CHAPTER 10
PRICE

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INTRODUCTION
Pricing is the ultimate measure of marketing skill. It requires you to calculate your cost of doing business, the psychological and financial impact of price on your target customers, and the response of your competitors.

Once, price was the most important element of the marketing mix. But today, competing solely on the basis of price is no longer an option for most small businesses.

Shrewd branding, high-quality products and excellent customer service can differentiate your business and decrease the importance of price to your customers.

Remember: Your goal is not to set a price that will make consumers want to buy, but to make a product that consumers will want to pay for.

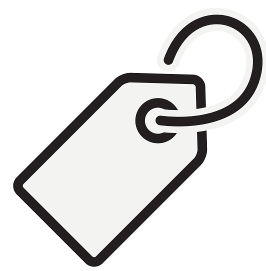
BASIC PRICING CONCEPTS
Let's start by defining our terms.

- **Cost** is what you spend to produce your product.
- **Price** is the amount you charge customers for your product.
- **Value** is what your customer believes your product is worth.
- **Revenue** is the amount of money your business receives from sales over a specific period.
- **Profit** is what's left over after you subtract costs from revenue.

In pricing, cost is often called the "floor." You can't go below it, or you'll be charging less than your product costs to deliver. (The exception is in cases where you pursue a short-term "loss leader" strategy in order to enter a market.)

That makes value the "ceiling." It's the maximum amount your customers will pay, based on what they think your product is worth. Note that the highest price for a product in your market may *not* be the ceiling price. Your costs should be as low as your branding and positioning allow, and your value should be as high as possible.

The goal is to find a price where the seller and the buyer both feel like they got a good deal. For a seller, a good deal means covering costs and making a profit that can sustain long-term operations and enable growth. For a buyer, a good deal is an affordable price that matches up with perceived value. Prices that are too high discourage buyers; prices that are too low won't keep your business afloat.



Pricing is the ultimate measure of marketing skill.

You can also look at price in terms of sales units. In a bookstore, a sales unit might be one book. In a service business, a sales unit might be the amount you charge per hour for gardening or carpentry.

Or it might be a flat rate for a specific job. For example, if you charge $500 to plant a tree, you'll earn that amount no matter how long the work takes. If you're a fast worker, this will be very much to your benefit. If you're a slow worker, your hourly rate will go down. But either way, your price needs to earn you a profit, which means it must be higher than your costs.

Demand

"Demand" refers to the amount of your product that customers are willing and able to buy at a given price. For example, a customer who has $10 to spend might be willing to buy two pillows if your price is $5 per pillow, but only one if your price is $7 per pillow. Being able to afford the product is an essential part of demand; just wanting it doesn't count.

Many factors affect demand, including personal income and the cost and availability of competing brands (direct competition) and substitute products (indirect competition).

Most customers are looking for the best value rather than the lowest price.

As a general rule, higher prices lead to less demand, while lower prices lead to more demand. (There are exceptions, which we'll discuss below.) But ultimately, most customers are looking for the best value rather than the lowest price.

Price Elasticity

Very simply put, **price elasticity** refers to the sensitivity of your customers to the price of your product.

If you increase the price of your product by one dollar, and your sales volume stays the same or increases, then the demand for your product is relatively inelastic in relation to that price increase.

On the other hand, if you increase your price and customers start flocking to your lower-priced competitors, the demand for your product is elastic, because it changes as your price changes.

The Four Cs of Pricing

The marketing approach to pricing is based on these Four Cs:

- **Customers**. Knowing your customers' income level and concept of value is central to setting a realistic price.
- **Competition**. Earlier, you identified your direct and indirect competition, and you compared their prices, features, benefits, strengths and weaknesses to yours. You must take all these factors into account when setting your price.
- **Company position**. If you provide better service and higher quality than your competitors, that means you offer greater value.
- **Costs**. To set a price that will earn a profit, you must know your total variable and fixed costs (including taxes).

Pricing Objectives

Your pricing objectives depend on your business and financial goals, as well as your costs, competitive environment and plans for growth. Common objectives include:

- **Maximizing profits.** This objective aims for high short-term profits. It may result in lower long-term profits, and it may also attract competition.
- **Maximizing sales volume.** This objective may lead you to give up a certain level of short-term profits in order to build a strong customer base, gain market share or meet sales targets.
- **Return on investment.** This objective requires you to set prices that ensure a targeted return on investment.

- **Meeting or beating the competition.** This objective requires you to set a price that matches or undercuts those of existing competitors, or discourages new ones from entering the market.
- **Status quo.** This objective matches competitor prices to maintain steady profits and avoid destructive price wars. It usually requires strict cost controls.
- **Quality leadership.** Price often implies quality, so a premium price may support your business's brand image as the quality leader in a given market.

CALCULATING YOUR COSTS

Before deciding how much to charge your customers, you need to know how much it costs to produce and deliver your product. This is especially important for sole proprietors who may have additional people working for them at some point.

Basic Cost Concepts

- **Fixed costs** stay the same no matter how many units you produce. For example, the cost of a commercial oven is the same no matter how many cookies you bake over the lifetime of the oven. Typical fixed costs include equipment, rent, insurance, wages and payroll taxes.
- **Variable costs** change with the amount of product you produce. For example, the amount you spend on sugar, flour and electricity increases with the number of cookies you make. Variable costs include materials, supplies, sales commissions and overtime wages.
- **Total costs** are the sum of total fixed costs and total variable costs.

