Pricing your product or service

How much are you going to charge your customers for your product or service? Getting your pricing right could double your profits at a stroke.

Many start-up businesses work out a cost figure for each product and add a modest mark-up — known as cost-plus pricing. While this method is common, it is not the only way to arrive at a price. Invest serious thought into your pricing methodology at an early stage — it can pay big dividends later.

Pricing is based on three critical points:

- What your product or service will be worth to your customers — its value.
- What it costs you to produce your product or provide your service.
- The price your competitors charge.

1 Cost and price versus value

1.1 Successful businesses maximise their profits by matching their pricing with the **value** customers put on their products or services.

- The cost is the total outlay required to create a product or service.
- The value is what the customer thinks the product or service is worth.
  For a plumber to fix a burst pipe, it may be £5 for travel, £3 for materials and £10 for one hour's labour. But the value to the customer is far greater than the £18, so a plumber may charge up to £50.

  Computer printer ink cartridges can cost less than £5 to manufacture. However, to the user who can't print without them, their value is much higher. And so is the price.

1.2 **Product pricing** is often built on a 'cost-plus' basis (see **4**), while service pricing is generally created on perceived value (see **6–8**).

However, both methods require a complete understanding of costs and the competition.

2 Building a cost structure

Your cost structure provides a basis for what you need to charge. But it will not necessarily show you what you can and should charge.

2.1 **Divide** your costs under two headings: variable and fixed.

- Variable costs will increase when your sales increase (eg goods and materials).
- Fixed costs remain largely constant, regardless of how much or little you sell (eg rent, salaries, business rates).

2.2 As long as the price you sell at is higher than the variable cost, each sale will make a **contribution** towards covering fixed costs — and making profits.

- For example, a car dealership has variable costs of £9,000 per car sold and total fixed costs of £200,000 a year.
  The contribution required depends upon the volume of sales. If the company sells 80 cars each year, it needs a contribution of at least £2,500 per car (ie £200,000 divided by 80) to avoid making a loss.

2.3 Based on this cost structure, the company can assess the **consequences** of different price levels.

3 Checking the competition

It is certain that you will face competition in some form. This gives you an opportunity to benchmark your potential pricing.

3.1 Phone your rivals and ask for a price **quote**.

- If your competitors know you, get someone else to call.

3.2 Use this **information** as a framework. It is probably unwise to set your prices too much lower or higher without good reason.

- Too low and you will throw away profit.
- Too high and you will lose customers, unless you can offer them something not available elsewhere.

4 Marking up

4.1 **Cost-plus** pricing is a traditional method, usually based on two elements:

- The mark-up you must add to the cost to make the desired profit, and
- The mark-up used by competitors.

The mark-up is usually expressed as a percentage of the cost.

4.2 Ensure all your costs (see **2**) have been factored in **before** applying the mark-up.

- If the final price looks uncompetitive, review the size of the mark-up.
Never obliterate the mark-up to make the price competitive. Try to change the cost base rather than give up potential profit.

4.3 Different products and businesses apply hugely different mark-ups. For example, **retail mark-ups** include:

- Fridges: cost plus 25 per cent.
- Branded clothing: cost plus 135 per cent.
- Jewellery: cost plus 250 per cent or more.

Dangers of cost-plus pricing

While cost-plus is the model employed by many start-ups, be aware of its pitfalls.

- Cost-plus pricing ignores the image and market position you will be aiming for.
- Cost-plus pricing ignores demand.
- Some hidden costs are usually forgotten, so true margins may be lower than you realise.
- Common oversights include holiday pay, depreciation and costs of handling waste.
- Cost-plus pricing assumes that you will achieve a sales target to breakeven or better.
- Competitors can lower prices to win business from you by having a lower cost base or working on lower margins.

5 Margins

5.1 Margins indicate the percentage **profit** a business makes after applying a mark-up.

- For example, if a business buys a product for £10 and marks it up by 50 per cent, thus selling it for £15, the margin is 33 per cent (the value of the mark-up, divided by the selling price x 100).

5.2 Margins are **good barometers** of how important particular products or services are to the profitability of your business.

- The higher the margin, the more lucrative it could be.
- Low-margin, low-volume products should not occupy large chunks of your time or storage space at the expense of higher-margin products.

“Selling on price is no substitute for getting your marketing right. Marketing means selling goods and services on qualities other than price.”
John Gammon, Hawkshead Management Consultants

6 Value-based pricing

The alternatives to cost-plus pricing focus on what customers are willing to pay.

This perceived-value pricing takes a number of forms:

6.1 **Convenience** — a late-night convenience store can charge much more than a supermarket for a pint of milk.

6.2 **Brand** — there may be little to choose in technical terms between a branded and an unbranded product, but big spenders will go straight for the expensive product if the brand is well marketed.

6.3 **Fashion** — some people will pay a premium for hot items (eg the latest trainers or cars).

