SCORE
East Central Iowa

Counselors to America's Small Business

#1 IN AMERICA

PRICING STRATEGIES

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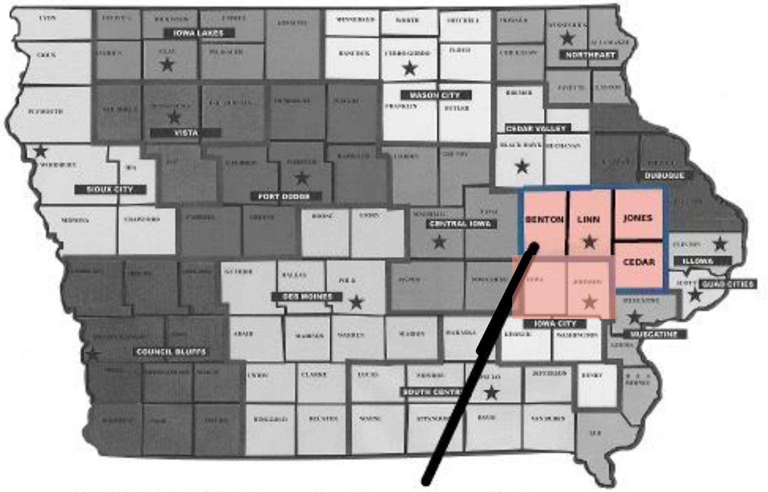
Agenda

- What is SCORE?
- Why pricing is important
- Multiple pricing strategies
- Different business types
- Questions/answers



SCORE East Central Iowa

SCORE®-ECI serves the following counties in East Central Iowa: Benton, Cedar, Linn, Jones, Henry, Iowa, Keokuk, Johnson, Chickasaw, Bremer, Black Hawk, Buchanan, Henry, Washington

What is SCORE?

National, volunteer organization

In partnership with the Small Business Administration

45 members in East Central Iowa

Help people start / manage a business by:

- ***Free/confidential, one-on-one counseling***
- ***Workshops, seminars, roundtables***

www.scorecr.org

Factors Affecting Price

- Company's image
- Customers' expectations
- Product or service costs
- Customers' characteristics
- Market forces
- Competitors' prices
- Sales volume
- Seasonal fluctuations
- Customers' price sensitivity
- Psychological factors
- Substitute products
- Credit terms and purchase discounts

