PRICING FUNDAMENTALS

Pricing your product or service is one of the most important business decisions you'll make. You must offer your products for a price your target market is willing to pay–and one that produces a profit for your company–or you won't be in business for long! There are many approaches to pricing, some scientific, some not. This article provides a framework for making pricing decisions that takes into account your costs, the effects of competition and the customer's perception of value.

A quick note about how the terms "cost" and "price" are used :

- Cost is the total of the fixed and variable expenses (costs to you) to manufacturer or offer your product or service.
- Price is the selling price per unit customers pay for your product or service.

So, when customers ask, "How much does it cost," your answer is your price

THE FUNDAMENTALS: Price Floors and Ceilings

Think of cost as the floor–you must set prices above the floor to cover costs or you will quickly go out of business. (If you decide to set prices at or below cost it should be for a temporary, specific purpose such as to gain market entrance.)

Think of customer "perceived value" as the ceiling–this is the maximum price customers will pay based upon what the product is worth to them. This is sometimes described as "what the market will bear." Perceived value is created by an established reputation, marketing messages, packaging, sales environments, etc. An obvious and important component of perceived value is the comparison customers and prospects make between you and your competition.

Somewhere between the floor and the ceiling is probably the right price for your product or service; a price that enables you to make a fair profit and seems fair to your customers. Consequently, once you understand your cost floor and your value price ceiling, you can make an informed decision about how to price your product or service.

In summary, while you must be mindful of costs in setting your prices, don't limit your thinking only to cost-based pricing. Value-based pricing makes you think about your business from the customer's perspective. If the customer doesn't perceive value worth paying for at a price that offers you a fair profit, you need to re-think your game-plan!

THE STARTING POINT: Calculating Break-Even

Before you can decide upon a fair price for your product, you need to know how much it's costing you! You'll need to know this no matter which pricing method you use.

Once you've identified costs, you can determine your break-even point. This is the point at which you neither make nor lose money in producing a product or delivering a service. For example, you would be at the break-even point if it cost you $100 to produce a product that you sell for $100.

A break-even analysis is the process you use to uncover those break-even numbers. To begin your break-even analysis, add up all fixed costs and determine what your variable costs are at different production volumes.

Fixed costs, sometimes referred to as overhead, are expenses that don't vary according to production amounts– such as rent for office space (and storage space if you store inventory), office equipment (telephones, faxes, computers, etc.), insurance, utilities, etc.

Variable costs are expenses that do vary with the amount of service provided or goods produced. They include costs such as hourly pay for a contractor on a specific project, raw materials, etc. Some variable costs don't depend specifically on the number of products produced but are still variable, such as advertising or promotion expenses.

PRICING FOR PROFIT: Cost-Based Pricing

After you've determined your break-even points which establish "floors" for your price, there are strategies for establishing pricing based upon additional financial objectives, such as:

Establishing a high price to make high profits initially.

This strategy is used to recover high research and development costs or to maximize profits before competitors enter the market. (Pharmaceutical companies often use this strategy when introducing new drugs.)

Setting a low price

Setting a low price on one or more products to make quick sales to support another product in development. (Some companies also employ this strategy when they need to increase cash flow.)

Setting prices to meet a desired profit goal.

For example, if the desired profit per unit is 20 percent and unit costs are $10 (taking into account your fixed and variable costs), set your price at $12.

Pricing for Profit: Value-Based Pricing

How high can a price be before the product or service is priced out of the market?

To understand the customer's perception of the value of your product or service, look at more subjective criteria such as customer preferences, product benefits, convenience, product quality, company image and alternative products offered by the competition.

- How do your customers describe what they get for their money?
- Do they save a great deal of money or time by purchasing your product or service?
- Do they gain a competitive advantage from using your service?
- Is it more convenient to use your service rather than try to do it themselves?
- What are the customer's choices?
- What does the competition charge?

With this information, you can begin to understand the maximum price the customer will pay for the benefit received. Often, a customer may think it's worth paying $75 per hour for the convenience and security of dealing with a local business, rather than a paying an impersonal chain $30 per hour. If the customer, however, is only willing to pay $30 per hour, you have to ask yourself whether you can make any money in this business.

A few value-based pricing strategies are listed below that take into account the break-even point, but are heavily weighted with subjective judgements - not just the numbers.

Price the same as competitors.

This strategy is used when offering a commodity product, when prices are relatively well established (such as with professional services) or when you have no other means to set prices. Your challenge then becomes to determine how to lower your costs so you can produce a higher profit than your competitors.

Establish a low price (compared to the competition) on a product in order to capture a large number of customers in that market. This strategy may also be used to achieve non-financial objectives such as product awareness, meeting the competition or establishing an image of being low-cost. It works if you are able to maintain profitability at the low price, or if you're able to maintain an acceptable level of sales should you later raise prices.

