Pricing Your Products

Pricing is a huge topic. It's an art not a science, and the art of pricing could be an entire book in itself, but I've outlined a few important points to always bear in mind.

Essentially, there are two types of pricing: cost plus and value based.

Cost plus pricing has been around for ages. This is by far the easiest way to price and is common in the service industries. The manufacturer or service provider works out how much it costs to create the product or service and factors in profit margin to create the price. Hourly rate pricing is also a form of cost plus pricing. In this case, profit must be estimated. Solicitors often use this method. Widget manufacturers and retail businesses often use a variation of this, in that they work out the costs per unit, taking into account all the costs to produce the goods, then add a profit margin.

But in the twentieth century, economists researched various forms of pricing and concluded that value pricing is the way to achieve optimum results. The *Financial Times* lexicon provides a great definition of value pricing:

'The term is used when prices are based on the value of the product as perceived from the customer's perspective. The perceived value determines the customer's willingness to pay and thus the maximum price the company can charge for its product.'

Once you have your core value offer you need to price it. As I've said throughout this book, all buyers want value:

Perceived customer = the total positive benefit value less the price paid

Often sellers get hung up on price, but if they have the right customer, they should be concerned about value.

The profit-building power of pricing

The following example highlights the potential power of effective pricing. Say you're an entrepreneurial retailer (with online and wholesale customers) and offer a range of products. Your total sales are £1,250,000 per annum.

The cost of those sales is £775,000, with an overall gross margin of £475,000 (38%). After salaries and overheads, the business' net profit is £90,000 (7.2%).

The 'What if?' reckoner

Annual turnover £ 1,250,000
Gross margin 38%
Annual cost of production/sales £ 775,000
Annual cost of overheads £ 385,000
Profit for the year £ 90,000

If you increase the average price of sales by 1% across all the business income sources with no other changes, the effect on the net profit 'bottom line' is an increase from £90,000 to £102,500 (£12,500 or 13.8%). This is significantly more than most owners would expect.

What if you increase the price by 10%? The net profit jumps by a whopping 139%. It's not some conjuring trick – it's the maths.

But so many businesses worry about the competition and being price competitive that they do the opposite: they reduce prices to sell more, and their profits fall drastically. You might think a 10% price increase will mean all your customers go elsewhere. It's possible, but what are the numbers? In this case, you could lose 26% of your customers and have the same net profits as before. And those that do leave are probably the ones you least want to keep anyway.

	Before	With 10% price rise	With 10% price rise and losing 26% of customers
Annual turnover	£ 1,250,000	£ 1,375,000	£ 1,046,053
Gross margin	38%	44%	44%
Annual cost of production/sales	£ 775,000	£ 775,000	£ 571,053
Annual cost of overheads	£ 385,000	£ 385,000	£ 385,000
Profit for the year	£ 90,000	£ 215,000	£ 90,000

I'm not suggesting you just ramp up prices. The reason I use these numbers is to help you realise the massive importance pricing has in your marketing efforts. Far too many people only focus on turnover and, in doing so, sell their product or services for a cheaper and cheaper price, to hit targets. This reduces the average price, which ultimately leads to lower profits.

Why value pricing?

Value pricing looks at the price from the customer's perspective rather than the producer's perspective. It's far more customer friendly and will usually result in much higher profits for the business providing a product or service.

Here's an example of value pricing in action. A major logistics distribution company relied heavily on their IT infrastructure. Their profits were in the millions. On one occasion, their IT system failed. Every lost minute meant lost orders and lost profits, as well as delays for their customers. They stood to lose £1 million for every lost day. The company tried to repair the situation in house but failed and had to call in an engineer. The engineer came along, went straight to a particular server, flicked a switch and brought back the system.

He produced a bill of £10,000. The managing director of the logistics company questioned the size of the bill, as the engineer had spent only an hour on site (and most of this time was spent negotiating with security, trying to get into the building), and asked for an itemised bill. The engineer produced this bill, which had two lines on it. Line one: £100 for time to flick switch. Line two: £9,900 for knowing which switch to flick. The managing director approved the bill without further questions.

The point is that to obtain the maximum value of our product or service, we need to ensure that our customers are fully aware of the value to them.

Optimal pricing

Value pricing is tough because value is subjective and therefore difficult to put a number on. We all value things differently. That's why it's important to have a system that allows price discrimination, effectively selling the same product to different groups at different prices. A classic example is peak and off-peak travel: the same journey at different prices at different times of the day. Your system should help you tap into the psychology of your customers, so as to maximise their value perception and willingness to pay.

The ultimate form of value pricing is optimal pricing. This means setting your prices at the maximum each individual customer is willing to pay – in other words, that particular customer's optimal price.

Retailers are now much more aware of the psychology of pricing and have multiple ways of obtaining the optimal price. For example, say you want to buy a 75-inch LED TV and your budget is £2000. If you visit a major electronics store, you'll be immediately struck with a vast array of options. The store will likely have a number of models that are within your budget and some a little outside of it. It's their job to maximise the amount that you spend. Similar TVs will be displayed close together, and some will have slightly better features than others. It's therefore easy for you to compare models and think, 'I'd like that extra little feature, or that function.' Rather than look at the overall prices, you look at the differences between the models. You're only making a decision on a small amount and are therefore much more likely to say yes to a TV not within your budget.

Why does this work?

It's human nature to compare things. We tend to find estimating the absolute value of something much more difficult than comparing two things. We need a point of reference to be able to work out a measurement.

There is no such thing as the right price

Unless you can read minds, you have no idea how much customers are willing and able to spend. Even if you could read minds, it wouldn't help much because usually the customers don't know either! How many times, when you are the customer, have you spent more than you thought you would in a shop?

The process of determining the optimal price is more important than the actual numbers. Should you increase the price by 20% or 30% if a customer wants a certain function? There is absolutely no way of knowing that until you begin to test.

As a general rule, price high and then build in enough options and upgrades to allow your customers to get to the price point where they say yes or you decide they're not the right customers for you.