Three Pricing Forces: Image, Competition, and Value

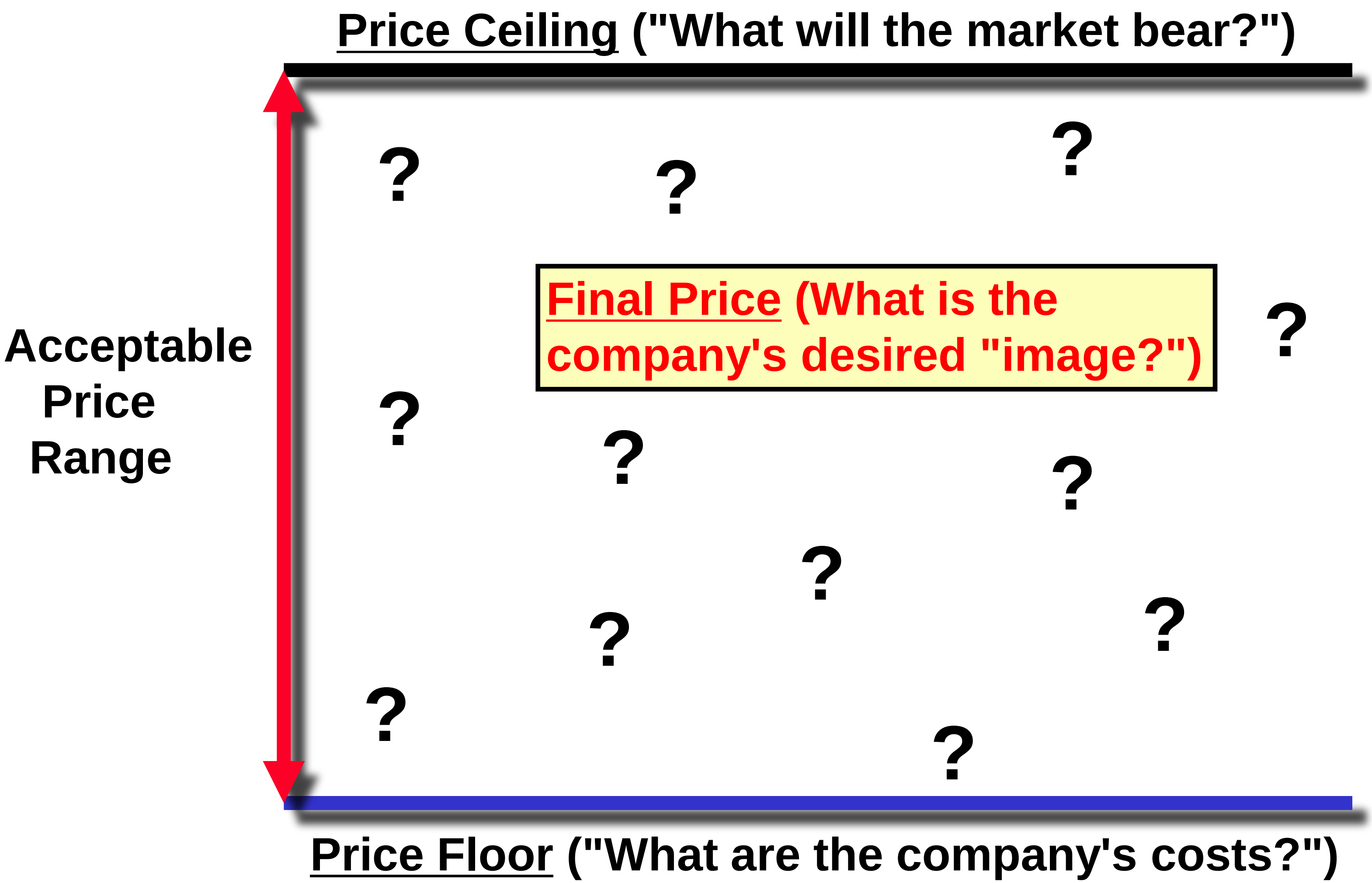
Price conveys image

- **Prices send signals to customers about quality and value**
- **Key is understanding your target customers**

When setting prices, business owners must consider competitors' prices

- **Competitors' locations**
- **Nature of the competing goods and services**
- **Avoid price wars!**

What determines price?



Three Pricing Forces: Image, Competition, and Value (Continued)

Focus on value for your customers

- **Objective value vs. perceived value**
- **Customers have three reference points:**
  - Price paid in the past
  - Prices competitors charge
  - Company's costs

Pricing: Dealing with Rapidly Rising Costs

- Communicate with your customers
- Include a surcharge
- Eliminate discounts, coupons, or “freebies”
- Focus on efficiency
- Consider absorbing cost increases
- Emphasize the value your company provides to customers
- Try to lock in prices with suppliers

General Principle – Seek The Highest Possible Prices

- **There is nothing illegal, unethical, or immoral in seeking the highest price for your offering that the market will pay**
- **Start with prices slightly higher than you think justified – generally it is much easier to lower prices than to raise them**
- **The marketplace will tell you if your price is too high. It will not tell you if your price is too low.**

❖ **"Too low prices" is one of the 10 most common reasons for business failure.**

Price Segmentation

If the market can be divided into high and low price buyers

and

If you can differentiate your offering to the different price groups

- ✓ **Price Segmentation** will always produce better results than a single price strategy

Pricing for Service Firms: Price per Hour

$$\text{Price per Hour} = \text{Total cost per productive hour} \times \frac{1}{(1 - \text{net profit target as a \% of sales})}$$

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$$\text{Price per Hour} = \text{Total cost per productive hour} \times \frac{1}{(1 - \text{net profit target as a \% of sales})}$$

Example: Ned's TV Repair Shop

$$\text{Price per Hour} = \$18.59 \text{ per hour} \times \frac{1}{(1 - .18)} = \$22.68 \text{ per hour}$$