High price

If your product has a mystique and uniqueness that is valuable to customers, you might have the ability to charge a very high price relative to your cost. Also, if your target market is affluent and you are positioning your product as a "prestige" product, an especially high price could be in order. (For example, do Rolex watches cost that much more to make than other brands? The high cost, however, brings a "status" benefit to Rolex's affluent market.) This strategy of charging "what customers are willing to pay"–even though it's high–requires alertness and a willingness to change on your part because customers (and competitors) might decide that you're making too much of a profit!

DISCOUNTS

Your pricing strategy might include discounts to customers who offer you a business benefit. You may offer cash discounts to customers who pay promptly. This rewards those who help your company maintain a steady, positive cash flow and reduce credit-collection costs. Offering quantity discounts for large orders often makes economic sense when the cost-per-unit to sell or deliver a product declines as the quantity increases. For example, a caterer might fill an order for 12 dozen cupcakes for one customer at 10¢ each, while cupcakes sitting in the bakery display rack might be sold to several customers throughout the day for 20¢ each. This is because the possibility that some of the cupcakes won't sell has to be taken into account, there are costs associated with having the store open for random customers' convenience, etc.

Seasonal discounts given to buyers who purchase during a product's slow season reward customers who essentially assist a company in balancing its cash flow and in meeting production demands. Trade-in allowances for returned old products that you may either re-use or re-sell for a profit might benefit both a company and customers. Promotional allowances often make economic sense. For example, if your product is sold by a retail chain which includes your product in its ads or in promotional activities, those activities leverage your marketing effort s. If so, you might choose to discount your price to this retail chain.

HOW TO TELL IF YOUR PRICE IS RIGHT

Are you offering people a price-shopped product or service, or one that is results-shopped? The distinction is critical. "Price-Shopped" items are essentially commodities--"things" (milk, for example). People buy "things" wherever they find the lowest price. Period.

But a "results-shopped" item is totally different. If your customers are looking for a particular result--a certain sense of fulfilment or inner satisfaction--then you as a seller have much more flexibility, and a better chance to make a nice profit when setting your prices.

Our recommendation is to always try to move your business toward the "results-shopped" business category and away from the "price-shopped" crowd.

WHAT TO DO TO GROW

Let's say that you are at least temporarily trapped in the "commodity" pricing web. What can you do to win at that sticky game? Here's the answer.

If you must price low, price even lower than your competition, but make your price contingent upon the customer buying some other product or service--or some combination of services or products--that have high profit margins.

Do it in a way that makes your customers or clients celebrate the great buying opportunity you're giving them. But don't feel compelled to price all of your products or services low. Low-ball only those items that are most price-sensitive.

With pricing, the thing to fix clearly in mind is that you might have to be a "commodity" in the first part of a transaction, but you rarely need to be a commodity beyond that point.

If something is heavily price-shopped, offer a bigger package. Refuse to compete on a commodity basis. If everyone is selling a print of something for $20, don't sell single prints alone. Pack five prints together at an incredible price--a price where you can get a purchasing advantage in quantity, and one you can use to make a good profit while offering your customers superb value.

And always test your prices, because you might discover that you're under-pricing out of sheer, unreasoning intimidation.

Be willing to stretch and expand a deal, too, even if you have to bid competitively. Come back with a bid that includes things preceding, following or simply complementing the main activity you were bidding on.

Example: If you're bidding on a job that calls for painting a building, then make it a package bid--one that also includes stripping, caulking, waterproofing and whatever. If the combined price is much lower than the separate bids their prospective customers have gotten, you may land both the job and a handsome profit.

Unless you're willing to price in an innovative proactive and inventive way, you'll always be at risk of selling products at less than you pay for them or they're worth. You'll also be at risk of failing in business.

Most business people fight price wars just to generate customer traffic. But unless you have a well-strategized plan of action behind what you're doing, you can't possibly profit from a price war. In fact, in most price wars, nobody wins.

Instead of rushing into a price war, we urge you to "position" your customers or clients to make repeated purchases from you. Do that when they make their first discounted purchase, but make sure that the additional things they buy from you aren't all being sold at a loss, or at only a meager profit. More likely than not, you don't have to discount that deeply or broadly.

DON'T PSYCH YOUR OWN PRICES DOWN

They may be tough, but most customers, clients and patients won't deny you the opportunity to make a profit. More often than not, we psych ourselves down the price scale.

Wouldn't it be sad if you found out next month or next year that you had been denying yourself 50% more profit on half or three-quarters of the services you sold just because you were afraid to ask customers to pay what the items were worth to them?