Pricing Your Products and Services

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Although pricing can be one of the most difficult marketing decisions, the basic process is straightforward—calculating your costs; estimating the benefits to customers and the limits on how much they're willing to pay; and comparing your products, services, and prices to others that are similar.

What You Need to Know

How important is pricing in the overall marketing mix?

Pricing is just one element in the marketing mix. Although competitive pricing may win business in the short term, you may find that brand building initiatives are more important for longer-term success. If you aim to build a reputation based on quality and service, low prices may not be important. However, tactical price promotions can be valuable for winning market share or quickly establishing a new product. So it is important to look at your overall marketing strategy and not consider pricing in isolation.

What to Do

Consider Both Price and Value

There are three important concepts in pricing products and services:

- the cost of your product or service is the amount you spend to produce it
- the price is your financial reward for providing the product or service
- the value is what your customers believe the product or service is worth to them

Your pricing should be in line with the value of the benefits that your business provides for its customers, while also bearing in mind the prices your competitors charge.

Research Pricing Issues

To determine prices, you need to carry out research in a number of areas:

- What benefits do your customers get from using your product or service?
- Is price one of their important criteria for buying decisions or are factors such as speed of delivery, convenience, or reliability more important?
- What value do your customers place on receiving the benefits you provide?

When you are looking at customer benefits, how does your product or service compare with competitive offers? Will customers be prepared to pay for those benefits? You may be able to charge a premium if you are first to market.

You should also consider how your pricing compares to the market price of similar products or services. Do not just look at your competitors' pricing—look at the whole package they offer. What value-added services do they offer?

Relate Price to Positioning

The perception of your product or service is also important. In many markets, a high price contributes to the perception that your product is of premium value. This might encourage customers to buy from you—or it might deter price-conscious customers. If you have products or services that are exclusive to your business, you can also use that to position yourself as a leader and set prices accordingly. However, it is probably unwise to set your prices too much higher or lower without a good reason. If you are running a discount store, you are always going to be trying to keep your prices as low as possible (or at least lower than your competitors). On the other hand, if you are positioning your product as an exclusive luxury product, a price that is too low may actually hurt your image.

Set Pricing Objectives

It is important to set pricing objectives—what are you trying to accomplish with your pricing?

- Maximize short-term profits—this could be important if cash flow is important or if you want to maintain confidence by demonstrating that your business is profitable.
- Maximize short-term revenue—this approach can help you to quickly increase market share and lower your costs through economy of scale.
- Maximize volume—this approach can also reduce long-term costs through building economies of scale. It can also be useful for growing revenue through repeat business.
- Maximize profit margin—this strategy is useful if you are selling low volume products or customized products where economies of scale are not possible.

- Differentiate your products—you can differentiate your products from the competition by offering low prices to demonstrate value for the money, or high prices to position yourself as a premium supplier.

Calculate Your Total Costs

Calculate the fixed and variable costs associated with your product or service. Figure out the cost of producing products, i.e. the cost associated with each item sold or service delivered, as well as the fixed overhead which does not vary with the number of products manufactured or services delivered. Your gross margin (price minus cost of goods) has to cover your fixed overhead and provide you with a profit. Make sure you include all your fixed and variable costs. The cost of labor and materials are obvious, but you may also need to include the costs of distribution, administration, sales, and marketing, together with the cost of any trade discounts.

Choose Your Pricing Method

There are many different approaches to pricing. These are three possible methods:

- Cost-plus pricing—You set the price at your production cost, including the cost of producing the goods and fixed costs, plus a profit margin. Provided you have calculated your costs correctly and have accurately predicted your sales volume, you will be able to operate at a profit.
- Value-based pricing—You set a price based on the value your product or service creates for the customer. Your costs, for example, might come to $250. But if your service saves your customer thousands of pounds a year, you may decide to charge a higher price, say $500. This is usually the most profitable form of pricing, if you can achieve it. One way of demonstrating the value of this type of pricing is to offer “payment by results” which is a practice in some service industries. Here, you charge on a scale according to the results you achieve.
- Return on investment pricing—You set your price to reach a target return-on-investment. For example, assume you had invested $10,000 in a new production line for a specific product. If your costs amounted to $50 per unit, and you had forecast annual sales of 1,000 units, you need to make $10,000 profit on 1,000 units. That means $10 profit per unit, giving you a target price of $60 per unit.

Test Your Pricing

It can be useful to carry out testing before going to market to find out how your pricing might affect demand. The simplest form of research would be to ask a group of people in your target market if they would buy the product or service at price X, Y, or Z price. For larger scale marketing programs, you should use a market research firm to carry out a more formal assessment.

Use Flexible Pricing Tactics

It can be useful to charge different prices to different customers, for example, offering lower prices to customers who purchase regularly as a reward for loyalty. You might also decide to charge higher prices to customers who require high levels of service or support.

Offering specially reduced prices can be a powerful incentive to buy. You can use this approach to reduce old inventory, encourage multiple purchases of the same or similar products, or encourage larger orders. However, discounting can be a double-edged sword. If you discount too frequently, customers may become reluctant to pay the full price in the future.

Avoid the “Lowest Price” Strategy

Some businesses believe that the only effective pricing strategy is to be to be the lowest price provider in the market. This assumes that price is the only factor buyers take into consideration. In reality, purchasing decisions are more complex, and price is only one factor. Even where price is important, the “lowest price” strategy can be risky because larger competitors with lower operating costs can damage businesses trying to compete on price alone.

For the same reasons, it is also risky to get involved in “price wars.” Businesses with a solid pricing strategy should avoid a price war and low price position.

Use Pricing to Support Marketing Campaigns

Pricing can be a useful element in a marketing program. It can be used to support a number of initiatives, including:

- launching new products;
- winning competitive business;
- protecting market share;
- entering new market sectors;
- developing niche markets;
- protecting volume and profit in mature markets.

Depending on the program you are planning, you can use five main categories of promotional pricing:

- money-off current purchase
- money-off next purchase
- cash back
- more product for the same price
- discounts on multiple purchase

What to Avoid

You Get Caught in a “Price War”

When competitors make similar price offers, this can lead to larger and larger cuts. Although one competitor may gain market share, it may be at the expense of profitability. Since it is difficult to retain loyalty through price promotions, this can be a damaging strategy in the long term.

Where to Learn More

Book:

Cram, Tony. Smarter Pricing: How to Capture more Value in Your Market. Financial Times/Prentice Hall, 2005.

Web Site:

Strategic Pricing Group: www.strategicpricinggroup.com