Break-Even Analysis

Break-even analysis pinpoints the sales level at which total revenue equals total costs. As the volume of units sold increases beyond this **break-even point**, a business begins to earn profits.

To identify your break-even point, you must first calculate your total revenue and costs. The formula for total revenue is:

$$\text{Price x Quantity}$$

And the formula for total costs is:

$$\text{(Total Fixed Costs + Average Variable Cost Per Unit) x Quantity}$$

The break-even point occurs when:

$$\text{Price x Quantity = (Total Fixed Costs + Average Variable Costs Per Unit) x Quantity}$$

Looking at the same equation in a different way, the break-even quantity is:

$$\frac{\text{Total Fixed Costs}}{\text{(Price - Average Variable Costs Per Unit)}}$$

The number that remains when you subtract average variable costs from price is called the **contribution margin**. This is the portion of your sales price that goes toward covering your fixed costs. Here's another way to look at this equation:

$$\frac{\text{Total Fixed Costs}}{\text{Contribution Margin}}$$

What does this mean in the real world? Let's assume you sell T-shirts for $10 each. Your per-unit variable cost is $5.50. When you subtract that amount from the $10 price, you end up with a contribution margin of $4.50:

$$\text{Price - Average Variable Costs = Contribution Margin}$$

How many T-shirts must you sell to break even, supposing you have monthly operating costs (fixed costs) of $1,350? To find out, divide your total fixed costs by your contribution margin:

$$\frac{\text{\$1,350 (Total Fixed Costs)}}{\text{\$4.50 (Contribution Margin)}}$$

$1,350 divided by $4.50 is 300, so you must sell 300 shirts a month to break even.

To identify your break-even point, you must first calculate your total revenue and costs.

Now, let's find out what would happen if you lowered the price of your shirts to $9. First, determine the contribution margin:

$$\$9.00 \text{ (Price)} - \$5.50 \text{ (Variable Costs)} = \$3.50 \text{ (Contribution Margin)}$$

Next, determine how many units you must sell to break even:

$$\frac{\$1{,}350 \text{ (Total Fixed Costs)}}{\$3.50 \text{ (Contribution Margin)}}$$

$1,350 divided by $3.50 is 386, so you'd have to sell 386 shirts a month to break even. Can you sell an additional 86 shirts at this lower price? Note that a lower price often leads to higher demand.

Of course, you could also raise your price. How many units must you sell to break even if your shirts are $11 each?

$$\$11.00 \text{ (Price)} - \$5.50 \text{ (Variable Costs)} = \$5.50 \text{ (Contribution Margin)}$$

$$\frac{\$1{,}350}{\$5.50} = 245 \text{ T-shirts}$$

Take your brand identity into account when making pricing decisions.

As you can see, breaking even takes fewer sales. However, you run the risk of lowering demand and selling fewer shirts when you raise your price.

Perhaps you can reduce your costs to lower your break-even point. How about less expensive shirt material, fewer ink colors or lower labor costs? All of these are possibilities, but you need to take your brand identity into account when making these decisions. If one of your selling points is that you offer high-quality shirts, using cheaper material would conflict with your positioning and brand.

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I sometimes wonder, if I'd taken a different route home that day, would I still have gotten the idea for my business?

I was stopped behind a school bus, over by the new subdivisions east of Route 50, and I saw this brand-new house. The lot was big, but it was mostly empty. There were a few little saplings here and there, but I felt like they made the land seem even flatter and emptier.

I remember thinking, "They need a nice shade tree over there—something to make the house homier and give it a little more sense of local history."

A few years ago, Sam Granville was working as a landscaper in Easton, Maryland, when he came up with the idea of starting a tree-relocating service.

Although Maryland's Easton Shore is steeped in colonial history, Sam felt like the subdivisions on the east side of town could have been almost anywhere. His goal, as he put it, was "to help the new kids fit in." His target customers would be owners of new houses and developers of subdivisions. His product would be beautiful, healthy, mature trees that would add badly needed charm to new construction sites.

It seemed ideal. He had expertise, equipment and a good reputation. Best of all, he had no competition. All he had to do was figure out how many prospective customers he had, how much it would cost him to move trees, and what he could charge.

He started working on these problems as soon as he got home.

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Planning for Profits

We've been talking about pricing from the standpoint of meeting costs. But to run a viable business, you have to earn a profit.

You can do this by setting a specific profit goal and figuring out the price and sales units it will take to meet that goal. Or you can set a sales volume goal and then calculate the profits. This type of goal-setting is exactly what you need to think about as you move into the financial sections of the business planning process. A sales forecast is a vital planning tool and a central element of your business plan.

Profit Goals

Returning to our T-shirt example, let's say that in addition to covering your fixed costs, you want to make a profit of $900. You know that at $10 per shirt, you must sell 300 shirts to break even. After you reach that break-even point, every additional unit you sell results in a profit of $4.50. (Remember: $4.50 is your contribution margin. It's the amount of money left after paying variable costs of $5.50 per unit.)

