



Excerpted from  
FastTrac® TechVenture™



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# Pricing

Pricing is a complex issue. Some experts consider it a marketing concept. Others argue that it is a financial concept. Both sets of experts are correct. Pricing affects *both* marketing and finance.

This section will help identify pricing strategies that support your marketing and financial plans.

## The Right Price

Pricing is one of the most complex challenges entrepreneurs face because it affects both marketing and profitability. Marketing strategies help dictate the price for products or services. For example, a marketing strategy that will attempt to create a premium image will likely feature a premium price.

The right price is what customers are willing to pay for a product or service. Therefore, the question is whether the business can make a satisfactory profit at that price.

The amount of profit a company can make depends on how much it can get for products or services above and beyond costs. Once costs are covered, the remaining sales dollars go directly toward profit. Based on that rationale, entrepreneurs would always charge a high price for their products or services. It is not that simple, however. The price also has a direct impact on how much is sold. If the price is set too high and no one is willing to purchase the product or service, then the company probably will not attain profitability.

Profit involves several different elements:

$$\text{Profits} = \text{Revenues} - \text{Costs}$$

$$\text{Profits} = (\text{Unit sales} \times \text{Price per unit}) - \text{Costs}$$

Usually, the lower the price, the more units a firm will sell. And theoretically, the more a business sells, the more profits it makes.

### *The Right Price*

Antonio wants to add an extra \$250 to the price of the electronic sensors he manufactures under his brand, Eclectics. If his business sells 100 sensors a month, that means \$25,000 extra profit for that month. That does not sound like much when the trade press discusses sums in the millions and billions of dollars. To Antonio, however, the additional \$25,000 a month is all profit, which will contribute substantially to his bottom line. So Antonio will evaluate the market in which he sells sensors to determine what type of impact a \$250 per unit increase in price will have on the number of units that he sells.



## Break-Even Analysis

You can use break-even analysis to determine how much product or service you need to sell at a specific price to meet all costs. Break-even analysis is a mathematical formula that discloses how much output must be sold for the business to break even. Break-even is reached when the money coming in equals the money going out.

The break-even point in units is the number of units that need to be sold to cover all costs, both fixed and variable. Fixed costs remain relatively constant no matter how many products or services are produced or sold. These costs typically include rent, insurance, interest charges, and executive salaries. Variable costs fluctuate directly with production and sales levels, such as manufacturing labor, materials used in production, and sales costs.

**Example** – When starting his manufacturing company, Ralph used break-even analysis to consider prices. The fixed costs of the company were estimated at \$50,000 and variable costs at \$.20 per unit. With a \$1 retail price per unit, the break-even point would be 62,500 units.

Here's the formula Ralph used to determine the break-even point:

$$\begin{aligned} &\text{Fixed costs divided by (Sales price per unit - Variable costs per unit)} = \\ &\text{Break-even point} \\ &\text{Fixed costs} = \$50,000 \\ &\text{Sales price per unit} = \$1.00 \\ &\text{Variable costs per unit} = \$.20 \\ &50,000 / (1.00 - .20) = 50,000 / .80 = 62,500 \end{aligned}$$

Ralph then asked, "Can I sell 62,500 units? What would happen if the price were increased to \$2 retail with the same variable cost per unit of \$.20?" So, he recalculated as follows:

$$50,000 / (2.00 - .20) = 50,000 / 1.80 = 27,778$$

Then Ralph thought, "Would it be easier to sell 27,778 units for \$2 or 62,500 units for \$1?" Going through this evaluation several times helped Ralph consider an appropriate range of prices for his products.

## Pricing Products

When pricing products, you must set the price at a point that will both contribute to profits and compel customers to purchase. You also need to cover the direct costs of the product and your operating costs.

The price a business establishes for its products is affected by several factors:

- Amount customers will pay. This amount is sometimes the hardest to determine, especially before starting a business. Customer surveys can be especially helpful in determining how much customers will pay.
- Break-even point. When the costs to operate the business are covered, any additional money is profit.
- Competition. The range of prices offered by the competition may limit the price.
- Cost. The price must adequately cover the cost of producing the product and provide a reasonable profit.
- Marketing costs. When large amounts of time are spent marketing and distributing a product, the price will generally be higher.
- Marketing strategy. You may add a premium to your price to appeal to a certain market.

Reality  
Check 

Break-even can only help you establish a range of profitable prices. The true price will be determined by how much the market is willing to pay.

Reality  
Check 

In general, costs determine the minimum price you can charge, and the competition determines the maximum price you can charge. Ultimately, the benefit perceived by the customer establishes the real "value" of your product and what you can charge.

