THE SWIFT PROJECT

Pricing

Workbook

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6/10/15

"Pricing is actually pretty simple...

Customers will not pay literally a penny more than the true value of the product."

Ron Johnson

Today's objectives

Part 1: Recognising the value & worth of your goods or services

Part 2: Understanding pricing strategies

Part 3: Knowing how to calculate the price

Information:

Fact: *"PRICE IS A MARKETING ISSUE BECAUSE IT SENDS YOUR CUSTOMERS A STRONG MESSAGE ABOUT YOUR POSITION IN THE MARKET"*

Many small businesses make the mistake of undervaluing their product or service, and starting out too low a price simply to get 'a foot in the door'. If you do this, it can cause three main problems for your business:

1. It stops you making as much profit as you could

2. It makes your customers see your product or service as lower quality, even if it is not. Once you are seen as offering lower quality products and services, it is very difficult to change customer perceptions of you as 'cheap' and to get them to accept price increases.

3. Competitors with better cost structures may be able to undercut your prices.

Tip*: If your customers value your product or service at less than the minimum price that makes you a profit, you have some serious thinking to do about whether you're in the right business.*

Some businesses decide the pricing for their product or service on a 'cost plus' basis, taking their total costs and adding a pre-set margin. This is almost never a good idea, because it has nothing to do with the needs and perceptions of your customers.

One common result of 'cost plus' pricing is much smaller profits than could have been made if the business had known how to valuable their service was to customers. Another possible result is that the business is undercut by competitors with better cost structures,

Some businesses price to match or undercut their competitors. This too has its problems. It can start destructive price wars, and again has nothing to do with actual customer needs and perceptions.

A much better approach is through market research. To work out what your product or service is worth to the customer, and price it at that level.

For example, people might pay a couple of pence extra to have a ring-pull on their can of baked beans, and many will pay a few pence more on top of that for the fact it's Heinz brand.

Getting the price right:

- Know the real costs for each product or service and its perceived value.

- Work out the minimum at which it is worth selling at all.
  Work out your margin.

- Find out from your customers what each product or service is worth to them.
  Customers like to be asked!

- Check your main competitor's prices, so you can pitch at the right price.
  Avoid creating a price war by undercutting them!

- If their price is lower than yours, is it worth selling at all? Think again!
  You could think about adding some extras and sell it at a higher price than your competitors.

- Be prepared to make range and price changes.
  Base them on your customers' needs and wants!

- Keep checking that your price is still right!

  Re-evaluate your costs, competitor's prices and the value to your customers. A change is as good as a restart.

Reasons to get the price right:

- It achieves a competitive advantage
- Pricing affects the overall marketing of a service or product
- Brand positioning & brand values EG: Quality & reliability
- Price positioning determines the market place
- Perceived value / perception 'Customers willingness to pay'
- Optimizing your margins

"Pricing is the exchange rate you put on all the tangible and intangible aspects of your business

Value for cash"

Patrick Campbell

Part 1: V**alue** your goods or services & know their **worth**

1. Describe your marketing objectives? Influencers: To attract new customers, to be market leaders, to maximise profit, to maximise market share, brand positioning & customer perceptions, market positioning. IE Niche, premium, volume markets?

2. Describe the value of your product or service

3. What market do I want to sell to? (Volume, mid-range or premium market?)

4. Who am I selling to? (Customers & markets)

5. Mystery shop the competition. (Value & prices)

Part 2: Pricing strategies explained:

Price makers & price takers: Price takers follow market leaders, small versus large organisations & have limited ability to control prices as set by market leaders

Price Makers: thinks between profit, price & cost. Will add value, offer quality & service

Price fixing: Exchange rates, Petrol, Utilities

Supply & Demand: Art, Gold & metal prices

Price incentives & loss leaders: Cash flow Estee Lauder GWP brings in cash - Supermarkets aspire for market share. Insurance companies to attract new customers.

Price wars: grocery retailing to computer software, frozen diet dinners, mots / car services, disposable diapers

Identify your price strategy:

- **Low quality & high price?** Convenience like the corner shop!
- **Low price & superior quality.** Discount retailers
- **Low quality, Low price?** Copycat goods, no frills airlines –
  Volume sales = small margin

Rip off strategy	**Overcharging strategy**	**Premium strategy**
Poor value strategy	**Medium value strategy**	**High value strategy**
Economy strategy	**Good value strategy**	**Superb value strategy**

Pricing is an art and a science: Qualitative & Quantitative inputs.