How many more shirts must you sell to make $900? You can calculate this the same way you calculated your break-even point:

$$\frac{\$1{,}350 \text{ (Total Fixed Costs)}}{\$4.50 \text{ (Contribution Margin)}} = 300$$

Simply substitute profits for fixed costs:

$$\frac{\$900 \text{ (Profit Goal)}}{\$4.50 \text{ (Contribution Margin)}} = 200$$

Thus, you must sell an additional 200 shirts to make $900 in profit. That means you have to sell a total of 500 shirts to cover your fixed costs *and* reach your profit goal. Here's an even simpler way to reach this conclusion:

$$\frac{\$1{,}350 + \$900}{\$4.50} = 500$$

Volume Goals

The second way to plan for profits is to forecast an attainable sales volume goal. Let's say that selling 500 shirts is a little too ambitious at this stage in your business. Perhaps your market research has shown that a sales volume of 400 is more realistic. What effect will this have on your profits?

$$\text{Profit} = (\text{Sales Volume x Contribution margin}) - \text{Operating Costs}$$

Or:

$$\text{Profit} = (400 \text{ T-shirts x } \$4.50) - \$1{,}350$$

Or:

$$\text{Profit} = \$1{,}800 - \$1{,}350$$

Or:

$$\text{Profit} = \$450$$

PRICING STRATEGIES

Your pricing strategies must be guided by your pricing objectives, which in turn must be guided by your financial goals, industry analysis, customer analysis and competitive analysis.

Your pricing strategies must respond and adapt to evolving market conditions.

Like any other part of your business, your pricing strategies must respond and adapt to evolving market conditions, so it's important to review them frequently. Many entrepreneurs combine several of the following approaches to reach the optimal pricing strategy.

Cost-Plus Pricing

Cost-plus pricing means totaling fixed and variable costs and adding a **target return** percentage to arrive at a sale price. This is the easiest and most common strategy.

Because cost-plus pricing ignores the impact of consumer demand, brand identity and positioning, it can lead to a price that's out of sync with your market or branding objectives. Also, it's easy to miss hidden costs. Therefore, it works best in industries where demand and competition are stable.

Competitive Pricing

This means basing your price on your competitors' price for the same product. Typically, you would choose this strategy in cases where it's hard to differentiate your product from competing products. For example, if you make handprinted greeting cards, and most competitors sell similar cards for $2.50 to $3.50, you might price your cards at $3. Instead of competing on price, you're competing primarily on the quality of your designs and materials. This strategy goes with the status quo pricing objective.

Loss Leader

In this strategy, you offer one product at a low price in order to attract customers who will then buy additional products that earn higher profits. This is a common strategy for retail stores; customers figure that as long as they are buying one product, they may as well pick up a few other items they need. Many websites also favor this strategy; they often tempt customers with a low price on one item and then suggest add-ons.

Multiple Pricing

Multiple pricing offers a discount for buying more than one of an item. For example, you might offer one Christmas card for $3 or two for $5. In some cases, this is an actual discount. In others, the multiple price is the desired price and the single-item price is inflated. In other words, your goal is to sell your cards at $2.50 each, so you boost the price of single cards to $3. This strategy supports the profit maximization objective.

Penetration Pricing

Penetration pricing means setting an artificially low price in order to enter a new market and encourage customers to try your wares. After achieving your goals, you gradually raise your price to a level that delivers higher profits.

Penetration pricing is a method of revenue maximization; it increases sales but delivers very little profit per sale. This can be a better strategy than maximizing short-term profits, assuming you can sustain it long enough to reap the benefits.

Penetration pricing can create goodwill among new customers, which may lead to word-of-mouth sales. It can also act as a barrier to entry for your competitors. Therefore, it's a good strategy for the introduction stage of the product life cycle. The downside is that your competitors may follow your lead by lowering their prices, which could lead to a price war. Also, customers may reject your product when you raise your prices.

Premium Pricing

Premium pricing means pricing above market value in order to evoke perceptions of quality, prestige or rarity in market segments that are less price-sensitive. You can use it to maximize profit or to stand out as a quality leader.

Here are some of the reasons customers will pay a premium price:

- **Social status or distinction.** People who see themselves as premium customers are more likely to pay premium prices for goods that reinforce their self-image.
- **They think they'll get a lower-quality product if they pay less.** Consider car tires. Although the lowest-priced tire may offer good value, consumers will often buy a higher-priced brand because they assume the more expensive tire is safer, likely to last longer or both.
- **Rarity.** The product is handmade or otherwise rare and exclusive.
- **Quality.** They believe a premium price indicates impeccable quality that can't be found elsewhere at a lower price.
- **Extravagance.** They want to give themselves a treat or reward themselves for achieving a particular goal.
- **Stability and reliability.** You've been around a long time, and you project an image of permanence.
- **Novelty.** You are first in the marketplace with a unique product.
- **Altruism.** Buying the product benefits society or supports a worthy cause.

These can all be powerful motivators, but they shouldn't guide your pricing strategy unless you truly understand your customers' psychology. A premium-pricing strategy that misfires can have negative effects in other target markets. If you choose this approach, be prepared to explain the value you offer, bearing in mind that it has to make sense for your product and market.

To understand this last point, let's consider a product for which people probably *wouldn't* pay a premium price: wooden pencils. Some pencils might be better than others—maybe they stay sharp longer or have a better eraser—but most consumers aren't going to make a detailed comparison. Their concern tends to be price, not quality.

Would it be possible to sell handcrafted pencils, or pencils made from reclaimed wood? Perhaps, but you'd probably have to keep the price similar to that of standard pencils. Studies show that customers are more price-sensitive the higher a price is compared to easily available alternatives.