Pricing for Service Firms: Price per Hour

- **Alternatively, start with your desired annual earnings**
- **Divide by number of productive hours per year (2050 available work hours per year)**
- **Answer is the required charge per hour**
- **Can you be competitive at this rate?**

Pricing Strategies for Established Goods and Services # 1

- **Odd pricing** – ending in 5, 7, or 9
- **Price lining** – good, better, best
- **Dynamic pricing** – premium price for those who are willing to pay/ lower price for repeat business
- **Leader pricing** – low price items to attract more customers

Pricing Strategies for Established Goods and Services #2

- **Geographic pricing**
  - Zone pricing
  - Uniform delivered pricing
  - F.O.B. seller

- **Discounts (or markdowns)** - move stale merchandise
- **Multiple pricing** – lower prices for volume buys

Pricing Strategies for Established Goods and Services #3

- **Bundling**
  - **Optional product pricing (autos/sunroof)**
  - **Captive product pricing (razors/blades)**

- **Suggested retail prices**
- **Follow-the-leader pricing – matching the market leader**

Pricing for Retailers: Markup vs. Margin

$$\text{Dollar Markup} = \text{Retail Price} - \text{Cost of Merchandise}$$

$$\text{Percentage (of Retail Price) Margin} = \frac{\text{Dollar Markup}}{\text{Retail Price}}$$

$$\text{Percentage (of Cost) Markup} = \frac{\text{Dollar Markup}}{\text{Cost of Unit}}$$

Example: Markup vs. Margin

Dollar Markup = Retail Price - Cost of Merchandise

Percentage (of Retail Price) Margin = $\dfrac{\textbf{Dollar Markup}}{\textbf{Retail Price}}$

Percentage (of Cost) Markup = $\dfrac{\textbf{Dollar Markup}}{\textbf{Cost of Unit}}$

Example:

Dollar Markup = \$25 - \$15 = \$10

Percentage (of Retail Price) Margin = $\dfrac{\$10}{\$25}$ **= 40%**

Percentage (of Cost) Markup = $\dfrac{\$10}{\$15}$ **= 67%**

Markup vs. Margin Chart

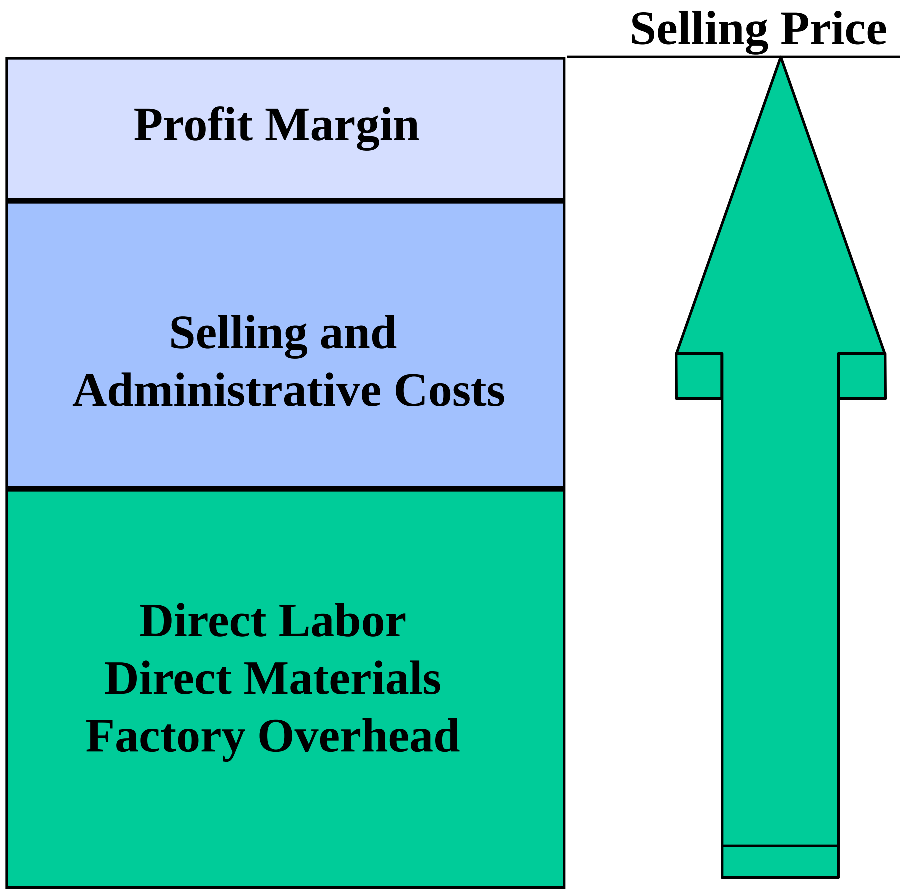
15% Markup = 13.0% Gross Profit (margin)
20% Markup = 16.7% Gross Profit
25% Markup = 20.0% Gross Profit
30% Markup = 23.0% Gross Profit
33.3% Markup = 25.0% Gross Profit
40% Markup = 28.6% Gross Profit
43% Markup = 30.0% Gross Profit
50% Markup = 33.3% Gross Profit
75% Markup = 42.9% Gross Profit
100% Markup = 50.0% Gross Profit