Latte: 

Qualitative:
- Robust aroma
- Frothy appearance
- Strong taste

Quantitative:
- 12 ounces of latte
- Serving temperature 150º F
- Serving cup 7 inches in height

Optimum pricing: Pricing according to the value of the product or service: Designer goods / Branded goods like Heinz
Price sensitivity: (start-up business, or selling within a highly competitive market place) Food, branded products
Value Perception: (mountain bike or pair of trainers)
Value metric (quantities or weight, eggs, ecommerce mailings) Cakes, Apples, targeted mailings
Packaging & Bundling: Bundling presents an opportunity for the seller to propose a discount. Marginal gain achieved through bundling. A box of seasonal vegetables. The opportunity to up sell, like your cleanser, toner & moisturizer
Tiered pricing: (bronze, silver & gold packages, such as Insurance.) Bundled discounting. Impact on sales & margin.
Customized pricing: (understanding your customer's values & aspirations, what makes them buy?) Products you've designed & made
Promotional discounting: To increase the average unit spend per customer. Loss leaders, generating sales.

Part 3: Calculating your price:

"The moment you make a mistake in pricing, you're eating into your reputation or your profits." Katharine Paine

We can determine the price in 6 easy steps:

- Competitor prices
- Market forces (supply & demand, economy)
- Market penetration (volume versus premium)
- Customers willingness to pay a price
- The value proposition of your products or services
- Margin / Profit

Setting a Price: This is critical to your breakeven analysis; you can't calculate likely revenues if you don't know what the unit price will be. Unit price refers to the amount you plan to charge customers to buy a single unit of your product.

Psychology of Pricing: Pricing can involve a complicated decision-making process on the part of the consumer, and there is plenty of research on the marketing and psychology of how consumers perceive price.

Pricing Methods: There are several different schools of thought on how to treat price when conducting a breakeven analysis. It is a mix of quantitative and qualitative factors. If you've created a brand new, unique product, you should be able to charge a premium price, but if you're entering a competitive industry, you'll have to keep the price in line with the going rate or perhaps even offer a discount to get customers to switch to your company.

One common strategy is **"cost-based pricing"**, which calls for figuring out how much it will cost to produce one unit of an item and setting the price to that amount plus a predetermined profit margin. This approach is frowned upon since it allows competitors who can make the product for less than you to easily undercut you on price. Another method, referred to by David G. Bakken of Harris Interactive as **"price-based costing"** encourages business owners to "start with the price that consumers are willing to pay (when they have competitive alternatives) and whittle down costs to meet that price." That way if you encounter new competition, you can lower your price and still turn a profit.

The formula: Don't worry, it's fairly simple. To conduct your breakeven analysis, take your fixed costs, divided by your price, minus your variable costs. As an equation, this is defined as:

Breakeven Point = Fixed Costs/ (Unit Selling Price - Variable Costs)

This calculation will let you know how many units of a product you'll need to sell to break even. Once you've reached that point, you've recovered all costs associated with producing your product (both variable and fixed).

Recording this information in a spreadsheet will allow you to easily make adjustments as costs change over time, as well as play with different price options and easily calculate the resulting breakeven point.

Limitations

It is important to understand what the results of your breakeven analysis are telling you. If, for example, the calculation reports that you would break even when you sold your 500th unit, decide whether this seems feasible. If you don't think you can sell 500 units within a reasonable period of time (dictated by your financial situation, patience and personal expectations), then this may not be the right business for you to go into. If you think 500 units is possible but would take a while, try lowering your price and calculating and analyzing the new breakeven point.

Alternatively, take a look at your costs - both fixed and variable - and identify areas where you might be able to make cuts. Lastly, understand that breakeven analysis is not a predictor of demand, so if you go into market with the wrong product or the wrong price, it may be tough to ever hit the breakeven point.

One of the most important financial concepts you will need to learn in running your new business is the computation of gross profit. And the tool that you use to maintain gross profit is mark-up. The gross profit on a product sold is computed as:

Sales - Cost of Goods Sold = Gross Profit

To understand gross profit, it is important to know the distinction between variable and fixed costs. Variable costs are those that change based on the amount of product being made and are incurred as a direct result of producing the product.

Fixed costs generally are more static in nature. They include:

- Office expenses such as supplies, utilities and a telephone for the office
- Salaries and wages of office staff, salespeople and officers and owners
- Payroll taxes and employee benefits
- Advertising, promotional and other sales expenses
- Insurance
- Auto expenses for salespeople
- Professional fees
- Rent

Variable costs include:

- Materials used
- Direct labour
- Packaging
- Freight
- Plant supervisor salaries
- Utilities for a plant or warehouse
- Depreciation expense on production equipment and machinery

Variable expenses are recorded as cost of goods sold. Fixed expenses are counted as operating expenses (sometimes called selling and general and administrative expenses).

Gross Profit Margin
while the gross profit is a pound amount, the gross profit margin is expressed as a percentage. It is equally important to track since it allows you to keep an eye on profitability trends. This is critical because many businesses have gotten into financial trouble with an increasing gross profit that coincided with a declining gross profit margin.

The gross profit margin is computed as follows:

Gross Profit/Sales = Gross Profit Margin

There are two key ways for you to improve your gross profit margin.