In other words, offering a "premium" pencil might make consumers switch brands, but it probably wouldn't justify premium pricing, because wooden pencils are widely available at a low price.

Price Skimming

Skimming maximizes your profit margin by setting a high short-term price and tailoring it to the price sensitivity of your market segments. This may be useful when your product is unique or innovative enough to have little direct competition, and buyers will pay to get it right away.

As demand from these buyers drops and competition increases, prices are gradually reduced. This is what distinguishes skimming from premium pricing, where a high price is consistently maintained.

Skimming has several advantages:

- Innovative products typically have high development and promotional costs. Skimming helps to recoup these costs before competitors enter the market.
- When you start out with a higher price, you can respond to competition by reducing it. Starting with a lower cost limits your ability to raise prices.
- Skimming can be adjusted to multiple market segments, so that you earn the maximum revenue from each segment.

Starting with a lower cost limits your ability to raise prices.

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I already had a business plan, so I had a head start on figuring out whether my new idea was viable. I knew the area as well as anyone, and I would be in roughly the same line of work, so that simplified some parts of my research.

The thing that gave me more of a headache was the number of potential customers, especially when I was looking at developers. I'd done odd jobs for developers around town, but nothing on this scale. I had to figure out if there was a sustainable market there, and if I had a real chance of tapping into it. That meant looking at demographics, and also at the business outlook—especially in the tech and aerospace sectors, which is where most of the jobs were.

Then there was the logistics of moving trees. I knew I couldn't get by with a pickup and a shovel, but I had no idea what it would actually cost to move a big tree. For that matter, I had no idea what qualified as "a big tree" in this context. I had to research tree spades and all the other equipment I'd need, and then I had to balance the cost of that equipment against the maximum size of tree it could handle. Not only that, but I had to consider what the local roads and bridges could handle in terms of weight. In some cases, I might have to take a roundabout way of getting to a location to avoid power lines and other hazards.

In the end, I settled on a maximum height of 45 feet — that seemed like the sweet spot where the tree would be substantial enough to provide shade and make a real statement, but working with it would still be feasible and affordable.

Figuring all this stuff out was complicated, no doubt about it. But I knew that if I didn't consider all these factors, I wouldn't stay in business long.

And going out of business was actually the least of my worries; lawsuits and safety issues were a much bigger concern. Any time I got bored with working on my business plan, I thought about the kind of things that can go wrong in a business like mine. And all of a sudden, I'd feel motivated again.

It took Sam about two weeks to finish his preliminary market research. Next, he began working on his pricing. He estimated that on average, it would take him a minimum of 12 hours to move a single tree, factoring in tree prep, site prep, transport and followup maintenance. He figured that in his first six months, he would be able to move 15 trees a month.

Sam's fixed costs would remain the same regardless of how many trees he moved. He had already bought his office and landscaping equipment, and he would need to lease a tree spade. His total costs would rise over time because his variable costs (labor, biodiesel and trees) would go up as he moved more trees.

Sam calculated that if he charged an average of $1,200 per tree, and moved 15 trees a month, he would break even after moving between seven and eight trees. The following chart shows how Sam arrived at these numbers.

Variable Costs Per Unit	
Labor (1 helper, 12 x $15/hr)	$180.00
Tree spade operator (4 x $50/hr)	200.00
Biodiesel fuel (10 x $3.50/gal)	35.00
Organic fertilizer and burlap	65.00
Tree	400.00
Office expenses	20.00
TOTAL VARIABLE COSTS	**$900.00**
Fixed Costs Per Month	
Landscaping equipment	$650.00
Office equipment	250.00
Rent	1,000.00
Tree spade lease	350.00
TOTAL FIXED COSTS	**$2,250.00**
Total cost: $2,250 + ($900 x 15)	$15,750.00
Total revenue: $1,200 x 15	$18,000.00
NET PROFIT	**$2,250.00**

Based on these numbers, Sam's break-even calculation was as follows:

$$\frac{\$2,250}{(\$1,200 - \$900)} = 7.5 \text{ trees}$$

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Competition-Based Pricing

Businesses often alter their prices based on competitors' prices. This is particularly common in large, highly competitive industries like airline travel, soft drinks and crude oil. Similar pricing is important because the price sensitivity of buyers increases when a product of this type is higher than the industry norm. The danger of this strategy is that your competitors' cost structure may be very different from yours.

Follow-the-leader pricing aligns with an industry's price leader. This is common in industries that sell standardized products—like farm commodities or industrial raw materials—because these industries tend to be dominated by a few large companies.

Pegged pricing aligns with industry-wide norms, usually in industries with no clear price leader. Businesses using this method might use the industry norm as a starting point, then offer a slightly higher (premium) or lower (economy) price to establish a niche. Having done this, the business works backwards to calculate if it can make an acceptable profit at that price level.

Going back to our $10 T-shirt example, suppose your competitors charge $8 to $13 for shirts like yours. The lower price is found in discount stores, while stores targeting higher-income buyers charge the higher price. If you were trying to reach customers in the middle income bracket, you'd probably charge $9 to $11. However, you also need to compare your shirt to other shirts sold in the same market. If your shirt is superior in quality, image or appearance to a $9 one, you can justify a higher price.

