood it is vital to know the likely volume of sales across a range of possible prices. This requires an understanding of a complex array of factors, including:

Customer needs. What do customers really want? How closely does your product meet these needs *relative to the competition*? If it is much closer to customer needs than the competition then you might wish to consider being a *price maker*: a business that innovates using price. If not, then you may prefer to opt for the less risky position of *price taker*, a business that charges the prevailing market rate.

The state of the market. Is it a developing or a mature market, moderately or highly competitive or saturated? What are the market trends and what does the future hold – for example, are there likely to be new entrants?

Sales channels. How will the product be sold and distributed?

The culture of the market. Is there a lot of discounting? What are the minimum expectations of the market?

The business's overall strategy and direction. Where it is currently and where it is heading. Pricing is a fundamental means of furthering and achieving strategic aims: it can help when entering new markets; it can raise or strengthen the brand, and can help when entering new sections of an existing market. Pricing can even create a whole new market: an example of this is the rise in recent years of cut-price airlines.

The strength of the firm to sustain the price. This includes examining the strength of the brand and assessing all its strengths and weaknesses. It may be necessary to review the financial position of the business to see, for example, how well it could sustain a price war if one developed. It may also be worth considering fallback positions based on the premise that once set prices can be cut, but it is usually extremely difficult to raise them without reducing demand and encountering adverse customer reactions.

The product portfolio and the overall strategy for new product development. Computer manufacturers are a clear example of businesses that develop an overall product portfolio or range. This approach ensures that products are complementary and reinforce each other, rather than competing or undermining pricing strategies.

Choose the best pricing strategy

Once costs, market and product issues have been considered, the pricing strategy can be set. This involves deciding whether to follow the prevailing pricing trends or to follow a potentially riskier but higher return strategy of innovating using price. The type of pricing strategy (e.g. loss leading or penetration pricing) can also be varied, so that the plan is to offer one price in one market (for instance to enable market penetration) and offer another (e.g. skimming) in a separate market.

Pricing strategy	Definition	About the technique
Loss leading	Selling a product at less than its cost in order to remove competitors or establish market share.	Loss leading is an unusual and even a desperate tactic. It can work at certain times, but it is risky. If demand rises too far too fast then so do the product's losses. Also, it can be a trap from which there is no easy escape, as customers expect low

		prices and may even resent them being increased.
Penetration pricing	Combining a low price (break-even or slightly better) with aggressive marketing techniques to penetrate the market, rapidly establishing a presence and gaining a significant amount of market share.	Another high-risk strategy, particularly suited to entering competitive markets or attacking established leaders in a specific market. The hope is that as demand rises unit costs will fall and the whole exercise will work out. The danger is that competitors will reduce their prices – so if possible it is best to do it when competitors' prices are already low.
Milking or Skimming	Charging premium prices for top quality versions of an established, standard product.	This involves selling an established product to a high-income market and convincing that market of the advantages over the standard version. An example would be a publisher producing a hard-back edition – or perhaps a gold-embossed limited edition – of a classic novel. In reality, the greater costs combined with a smaller market often make this approach of limited value.
Price differentiation	Charging variable prices for the same product in different markets, according to what customers are willing to pay.	This strategy enables the business to generate the most revenue from their product; however, it has its risks. It only works when there are barriers to entry, such as tariffs or high transport costs, that prevent wholesalers buying in low price markets and reselling. It also relies on a measure of consumer ignorance – or tacit acceptance – of prices elsewhere. Examples include the music industry charging different prices for CDs in different markets, and car manufacturers charging widely varying sums for the same model in different European countries.
Target pricing	The business targets a minimum level of profit, estimates likely sales volumes at specific prices and fixes the price accordingly.	This is one of the most popular approaches to pricing, but it does rely on accurate estimates of sales volumes and it can tend to ignore competitors' actions.
Marginal cost pricing	Charging a price that reflects the extra cost to the company of supplying one extra item to a customer.	This approach works when the cost of one extra item varies significantly (for example, postage or parcel delivery rates varying according to location). But it does require an explanation as to why prices vary for essentially the same item.

Pricing strategy	Definition	About the technique
Variable pricing	Prices are reduced to stimulate business, and prices are raised to deter business (if production capacity is full, for example).	This is a popular tactic in extreme situations, both to stimulate demand when sales are low and to deter it when sales are too high (it can happen!). The dangers are in explaining to customers about the price fluctuations, and particularly why a reduced price must now rise.
Average cost pricing	Calculating total costs and desired profit margin, then dividing this total by likely sales volumes to set a base price.	Together with target pricing this is one of the most popular approaches to pricing and is most readily accepted by customers. It relies on accurate estimates, but it has the advantage of enabling firms with the lowest costs to charge the lowest prices.
Customary pricing	Charging the same price but reducing the contents of the package.	This is an attempt to increase profits by tacitly misleading customers. It tends to happen when costs are rising and demand is slow; this risks incurring resentment from the customer.
Barrier pricing	Reducing prices to deter or remove new entrants to the market.	This can happen in highly competitive or price sensitive markets. It can even take the form of a group of businesses in an industry collectively charging lower prices to deter new entrants. It is an aggressive strategy that works when the company lowering their prices is defending a core market and established (and wealthy) enough to sustain such an approach.

Consider using price innovations

Finally, it is important to note that 'price' innovations can be achieved using elements closely related to the simple question of how much is charged. For example, a food manufacturer may wish to launch a new *size of product* with a new price; a lawyer or accountant may wish to stop charging on a per day rate and start charging a *percentage of the amount saved* for the client. A higher price for an item of capital equipment may be offset by *extended payment terms*. These extra factors are used for a variety of purposes: everything from obscuring the real price to establishing or strengthening the brand.

