Section 3.4
Product Pricing

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Section Summary

- Define price and its importance in the marketing mix
- Show steps in developing successful pricing program
- Discuss pricing policies & other pricing methods

Price

- Must complement your product, distribution channels (place) and promotion strategies
- Relates to your costs, competition and customers
- Impacts revenue and profitability
- Acts as a substitute for value (customer perception)

Developing A Successful Pricing Program

1. Set pricing objective
2. Study demand
3. Determine costs
4. Analyze competition
5. Select pricing strategy
6. Determine final price

Source: Albert E. Essel. "Points to Consider When Pricing a Product". Virginia State University. Presented at the National Small Farm Conference Sept. 10-13, 1996.

1. Set Pricing Objectives

- Maximize sales growth
- Maximize revenue
- Maximize profit
- Maximize price (market skimming)
- Provide quality/value leadership

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Pricing Objectives

- Target the product you have positioned, or develop a broader strategy for a line of products and services
  - Maximize profit margin on steaks and other high-end cuts
  - Maximize quantity sold of ground beef
- Outline financial goals for your pricing strategy
  - $1400 per head return
  - Cover costs and earn 10% profit

Pricing Objectives

Address both cost and value issues

- How do you relate price strategy to product’s perceived added value?
- How do you cover costs? Is your strategy a response to cost structure?

2. Study Demand

- Demand shifts caused by changes in:
  - Income
  - Population
  - Product's substitutes & complements
  - Consumer tastes and preferences
- Be familiar with your target market
- Price responsiveness (measured by elasticity) is important in developing market strategy & effective pricing

Elasticity Of Demand

- The absolute value of a % change in quantity divided by a % change in price
- Elasticity greater than 1 is elastic
  - Increasing price, raises revenue
- Elasticity less than 1 is inelastic
  - Increasing price, lowers revenue
- If elasticity higher than desired, how can other marketing strategies (promotion or distribution changes) “pivot” demand?

An Elasticity Example…

- Hamburger at $2.50/lb; considering an increase to $3.25/lb
- Current sales at 200 lbs/wk would drop to 160 lbs/wk
- Resulting elasticity: -0.85 (see the following slide for the elasticity calculations)
- Resulting revenue:
  - $2.50*200=**$500** < $3.25*160=**<u>$520</u>**

Elasticity Example Calculations

$$\frac{\text{\% change in quantity}\left\{\dfrac{(160 - 200)}{\dfrac{(160 + 200)}{2}}\right.}{\text{\% change in price}\left\{\dfrac{(3.25 - 2.50)}{\dfrac{(3.25 + 2.50)}{2}}\right.} = \frac{-0.22}{0.26} = -0.85$$

3. Determine Costs

- Consider all costs (management expertise and labor, land, capital equipment, depreciation on machinery, animals, and buildings)

- Separate costs into fixed & variable:
  - Fixed costs incurred whether product is produced or not (building, machinery, land)
  - Variable costs incurred only when product is produced (feed, processing, packaging)

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Know All Costs

- Add fixed & variable costs to calculate total cost
- Calculate per unit or break even cost: divide total cost by total quantity produced
- Important for determining price
- To stay in business, price your product above the production costs

Estimating Costs

- In planning a start-up business, research the costs of inputs, labor and equipment
- Project how much you plan to produce
- If production varies throughout the year, project output on a monthly basis
- Use cost and output estimates to project per unit costs

4. Analyze The Competition

- How many competitors operate in my market?
- Are my competitors large or small? Near or far?
- Is it difficult for new competitors to enter the industry?
- What types and numbers of products do they sell?
- What pricing methods do my competitors use?