First, you can increase your prices. Second, you can decrease the costs to produce your goods. Of course, both are easier said than done. An increase in prices can cause sales to drop. If sales drop too far, you may not generate enough gross profit dollars to cover operating expenses. Price increases require a careful reading of inflation rates, competitive factors and basic supply and demand for the product you are producing.

The second method of increasing gross profit margin is to lower the variable costs to produce your product. This can be accomplished by decreasing material costs or making the product more efficiently. Volume discounts are a good way to reduce material costs.

The more material you buy from a supplier, the more likely they are to offer you discounts. Another way to reduce material costs is to find a less costly supplier. However, you might sacrifice quality if the goods purchased are not made as well.

Whether you are starting a manufacturing, wholesaling, retailing or service business, you should always be on the lookout for ways to deliver your product or service more efficiently.

However, you also must balance efficiency and quality issues to ensure that they do not get out of balance.

Computing Markup
ABC Clothing did a better job in Year 2 of managing its mark-up on the clothing products it manufactured. Many business owners often get confused when relating markup to gross profit margin. They are first cousins in that both computations deal with the same variables. The difference is that gross profit margin is figured as a percentage of the selling price, while markup is figured as a percentage of the seller's cost. Markup is computed as follows:

<u>Mark-up:</u> (Selling Price - Cost to Produce)/Cost to Produce = Markup %

While computing markup for an entire year for a business is very simple, using this valuable markup tool daily to work up price quotes is a bit more complicated. However, it is even more vital. Computing markup on last year's numbers helps you understand where you have been and gives you a benchmark for success. But computing markup on individual jobs will affect your business going forward and can often make the difference in running a profitable operation.

In bidding individual jobs you must carefully estimate the variable costs associated with each job. And the calculation is different in that you typically seek a desired markup with a known cost to arrive at the price quote.

Here is the computation to find a price quote using markup:

(Desired Markup x Total Variable Costs) + Total Variable Costs = Price Quote

What if you're a new business owner and don't have any experience to base an estimate on? Then you need to research material costs by getting quotes from suppliers as well as study the labour rates in the area. You should also research industry manufacturing prices. Armed with this information, you will have a well-educated "guess" to base your job quote on.

How you use markup to set prices will depend on the type of business you are starting. If you are launching a manufacturing, wholesale or retail operation, you will be able to compute markup using the above formulas to factor in all the variables in the cost of producing or generating the items you will be selling. Markup can also be used to bid one job or to set prices for an entire product line.

If you are starting a service business, however, markup is more difficult to calculate, particularly for new business owners. With most service businesses, the key variable cost associated with delivering the service to your customers will be you and your employees' time. In computing proper markup for a service business, you must pay close attention to the time spent to provide the service to customers, as well as to market prices of the services provided. In starting a service business, you will need to research the going rate paid to employees and the market prices for the services you will be providing.

For instance, if you are starting a temporary help agency, you will need to know what rate is typically paid to employees in this industry, as well as the market rate charged to your customers for temporary labour. This will enable you to compute the proper markup in setting your price to ensure that you will be profitable

Mark - up

Say you bought an item for £50 and could sell it for £100, doubling your money.

In this case your markup would be (the difference between selling price and cost price) divided by the cost of the item and multiplied by 100 to bring it to a percentage.

i.e. **(£**100 – £50) = £50(difference). £50(difference) / £50 (cost) = 1 x 100 = 100% (here "/" stands for divide)

Your mark-up is 100%.

When you look at the profit margin on that sale, that would be (difference between selling price and cost price) divided by the selling price and multiplied by 100 to bring it to a percentage.

i.e. **(£100 – £50) = £50(difference). £50(difference) / £100(selling price) = .5 x 100 = 50%**

As you can see in the examples given above, the only difference in the equations is in red (dividing by the cost or by the selling price).

"**Profit**" is the difference between what you sell it for and what you paid for it.

"**Margin**" simple means you turn that into a percentage of the selling price. You do this so you can compare different items easily. So the difference is that markup is your profit as a percentage of the cost price and profit margin is your profit as a percentage of your selling price.

When would you use the terms?

When you are deciding how much you want to make on the item and determining the price in which the goods should be sold, you would use markup. You would know it costs you £50 and if you want to double your money you would use a markup of 100%. Of course, you could just double the £50 as well and get to the same price.

When you are looking at the success of your business afterwards and know how much money you took in, you would calculate the profit margin because those are the figures immediately available to you at that stage.

The "profit margin" as calculated here is actually a **Gross Profit**. In order to find out how much money you're actually making, you would need to calculate **Net Profit**, which is simply the gross profit minus what it, cost you apart from the cost price to produce that income (your expenses).

Your costs such as your rent, utilities, travel, telephone, advertising costs, etc. are deducted, so you know how much money you actually made in the end.