Avoiding problems

Pricing is a vitally important aspect of business strategy: the wrong price can undermine an entire business strategy and brand, whereas an effective pricing strategy will support the aims and success of the business. Pricing is an operational or tactical issue of such importance that it is explicitly included as a factor in business strategy.

There are several essential points to remember about pricing:

- Customers' perceptions are a vital consideration when setting prices: a price change may often result in unforeseen changes to the market.

- Once decided, a pricing strategy must be consistently held; if not, the danger is resentment among customers and competitors.
- The competitive position and other market and economic issues need to be carefully considered when pricing.
- There is much more to pricing than top-down views of the market or bottom-up calculations of cost.
- Price is a tool that can be used to reinforce many other areas of business strategy, including brand, profile, customer-base, product position and future development.

When estimating likely sales volumes, take into account several factors: customer needs, market maturity, sales techniques, the culture of the market, any expectations that may exist, the product portfolio, the firm's overall strategy and the ability to sustain the price.

Dos and don'ts

Do:

- View pricing decisions from the customer's perspective.
- Consider how competitors may respond to pricing decisions.
- Try to build in flexibility into the price, for example, allowing room for distributors or sales people to provide special offers.
- Cover your costs – all of them, now and in the future.

Do not:

- Rush into pricing without adequate consideration or research.
- Omit to consider timing when setting or altering prices.
- Forget that pricing can be a powerful sales technique – decide which approach suits you best.
- Overlook future developments, from market changes to supplier costs.

Key questions

- How elastic are product prices? Could prices be increased without reducing revenue?
- When is the next price rise planned – could it happen sooner?
- Are there forces driving down prices in your market? What are they and how can they be countered?
- Who fixes prices in your organisation, how do they do it and could the process be improved?
- Are discounts targeted at the right sectors or are they needlessly eroding profitability?
- Could pricing be used more effectively?

Things you can do

The issue of pricing is relevant whether you are looking to enter a new market, launch a new product, sustain an established product or simply increase sales. It is vitally important to remember that pricing is a sales issue that underpins other business issues – from customer loyalty to brand building. The first thing to do, therefore, is to understand pricing in its widest context. In practice, this can be done in several ways.

View pricing from the buyer's perspective

If you can, test your understanding of the most important issues facing your customer. Whether in person or in the form of written communication (such as a mailshot), you should make your customer feel important by relating your product to their key objective.

Develop your customer's interest, encouraging them to act now

This can be achieved by outlining the benefits that they will gain from using your services. When meeting customers in person, it is also worth checking that these are regarded as benefits and that their worth is appreciated. It can help to link the benefits logically to prove that if one is achieved then the others will follow as a consequence, and show that the final benefit in your chain of logic is the customer's key objective.

If you are meeting with a customer in person, then as well as getting the price right you should also:

- **Tell your customer all that they need to know about your product**, in sufficient detail. If you are meeting with the customer in person and lose their attention, then stop talking, wait for your customer to speak, listen actively and demonstrate that you have listened by repeating a key idea or feeling in your own words. You should deal with any problems and only continue when you are convinced that the customer is satisfied and ready to listen.
- **Ask for the order** – this is best done without tricks or closing techniques, just ask! It may be useful to look for buying signals (such as nods of approval or a tendency to build on your ideas) and move straight to the order request.

Build a sales culture that generates increased revenues

To do this, consider:

- **Running an internal sales programme** highlighting who your customers are (customer segments), what they value and the sales strategy.
- **Brainstorming ideas with team members to generate increased sales**. Prioritise each idea and assign someone to lead its implementation.
- **Reviewing how customer information flows** and ensure that it reaches everyone in the team, then allow people the opportunity to comment. This may elicit ideas for improvement or suggestions for ways in which you can build on successes.

Review the effectiveness of past sales techniques

- **Which technique worked best?** Measure the marketing efficiency for each technique. (This is sales revenue divided by marketing expenses. So, if you spend US$1,000 on marketing and generate US$10,000 revenue as a result, then your marketing efficiency is 10; for every $1, spent $10 is generated.)
- **Why did it succeed?** This can be explained by focusing on *customer segmentation*.
- **Review prices and discounts** and find out if you are giving away discount unnecessarily, or do you have the opposite problem – pricing too high? Price is a powerful sales tool, ensure you are using it effectively. It may also help to organise a trial offer to test different approaches, without committing too much expense.

Gather customer feedback

This can be done by:

- Looking for opportunities to talk informally to customers.
- Following up on sales to see what happened post-sale.
- Exploring in detail why individual customers went elsewhere.
- Using customer feedback as evidence in making internal recommendations.

Use pricing to exceed customer expectations

Exceeding customer expectations helps you to sell and makes it more likely that customers will tell their contacts, generating potential new business. You can 'delight' a customer by providing more than they expect. Once you know what a customer values you can exceed expectations by:

- Keeping the customer informed.
- Delivering before the agreed deadline.
- Saving the customer time.
- Making things easier for the customer.
- Personalising service.
- Giving the customer peace of mind.

Further action

Use the following table to identify areas for further development.

Issue	Response	Further action
Do you use pricing as a mechanism to actively raise sales revenue? Do your prices attract new customers or maximize the revenue from existing ones?		
What issues are raised by your prices both for yourself and your customers?		

Does your business set prices based on internal factors (your costs and perceptions) or external ones (market forces)?		
Are you aware of how your prices influence customers' perceptions of other competitors and their perceptions of your product value?		

For Further Information or to Arrange a Consultation

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