Next, suppose you can't find anything that makes your shirt better than the one that sells for $11. If the $11 shirt sells well, you might want to set your price at $11 too and compete for the same customers. You could also set your price slightly lower to give buyers an incentive to choose your product.

How do you know which is the right decision? Again, it goes back to knowing your costs, your desired profit, your break-even point and your customers' desires.

You may want to develop some "what if" pricing scenarios based on anticipated competitor responses. For example: "If my competitor responds by lowering its prices, I can afford to lower prices by ___ percent."

Experimenting with different price levels can take time and resources that a new business can't afford. However, you might try setting slightly different prices in different geographic areas, or conducting a focus group to gauge the price sensitivity of prospective customers. You can also offer short-term discounts to see how price affects demand, or experiment with different price structures online.

Value-Based Pricing

In this strategy, you base your price on your customers' perception of its value. The goal is to charge an above-average price while leaving customers with the feeling that they've gotten a good deal. Consumers may pay more for your product because:

- They like and trust you.
- You were recommended by someone they like and trust.
- You offer convenience or faster service.
- You offer security or reduced risk.
- Your products have features and benefits that competing brands lack.

Branding is central to creating perceived value, and perceived value is at the heart of value-based pricing. Every branding choice affects the perceived value of your product, which in turn affects your ceiling price.

Every branding choice affects the perceived value of your product.

Think about the headache tablets at your local drugstore. A name-brand tablet sits right next to a generic tablet that costs half as much. And yet the name brand often sells as well as—or better than—the generic. The two tablets have the same ingredients in the same dosage; they may even have been made in the same plant. But the name brand offers security and familiarity, so people are willing to pay extra. This perceived value allows brands to withstand strong competitive pressure, even in the mature stage of a product's life cycle.

In fact, underpricing your goods can actually make customers *less* likely to buy. The old saying "you get what you pay for" holds a lot of truth. In cases where consumers want to feel sure that they're getting a good product, spending a little more often helps them to feel positive about their decision.

When dealing with certain customers, it's necessary to communicate your product's **value in use**. This refers to the overall savings a customer will realize by paying a little more for your product. Does your product last longer or require less maintenance than a less-expensive competing product? Does it save customers time or trouble? If so, show your customers how paying a little extra up front can save a lot down the road.

Retail Pricing

Retail pricing applies when merchandise is purchased from a manufacturer or wholesaler and then sold again to the end user.

Although retailers usually don't produce the goods they sell, they still have overhead costs (rent, wages, utilities and advertising). Their price must cover the cost of doing business and offer an acceptable level of profit.

To get a selling price, you can multiply the wholesale price by a certain percentage (called a **markup**), and add that to the wholesale price. For example, if your company sells T-shirts, you can find your markup percentage by adding a percentage of the cost to the total cost of the goods:

Cost	$5.00
50% Markup	x .50
Markup Price	$2.50
Cost	+ $5.00
Selling Price	= $7.50

Alternatively, you can base your price on a percentage of the retail price by dividing the cost of the product by the markup percentage:

Cost	$5.00
50% Markup	÷ .50
Selling price	$10.00

The most common retail pricing strategy is to take a percentage of the retail price. However, you must understand how your competitors price their products so that you can choose a competitive pricing method.

You must understand how your competitors price their products so that you can choose a competitive pricing method.

Many retailers base their selling price on the manufacturer's suggested retail price. This is an easy way to determine prices. But the simplest retail pricing technique is called **keystoning**. This means doubling all your costs to arrive at your selling price.

Cost of shirt	$5.00
Keystone	x 2
Selling price	$10.00

The key to retail pricing is to make sure your pricing method covers your overhead, expenses, taxes and profit. If your price doesn't earn a profit, you'll either need to raise it or lower your costs (unless you're pursuing a short-term loss leader strategy).

Discounts

List price is the "official" price that businesses charge, from which they subtract any discounts. It's seldom the actual selling price; adjustments are usually made for trade or channel partners, and for the final customer. This is common in the auto industry, where car manufacturers set a list price that the dealer and the buyer negotiate to arrive at a final sales price.

Businesses usually offer discounts to buyers who meet criteria that reduce selling costs. Here are the most common discounts:

- **Quantity discounts** are given to customers who buy in bulk. This can be a powerful way to increase the amount of units you sell.
- **Trade discounts** are given to distributors or reps who perform marketing functions such as advertising, promotions or technical support. They are often used as a leveraging tool for new products in distribution channels or retail outlets.
- **Seasonal discounts** encourage customers to make purchases during off-peak selling times, which lowers inventory levels when demand is down.
- **Cash discounts** are given to customers who buy with cash instead of credit. This encourages speedy payment of bills and minimizes accounts receivable, which can improve cash flow.

Discounts can be a good way to attract new customers, but they also set an expectation that your business may not be able to meet. If you offer a steep discount to get an important client, you may find that unforeseen costs make the price unsustainable in the near term. You also have to consider the possibility that referrals and word of mouth will create an expectation among new customers that they will get a steep discount, too.

Therefore, it's usually preferable to use discounts to reward loyal or big-spending customers rather than to attract new ones. A discount should never simply be bait; it should require a concession from the buyer, such as bigger or more frequent orders, a subscription, faster payment, or placing an order by a certain date.