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5. Select A Pricing Strategy

- Cost-based
- Competition-based
- Customer-based

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Cost-Based Pricing

- Use per unit or break-even costs to determine price

- Set interactive price and volume sales goals with a desired profit level

- Add the desired profit level to the break-even price

Disadvantages Of Cost-Based Pricing

- Does not consider how consumer demand affects price
- Does not account for market seasonality or varying input prices
- Actions of your competitors are not included in price; competition should affect how you price your product

Competition-Based Pricing

- Pricing to gain market share & attract and hold as many customers as possible
- Base prices on competition, if product is comparable to competitor's product
  - Larger firms price product the same, smaller firms follow the lead of large firms
- Penetration pricing: price set lower than competition to lure customers away

Disadvantages Of Competition-Based Pricing

- Less attention to product cost or demand; risk ignoring own production costs if you focus too closely on the prices set by competitors
- Must constantly update market research; greater time commitment
- Easy for competition to mimic your pricing strategies

Customer-Based Pricing

- Price relates to the benefits buyers perceive they will gain while using product (nutrition, convenience, etc.)
- Increase price by increasing perceived value through product differentiation
- Price to support product image, higher price often perceived as higher quality
- Offer promotion price to gain consumer attention: coupons, special offers, holiday discounts

Customer-Based Pricing

- Set price to increase sales volume by giving discounts for bulk purchases
- Package pricing: bundle several products together to boost sales volume & encourage variety purchased
- Bottom line: price according to benefits buyers think they will get from purchasing the product

Disadvantages Of Customer-Based Pricing

- Potential to ignore production costs; still need to account for any costs incurred during value-added production

- Need to monitor your competition’s pricing strategies

6. Determine Final Price

Consider these factors when establishing price:

- Market conditions within your industry
- Seasonality of your product
- Number of substitute or complement goods
- Brand loyalty by consumer
- Percent of consumer’s budget spent on product

Psychology of Pricing

- Buyers perceive price changes in proportional terms, rather than absolute terms
- Series of small price increases below some upper threshold is more successful than one large increase
- Buyers respond more to one large price decrease than a series of small, successive discounts

Formulating Reference Prices

People formulate a price reference to make purchase decisions

- Current price influences judged by comparing one price to another
- Instead of using current prices for comparisons, consumers use past prices

Evidence Of Reference Prices

- Consumers feel that middle prices are a good compromise

- Consumers need endpoints to serve as boundaries for decisions

  - Given a new end point, some consumers don't want to purchase the cheapest brand; now have an alternative

Evidence Of Reference Prices

Studies conducted where prices are shown in descending order (high to low prices) & another group is shown the same products in ascending order (low to high prices)

- Those shown the higher price first are willing to pay more
- Those shown the lower price first want to pay less

Determinants Of Price Sensitivity

- Perceived substitute effect: How many substitutes exist for your product?
- Unique value effect: Can you increase market share through differentiation?
- Switching cost effect: Changing from one product to another - people are reluctant to change and learn something new

Determinants Of Price Sensitivity

- Difficult comparison effect: Hard to compare products/services
- Price-quality effect: Often associate a higher price with higher quality
- Expenditure effect: Consumers more sensitive to price changes on large, expensive products than small, inexpensive ones (such as price changes on meat compared to salt)

Determinants Of Price Sensitivity

- Fairness effect: People impacted by what they consider fair - grass-fed vs. conventional (sense of value-added)
- Inventory effect: Seasonality affects price sensitivity - in summer higher demand for steak due to outside grilling
- End-benefit effect: People willing to pay more for product that protects the environment or the family farm

Other Pricing Policies

- Price skimming (pricing slightly higher than competition) works for loyal and convenience customers
- Penetration pricing (pricing slightly lower than competition) works for price-oriented consumers
- Combine above policies to gain:
    - large customer base (penetration) to cover fixed costs
    - smaller consumer segment (skimming) for increased revenue

Other Pricing Methods

- Offer introductory price cuts for new goods or customers
- Use price points (prices pleasing to the eye)
  - $2.99 is more pleasing than $2.98 because it is an odd number
  - May use even prices, such as $3.00, for niche products because it tends to convey that the product is “not cheap”

Discounts

- Quantity discount: Helps achieve sales goals; recognizes a fixed cost per transaction
- Seasonal discount: Helps solve storage or capacity problems
- Trade discount: Improves economies of scale, brings faster payment from buyers
- Cash-based discounts: Encourages faster payment

Allowances & Credits

- Advertising allowance: Member of distribution channel gets a discount on your product for advertising it for you
- Trade credit: Improves customer loyalty but more risk for the seller

Pricing Your Product

- Set your product price to fit in the marketing mix

- Tailor your pricing strategy to your:
    - customer segment
    - distribution strategy
    - product location in its life cycle