- Location. Location will affect the price charged for a product.
- Personal goals. The price should contribute to overall profitability and help you reach your personal goals.
- Uniqueness. A higher price can be charged for a unique product with high customer demand.

## Pricing Services

If you have designed a service with greater perceived value, you can charge a higher price. Experts report that professionals who charge fees in the upper range of the pricing bracket usually have a large client base and high profitability. Prices for services can be based on your reputation, years of experience, amount of competition, length of time as a service provider, and what the market will bear.

Consider non-billable time and taxes when setting prices. Include enough margin to pay federal and state income taxes and payroll taxes, including FICA (Social Security and Medicare taxes) and federal and state unemployment taxes. Be sure to use income tax rates based on your own individual tax situation.

## Procedure for Pricing

A four-step procedure is recommended for setting prices:

1. Determine the relevant price range.
2. Evaluate price sensitivities.
3. Select a strategy.
4. Set the price.

### Determine the Relevant Price Range

First, determine the reasonable range of prices in which a price must be set. In other words, know the following limits that apply to your product or services:

**Price floor** – The bottom of the range, the floor, is usually set by costs. Just how little can a business sell its product or service for and still stay alive? The costs determine whether you will stay in business or go out of business at the market price.

**Market price** – The market price is what a seller is willing to sell the product or service for and what a customer is willing to pay.

**Ceiling price** – Just how much can a product or service sell for? How high can the price be and still attract purchasers? That question is far more difficult to answer than the one concerning the price floor. When you find the answer, you have found the price ceiling for your product or service.

### Evaluate Price Sensitivities

In most markets, customer demand is sensitive to the price. *Elasticity* refers to the degree to which a change in price affects the quantity of demand. If demand is very elastic, a lower price means the amount purchased increases significantly. If demand is inelastic, the amount purchased does not vary much with price changes. Understanding the elasticity of demand for a market helps entrepreneurs recognize opportunities in setting their prices.

Reality  
Check 

Don't hasten to the conclusion that costs set prices; the market always determines price.

The following major factors affect price elasticity and should be studied before deciding on an item's price:

- **Savings.** When a business sells something that saves the customer money, its price can be based on those savings.
- **Competitors' prices.** Competitive prices clearly affect your prices. In one way or another, competitors will influence how you set your price.
- **Negotiation.** In some industries, list prices are really just invitations to negotiate. In other industries, asking prices are firm. Prices can almost always be cut when the seller needs to do so.
- **Prices of substitutes.** Like competition, substitutes can limit how much a venture can ask for its goods. You should recognize the potential substitutes for your products or services and understand the effects the prices of those substitutes have on the market.
- **Role of complementary products or services.** Often an item is purchased as part of a package of products and services. The purchaser of an automobile for \$30,000 hardly pays any attention to \$600 for a radio/CD player. Yet \$300 could be saved by buying the radio elsewhere. High profits can be made when selling products or services that are small in the total package.
- **Market's perceived values.** This factor is elusive because the value a customer assigns to a product or service is difficult to determine. In the end, what the product or service costs or what other products or services sell for matters less than what the customer will pay. The extreme of this situation is referred to as an *inverse-demand curve*. Normally, the economic theory of demand dictates that fewer goods will be sold as the price increases and vice versa. That theory is logical. But people are not always logical. If the quality of a product or service is not apparent, which is often the case, price is often the major element by which the customer determines the quality of an item. Buyers often assume that the highest-priced article is the best.
- **Distributors.** Often price must conform to the attitudes of product distributors. A computer manufacturer might have three price points, sometimes called price lines, for his computers: \$995, \$1,250, and \$1,325. That manufacturer would go to market to buy components to fit into those price points. You should investigate where the middleman wants to price the products.
- **Governmental regulation.** Sometimes this regulation is helpful and sometimes it is not. Airlines might prefer to return to the time when the government set their prices, because they made more money then. Now that they must compete in an open market, many airlines cannot maintain profitability.

### Select a Strategy

Two basic pricing strategies exist: price skimming and penetration pricing. The question is whether to price at the top of the range or at the bottom of it. In many instances it makes sense to price somewhere between the extremes.

**Price skimming** – Some new ventures begin by trying to price skim. That is, they price their wares or service at the top of the relevant price range. The reasons for doing so are persuasive.

- **Guards against pricing mistakes.** This strategy guards against errors in estimating the cost of the product or service.
- **Keeps production low.** An entrepreneur may have good reason to want to limit sales, and thus production, in the early stages. Typically, much learning occurs early in a venture, and it is best done at low levels of activity. A low price may attract more activity than you can handle. This could lead to an unfortunate

Reality  
Check 

Entrepreneurs must be careful to avoid the trap of negotiating away too much and working for less than they want.