Making Price Fit Your Marketing Mix

No matter which pricing strategy you use, it should match the other elements of your marketing mix. Here are the main points to consider:

- **Product strategy.** Is your price in line with your customers' perception of quality? If not, consider lowering your prices, improving your quality or educating your customers.
- **Placement strategy.** Is your price in line with the image of your distribution channels? Premium products should be distributed selectively, while economy products should be widely available. Are you using the right incentives for your distributors?
- **Promotional strategy.** Does your advertising message suit your product's price? If you sell a premium product, is your image one of quality and service? If you sell an economy product, is your image one of value and convenience? Are your sales promotions undercutting your pricing strategy and profitability? Are coupons or price discounts encouraging only short-term business by fickle customers?

You should review your pricing strategies regularly to make sure they still fit your costs, customers, competition, positioning and product life cycle. A quarterly pricing review suits most growing companies, unless they're in a very fast-paced business.

Common Pricing Errors

- Don't base your prices on current overhead costs. Instead, anticipate how your overhead might rise over time.
- Don't base prices solely on your costs. Consider competitors' pricing, and look for ways to maximize the value of your product through higher quality or better service.
- Failing to include in the price an allowance for warranty costs, future service, research and development costs, cost of capital, dealer discounts, and sales commissions.
- Ignoring the way customer demand for the product will change at different price levels. Would sales volume increase if you lowered prices by 10 or 20 percent?
- Don't base your price solely on your impression of what the market will bear. Always do your homework!

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Maybe it sounds conceited, but I felt confident that I had a leg up on any likely competitors. I grew up on an orchard. I know the land, I know the soil, I know the pests and the climate. I know just about everything there is to know about looking after trees in this part of the world.

Based on my research, I knew I could charge an average of $1,200 per tree. But I wasn't thrilled about my monthly revenue or my break-even point of 7.5 trees. With my knowledge and expertise, I felt like I could nudge my profit margin up a little.

Here are Sam's calculations, which he based on moving 15 trees per month with a target profit margin of 40 percent. This is expressed as 1.40, which represents the break-even amount of 1, plus his desired profit margin of .40:

(Units x Average Variable Cost) + Fixed Costs x Profit Margin ÷ Units

Or:

$$\frac{(15 \times \$900) + \$2{,}250 \times 1.40}{15}$$

Or:

$$\frac{\$15{,}750 \times 1.40}{15}$$

Or:

$$\frac{\$22{,}050}{15} = \$1{,}470 \text{ per tree}$$

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ONLINE PRICING

E-commerce has affected pricing strategies in a number of important ways. First, it has increased competition, which has tended to increase consumer choice and drive prices down for many types of goods.

Second, it has brought about a new era of price transparency. Buyers can either look for the lowest price by checking multiple sellers, or by visiting sites that compare prices from a wide variety of retailers.

Dynamic Pricing

This is a flexible approach that allows retailers to adapt automatically—in real time—to circumstances ranging from market demand, to competitor pricing, to a specific customer's past purchase history. Dynamic pricing is based on complex factors that include sales and browsing data, consumer ratings, seasonality and even weather forecasts. Wiser (*www.wiser.com*) is an example of a company that automates online repricing based on data analytics.

Dynamic pricing is widely used for travel-related products like airfare and hotels, and for products offered online. Basically, the goal is to maximize prices during times of higher demand, and maximize sales during times of lower demand.

The danger of this approach is that setting high prices for times where a high demand is expected can result in accusations of price-gouging; even in cases where the price is justified by an increase in costs, customers may blame the seller.

Name Your Own Price

Some sites allow consumers to set their own prices. This form of dynamic pricing typically allows consumers to name their preferred price and set an expiration date for the offer. Participating retailers have the option of accepting the offer within that time period. In similar systems, a product is offered for a minimum price, but buyers can pay more if they wish, based on their perception of its worth.

Studies show that these approaches can boost sales and may even increase the seller's understanding of the comparative price sensitivity of their target markets.

Freemium Pricing

This is a common pricing strategy for digital goods and online services, in which basic access is free, but additional features and functionality are available for a price. The file hosting service Dropbox is a typical example. Any user can have a basic amount of storage; they can get more storage and better features either by paying a subscription fee, or by taking specific steps to recommend the service to other users.

Games and apps that allow basic functionality, but require payment to unlock more robust features, are another example. This strategy aims to build up a large customer base quickly, while also providing incentives to turn them into paying customers or brand ambassadors.

The drawback of freemium pricing tends to be the "free" part. If your product doesn't have enough functionality to prove its worth, customers may not be interested in the premium version. If it does, they may decide the free version is adequate for their needs and refrain from upgrading. Coming up with a freemium strategy that will generate wide interest *and* attract enough paying customers to cover your costs can be a challenge.

Offering Value Online

As we've said, the customer's ceiling price depends on perceived value. Online, the credibility of your business and the quality of your service are particularly important.

If you search online for a given product, and look at the first 10 sites that appear, you'll probably find that some of them look far more professional than others. They have a clean, nicely designed interface with high-quality pictures of the goods, detailed technical information, a clear return policy, and a live chat link for customer questions.