6.4 **Monopolies and cartels** — if one company, or group of companies, exclusively supplies a product or service, it can set its own prices.

6.5 Pure perceived value — fine art is a good example. A sculpture is priced at £20,000 or £60,000 based on its estimated value to the purchaser, rather than simply the cost of its creation.

6.6 Supply and demand — tickets for top-level sports events can be highly priced as there will be more committed potential customers than available seats.

- Higher prices can give you fat profits. But beware — they may also alienate customers and draw in new competitors who fancy a share of the spoils.

7 Flexible pricing

7.1 Should you use **different margins** for different items, as department stores do?

- You may want higher margins on products with low unit costs or slow turnover, and on products that take up a lot of space.

7.2 Is demand **seasonal**?

- It costs more to go on holiday in the summer and over Christmas than in March.

7.3 Will some customers pay a **premium**? This strategy can be extremely profitable.

- For example, a plumber may offer low daytime prices (to ensure a full workload), but charge heavily for emergency call-outs (when customers will pay much more).

Discount with care

Offering too many discounts can lead customers to question your full-rate pricing. But, used sparingly, discounting can work if it achieves one of the following objectives:

A Capture big orders with a **bulk** discount.

- It may cost you a little extra to process a much larger order.

B Persuade customers to buy during your quiet period with an **off-peak** discount.

C Encourage your customers to stick to one supplier through a **cumulative** discount (or retrospective discount).

- Your records should show a rolling total, indicating how much each major customer has bought.

D Match the competition, for example by offering the standard **trade** discounts.

E Get rid of old stock (and improving cashflow) with **clearance** discounts.

F Encourage early payment with discounts for **cash** or payment within 30 days.

8 Vanishing opportunities

Some goods and services are valuable today and worthless tomorrow. Your pricing should reflect the situation.

8.1 Perishable goods are worthless after their sell-by date.

- If you sell off goods cheaply, ask yourself if the same customers would have bought full-price items.

8.2 Many products gradually become **obsolete** as improved models become available or as fashions change.

8.3 If you have to sell off goods cheaply, explain the reason for the special offer. If your story is plausible, your customers will still have **faith** in your everyday pricing.

- Offer the goods at special prices to regular customers first to generate goodwill.

9 Aim high

9.1 It is easier to **reduce** prices than raise them.

- If in doubt, try higher prices first.
- Be prepared to lower prices if the required sales volume is not achieved and your cashflow is under pressure.

9.2 Low prices often go hand-in-hand with poor quality and service. Is this the **image** you want to create?

- Some companies can win more customers (as well as boosting their margins) by putting their prices up.

9.3 For a start-up, competing on price is often a **mistake**. Low pricing is more often a strategy of big companies that cannot compete on service.

- What you will be able to offer is a string

of benefits such as convenience, speedy delivery and specialist skills.
- Many small firms underprice in order to ‘build up sales’. Aim to build up profits instead — the buying decision is rarely made purely on price.

10 Special tactics

There may be times when the right price is dictated by factors other than cost or perceived value. Tactical pricing can be used to achieve many different objectives.

10.1 Odd value — the retailer’s habit of selling something for £9.99 instead of £10.

- This signals price awareness and is useful in creating a favourable impression to cost-conscious customers.

10.2 Loss leaders — selling some products cheaply to win new customers.

- You may include a couple of zero mark-up products in your range for this purpose. Or you may offer lower prices to new customers, reverting later to normal prices.

10.3 Price **war —** deliberately undercutting rivals to win market share from them.

- Will it hurt you more than it hurts them? If you are a start-up, the competition may have deeper pockets than you.
- Will your new customers stay with you when the prices go back up?

10.4 Skimming — selling a unique product at a high price until all customers who need it have bought it.

10.5 Penetration — the opposite of skimming.

- This tactic involves starting a product at a low price and getting the market sewn up before competitors can catch up with you.
- With significant market share under your belt, you find ways to raise prices later.

11 Trading up

11.1 Work out realistically how your customers would react to **higher** prices.

- Would you lose volume — or customers?
- Discuss it with customers beforehand.

11.2 Sell **yourself**.

- Make sure customers know why they are buying from you rather than a competitor.

11.3 Explain the reasons behind your prices.

- Remember to attribute part of your price to the cost of providing high-quality back-up and after-sales service.

11.4 Unreasonably high prices can destroy **goodwill**, especially if the customer has no immediate alternative supplier.

12 Other considerations

12.1 Would more **marketing** muscle help?

- Would sales rise if you increased prices by five per cent and spent the extra revenue on promotional activity?

12.2 Control your **variable** costs.

- Are there cheaper supplies elsewhere?
- Would the suppliers you have already lined up be prepared to drop their prices?

12.3 Can **fixed** costs be pared down?

- What could you negotiate?

12.4 Should you alter your **product mix**?

- If you cannot make enough profit on a product, consider dropping it.

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