**Tip** An inverse demand curve happens in the fragrance industry, where the best selling perfumes such as Chanel No. 5 are the most expensive. To many consumers, an exclusive image justifies the higher price.

Reality  
Check 

It is far easier to lower a price set too high than it is to raise one set too low.

reputation for poor service just at the time the company is trying to impress the market.

- Increases gross profits. A price skimming strategy increases gross profits, which brings in money at a time when it is especially needed. Over time, this strategy maximizes total revenue for the item as each market segment is charged what it will pay. By starting high and progressively lowering price, each segment of the market buys in on the proposition when the price hits its value scale.
- Inverse demand requires it. Finally, a price skimming strategy is encouraged if an inverse-demand situation seems likely. To price low in the face of an inverse-demand curve is to invite disaster.

The major disadvantage of price skimming is that it attracts competition. Other firms noting a high price can figure out the costs and offer goods at a lower price. High profits attract competition.

**Penetration pricing** – For the entrepreneur who thinks an item will have a good, long-run market and who doesn't have any way of restricting competition, setting a low price may be an effective pricing strategy. First, it will discourage competition. Second, the low price will facilitate market penetration. By getting into the market first and obtaining the best distributors, you help block competition from the market.

By pricing an item to penetrate the market quickly, you must be prepared to deliver the goods, a huge task for new concerns. Financial requirements for a penetration-pricing strategy are often higher than a new venture can afford.

### Set the Price

Determining prices is a continual process, as you constantly reconsider all the relevant factors. Prices should never be static simply because they were previously set. After you have studied your marketplace, conducted your break-even analysis, and selected your pricing strategy, you still need to consider factors that will influence setting your price. As you continue to evaluate your price in the marketplace, keep in mind the following pricing best practices.

- Motivate large orders with volume pricing. Small orders are costly, and many are even sold at a loss. Entrepreneurs should study costs carefully to determine how much they can afford to reduce prices in order to encourage large orders.
- Avoid price conflicts if possible. Price wars are generally worthless and costly. If a price war develops, a firm should try to handle it in an indirect way and not try to match the competitor's price cuts penny for penny. Price cuts are too easy to copy.
- Bundle products and services. By selling related products or services together, entrepreneurs increase the amount of sales per purchase.
- Offer tiered pricing. Preferred customers receive better pricing, typically based on the amount purchased over time.
- Bid a fixed price. Instead of working for an hourly rate, service providers should give the customer a fixed-price bid for the job. This practice protects the customer and provides an incentive to work efficiently. The customer is paying for results, not time.
- Disguise price cuts. Price reductions should be disguised so that the previous price structure is not destroyed. A business may want to go back to an earlier pricing structure when more favorable market conditions return.
- Price creatively. Some of the biggest fortunes have been made by people who develop slightly different ways of pricing their goods to the market. Payment terms are one way of creatively pricing products or services.

### Reality Check

Don't fall into the trap of lowering your prices at the inception of your business to try to gain market share. Raising your prices later and keeping the same customers is nearly impossible.

**TIP** If you are not happy with sales volume at the existing prices, you can consider cutting prices or providing incentives such as free goods with a purchase.

## Price Creatively

By combining mail order purchasing with a “build it your way” approach, Gateway Computers circumvented the middleman. These tactics allowed it to price competitively and acquire a significant piece of the market share. Using this approach, Gateway was able to remain in South Dakota with less expensive costs for infrastructure and labor. Its well-known cow designs highlight the location of the business.

From Real   
Entrepreneurs

- Push high-margin products or services. Different products or services usually have different gross margins. The high-margin articles are often more difficult to sell, so the marketing program will need to target these items.
- Avoid making money on price and losing it on terms. Some clever buyers will not argue about a price because they are fully aware that a business will stand firm. Rather, they will try to gain more favorable terms. For example, the seller pays the freight, delays billing, or allows a larger cash discount. You should carefully cost out any concessions.
- Use a price list. Unfortunately, some businesses open without having a price list. When customers call asking about quantity discounts, the entrepreneur does not have the answer. Featuring quantity discounts on the price list can be a highly profitable marketing strategy. The price list is an unappreciated marketing tool. When a distributor, dealer, or industrial customer needs to buy a certain product or service, the price lists and marketing materials serve as an on-the-spot sales representative. A price list does far more than disclose prices. A price list should also clearly identify the products and services, inform the customer of cost per item and terms of sale, and tell the potential customer where the goods can be purchased.
- Use discount pricing strategically. When you need to move inventory or keep service employees busy, you may offer discount prices for a short period of time.

**TIP** Your price list can be one of the most important marketing pieces your company distributes.