If you'd prefer to deal with a business like that, you're not alone. Studies have shown that features like these can coax online buyers to pay up to 20 percent more. Here are some basic ways to increase the perceived value of your online offerings:

- **Make your site easy to read and navigate.** Keep text clean and clear; avoid the temptation to use lots of fonts and colors, capital letters, underlining and multiple exclamation points.
- **Simplify checkout.** The fewer steps it takes to buy from you, and the more secure your payment system is, the higher the perceived value of your site.
- **Accept customer feedback.** Allowing customer reviews, ratings and comments can increase consumer confidence and sales. Although you may get some negative feedback, you can also earn respect for transparency, fair conflict resolution and customer service.
- **Make returns easy.** A simple, no-hassle return policy makes a powerful statement about your dedication to customer service.
- **Promote your business ethics.** Some online retailers make a point of donating a certain percentage of sales to a local, national or international cause. Studies consistently show that customers will pay a little more, and buy a little more often, to make a difference.

PRICING SERVICES

Service businesses must focus their pricing strategies on the ability and capacity of the owner, the productivity of workers, the requirements of the customer, and the nature of the competition.

Before approaching a customer, list the benefits your service provides. At the same time, take a hard look at your costs. It's easy for service providers to overlook things like travel time, transportation, research and phone or email consultation. Understanding everything that goes into your service, and listing all the benefits it provides, is essential to setting a realistic price and getting clients to accept it.

Before approaching a customer, list the benefits your service provides.

Understand Your Market

Before you set your own price, you need to know what's standard in your industry and in your region. If you offer a service that can be provided remotely — such as graphic design—you may also need to look at the fees charged by international competitors. Although many clients still prefer to hire local service providers, advances in

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BUSINESS RESOURCES AND THE WEB

Testing Prices Online

Selling online allows you to experiment with pricing to see how it affects sales. For example, you might consider how the following factors affect customer demand:

- Unit price
- Discounts for complementary or bundled items
- Discounts for buying a certain number of items or spending a certain amount
- Free or reduced-price shipping
- Limited-time offers and online coupons
- Payment options (credit card, phone orders, one-click buying)
- Return policies and warranties

By tracking how customers respond to different prices and sales promotions, you can arrive at a price structure that meets your sales and profit goals. That said, it's important to keep your online pricing structure in line with your offline brand identity. If your business offers the best prices in town, it needs to maintain that image online. If you offer high-quality or otherwise unique goods, your online prices should reflect that. Sending mixed pricing messages is likely to confuse customers and undercut your branding strategy.

videoconferencing and related technology are steadily eroding this advantage.

Understanding the forces at play in your market will give you a good idea of the amount prospective clients will expect to pay. From there, you can consider how the specific value you offer sets you apart.

Understand Your Value

Small-business service providers often undervalue themselves and their time, leading them to set artificially low prices.

Underpricing your services to develop a client base is usually a bad strategy. If you don't seem to value your time, neither will your clients. It's better to charge what your service is worth.

When a business prices its services too low, customers may worry that they're trading price for quality. Even if they don't have this reaction, businesses usually find that it's easier to make a profit by setting the right price than by setting a low one and trying to make up the difference in volume.

Even if your low bid gets the job, what happens if you can't reach your profit goals, or deliver the specified results, at that price? If you have to raise your prices after a few months, you run the risk of losing customers. Therefore, just as with products, it's best to communicate the value you offer instead of trying to compete on price. Focus on expertise and results rather than price.

When negotiating prices, remember that you are the expert on your skills, your

When a business prices its services too low, customers may worry that they're trading price for quality.

costs and the results you can deliver. Don't treat price objections as a cue to offer steep discounts, to defend yourself or to complain about your high costs; these tactics will make you seem weak. Instead, treat price objections as a chance to highlight value.

This doesn't mean that you should never negotiate a lower price. It's good to be flexible, but you should always receive something in return. For example, you might reduce your price by 10 percent if the customer signs a six-month contract. Knowing your costs is essential when negotiating deals like these, as is knowing what your customers value.

When considering the benefits you offer, don't forget time savings. Many service providers undervalue their clients' time as well as their own. Consider window cleaning. This is a task almost anyone can do, and yet businesses and homeowners often hire people to do it for them. Why? Because they value their time and know there's no such thing as "free" labor.

Suppose a small-business owner normally earns $40 an hour, and it would take her three hours to clean her company's windows. If you charge $50 to do the job in two hours, your service will save her $70. And if you do a better job because you have specialized tools and experience, you also offer her better value for less money. If you offer a discount for a monthly window-cleaning contract, you not only offer a price break, but you're also giving the business owner peace of mind: You're thinking about the windows so she can focus on more important tasks. Don't underestimate the importance of these factors. Often, they may be your client's main concern, even if she never mentions it.

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I have to say, my pricing worked out well. It was high enough to cover my expenses and meet my profit goals, but it was also affordable enough to attract developers and homeowners. It was flexible, too. I was able to negotiate a discount with the local golf club for moving multiple trees. That job alone got me to my break-even point.

That's not to say that I didn't have pricing problems. There were definitely a few jobs where I came in well over budget. But I learned by trial and error to adjust my quotes based on terrain, distance and types of trees.

For the sake of promoting himself, Sam also agreed to accept a lower price for prestige jobs like historic mansions and churches. He reasoned that this sort of flexibility and visibility would keep would-be competitors at bay. This was good thinking; the local newspaper ran a story on a major relocation project, which brought in several more jobs.

Sam's expansion into tree-relocating also brought him more landscaping work, which was something he hadn't bargained for. Clients who were pleased with his efficient, careful work and his use of organic gardening materials often asked him for quotes on other landscaping projects.