Pricing for Manufacturers: Cost-Plus Pricing

Net profit

Fixed costs

Variable costs
(Cost of goods sold)



Gross Profit Calculation Example

Sales/Revenues	$ 500,000.00
Cost of Goods Sold (Variable Costs)	
Materials	$ 75,500.00
Labor	$ 110,000.00
Other Variable Costs	$ 100,000.00
Total Cost of Goods Sold	$ 285,500.00
Implied Markup in this Example	**75.0%**
Gross Profit (Sales – Cost of Goods Sold)	$ 214,500.00
Gross Profit Margin (Percentage)	**42.9%**

Profit and Loss Calculation Example

Sales/Revenues	$ 500,000.00
Cost of Goods Sold (Variable Costs)	$ 285,500.00
Gross Profit (Sales – Costs of Goods Sold)	$ 214,500.00
Gross Profit Margin (Percentage)	**42.9%**
Fixed Costs	$164,500.00
Fixed Costs (Percentage)	**32.9%**
Net Profit (Gross Profit – Fixed Costs)	$ 50,000.00
Net Profit Margin (Percentage)	**10.0%**

Pricing for Manufacturers: Breakeven Selling Price

$$\text{Breakeven Selling Price} = \frac{\left\{\begin{array}{c}\text{Variable cost} \\ \text{per unit}\end{array} \times \begin{array}{c}\text{Quantity} \\ \text{produced}\end{array}\right\} + \begin{array}{c}\text{Total} \\ \text{fixed} \\ \text{costs}\end{array}}{\text{Quantity produced}}$$

Pricing for Manufacturers: Breakeven Selling Price

$$\text{Breakeven Selling Price} = \frac{\{\text{Variable cost per unit} \times \text{Quantity produced}\} + \text{Total fixed costs}}{\text{Quantity produced}}$$

<u>Example</u>:

$$\text{Breakeven Selling Price} = \frac{\{6.98/\text{unit} \times 50{,}000\ \text{unit}\} + \$110{,}000}{50{,}000\ \text{units}}$$

$= \$9.18$ per unit

New Product Pricing

Three types of products:

- *Revolutionary products* transform an industry
- *Evolutionary products* make improvements to products that are already on the market
- *Me-too products* are those that allow a company merely to keep up with competitors

❖ Pricing flexibility exists for each type

Introducing a New Product

<u>Three Goals</u>:

- Get the product accepted
- Maintain market share as competition grows
- Earn a profit

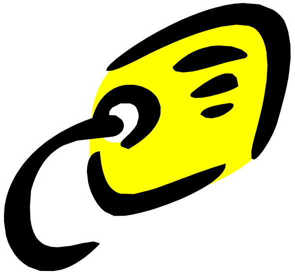
Introducing a New Product

<u>Three Strategies</u>:

Penetration – low initial price to gain market share

Skimming – high initial price to skim profits on a unique product with little competition

Life cycle pricing – high initial price, decreased over time as volume efficiencies or technology reduce costs



Summary

- Pricing strategy is a meaningful tool to use that helps create (or sustain) your company's image
- There are multiple variations of pricing strategy – each business is unique
- Setting the right prices for your business can maximize profits
- SCORE mentors are available to assist