As Sam's business grew and his reputation spread, he moved away from cost-plus pricing and toward value-based pricing. He had come to realize that what made him special was not the service he offered, but his reputation.

I started to see that I was selling clients peace of mind they couldn't get anywhere else. A lot of my customers had a strong attachment to their trees. They knew I wasn't just going to dump it in a hole and leave; they knew I'd follow through. They trusted me to check back and monitor the tree's progress. They knew I'd do whatever it would take to keep it healthy and happy. My service gave people security. In good times or bad, that's worth a lot.

I've gotten some competition as I've grown. It worried me at first, but now I welcome it. People have tried to undercut my price, but it's pretty hard to do that without cutting corners and holding back on service. Even in neighboring counties like Queen Anne's and Dorchester, my reputation trumps their lower prices nine times out of 10. And if I have anything to say about things, it always will.

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Understand Your Costs

It's essential to consider every cost involved in serving your clients.

One of the most common mistakes service providers make is underestimating their indirect costs, or **overhead**. It's essential to consider every cost involved in serving your clients. These costs include:

- Rent
- Computer supplies
- Phone/email/ postage
- Salaries and wages
- Equipment rental
- Interest payments
- Taxes and license fees
- Books and reports
- Travel costs
- Office supplies
- Shipping costs
- Printing
- Utilities
- Equipment
- Clothing
- Insurance
- Gas
- Printing
- Advertising

One way to calculate your overhead rate is to total your indirect expenses over a given period—i.e., all expenses that are not labor or materials—and divide this number by the cost of labor and materials for that period.

For example, suppose your indirect expenses for last year were $18,000, and your cost of labor and materials was $45,000:

$$\frac{\$18{,}000}{\$45{,}000}$$

This gives you an overhead rate of 0.4, or 40 percent. This is the extra amount you need to charge, above labor and materials costs, to cover your overhead expenses.

Service Pricing Questions

Consider these questions when approaching a new client:

- What is the scope of the work? What is and isn't your responsibility? At what point is the job finished?
- What is the minimum time the job will take? What is the maximum time?
- What are the tangible benefits of your work (cleaner windows, more sunlight)? What are the intangible benefits (stress reduction, improved morale)? Which features sell which benefits?
- What standards will your client use to judge your work? Do you measure success in the same way? How does the contract define success?
- Is this a one-time job, or are you building a long-term relationship?
- What do competitors charge? What level of quality, speed and service do they offer? Why are you a better choice? Can you outperform them and still earn a profit?
- Not all hours of the workday are billable to your customers. Will you have enough billable hours in the day to make the amount of money you need?
- What value can you add to the transaction? Consider free tests or estimates, discount coupons for future work, consultation, maintenance, documentation and so on.

This doesn't include profits, of course, so you will need to add your desired profit margin as well.

Always watch out for unexpected costs that eat into your profits. Chances are, you will find that most of them result from weak management or poor negotiation skills.

Understand Your Time

Accurately tracking time is one of a service provider's most important tasks. It's also one of the hardest, due to common issues like interruptions, stress and the need to multitask. An app that allows you to clock in and out of jobs is ideal, but even a timer is better than nothing. If you don't track your time, you will have to estimate it. Human nature being what it is, you're unlikely to estimate it accurately.

Start by estimating how long a given job will take. Then, track every minute of time you spend on it, including phone calls, emails, buying supplies and so forth.

Most service providers who do this will find that they underestimated their time. Unless they improve, they may work long hours without ever seeming to get ahead.

Preparing Bids

Service providers are often asked to submit a fixed-fee bid that reflects the scope of the work, the timeframe and the costs. The process can be broken down into the following steps:

- Map out the entire project and identify its components.
- Assign detailed cost estimates to each component.
- Total the costs for all components.
- Apply your overhead rate and profit margin to total costs.

When arriving at a price, the most important task is to assign costs to the various components of the contract. For example, a trainer might break a contract down into the following components:

- Determine training requirements
- Measure existing skills of employees
- Develop training objectives
- Design training progress measures
- Write training outlines
- Formulate training schedules
- Complete training
- Assess results

Accurately tracking time is one of a service provider's most important tasks.

To assign accurate costs to each component, calculate the following:

- **Direct labor**. Estimate the hours you (and your staff or contractors, if applicable) will spend on each component of the contract. Then, multiply this estimate by the labor rate for each employee.
- **Direct expenses**. Estimate the expenses you must incur to complete each component of the project. Common direct expenses include equipment, printing, research and transportation.

Once you've calculated your costs, it's wise to create a standard pricing sheet for your services. List all your standard expenses, and leave space for unusual or one-time expenses. Many inexpensive programs can help you do this. In addition, the methods described in Chapter 27 ***Project Management*** can help you stay on top of scope, deliverables, timeframe and costs.

CONCLUSION

Pricing is a difficult task that requires a complete understanding of your customers, costs and competition. It's no wonder that businesses spend so much time measuring costs and monitoring the effect of prices on customers and competitors.

When you offer a product, a service or both, the most critical element of pricing is understanding costs. Once you know what your fixed and variable costs are, you can select the pricing method that is best for you. Different industries demand different pricing strategies, and different approaches to maximizing perceived value.

Understand the standard practices in your industry, and then tailor your strategy to fit your customers and the unique value you offer them.