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Pricing Best Practices

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PART 1: INTRODUCTION TO PRICING

The importance of pricing

Why pricing should matter to you

There are two ways that businesses make money:

- **Cut costs**
- **Raise prices.**

A study of company strategic priorities[1] found that **55% of companies considered cost management a higher priority** and **only 17% considered price management a higher priority**.

But research suggests that pricing should deeply matter to firms. According to research by McKinsey, a **1% improvement in price created an 11.1% improvement in operating profit**. In comparison, the same improvement in fixed cost created only a 2.3% improvement in fixed cost.

Pricing is in fact:

- A powerful form of expression
- About sharing advantages
- A source of emotion

Internal struggles during pricing

Defining your pricing can be a difficult process within the company. You should be aware of the following internal dynamics when setting your prices:

	Sales, Marketing, Growth	**Product, Executive Office, Operations**
Pricing pressure	**REDUCE** prices	**INCREASE** prices

Our fictional company example

<u>The VitEasy example</u>

Throughout this guide we will use a fictional example of a company called VitEasy. VitEasy is a direct-to-consumer nutritional supplement brand. This is a fictional business and is used to illustrate the payment strategy journey.

[1] Simon-Kucher & Partners, 2009

PART 2: COLLECTING YOUR DATA

Finding your marginal cost

What is cost analysis?

A basic rule of pricing is **not to charge less than what your product costs to produce.**

There is one exception to this:

- A **loss leader strategy** involves **selling** a product or service **at a price that is not profitable** but is sold **to attract new customers**. Loss leading is a common practice when a business first enters a market.

To begin a pricing exercise, you must first understand what your **breakeven or 'marginal' cost** is.

Determining your floor price

Not all costs are relevant when deciding your costs for pricing.

In determining what costs to include a simple rule is to include the costs incurred because a product is sold, or not incurred because a product is sold.

Accounting costs	Relevance for pricing
Variable costs (raw materials, labor, etc)	**Yes** Need true incremental costs, not average costs
Semi-fixed costs (incremental product capacity)	**Maybe** If price change leads to sufficient change in volume
Fixed costs (Plant, R&D, brand advertising)	**No** Unless for costs of implementing price changes

<u>The VitEasy example</u>

VitEasy operates a simple business model - it buys vitamin supplements and delivers them directly to consumers. The company determines that their unit of business is a 'delivery' and outlines the variable costs of each delivery:

COGS of a delivered unit (Per unit in USD)

- Purchase price: $0.20
- Delivery costs: $0.30
- Data storage and management: $0.05
- Returns and failed deliveries: $0.42

Marginal Cost: $0.97

Projecting true unit costs

We do not advise changing your pricing often. **Changes in pricing** can lead to

- **Resentment if prices go up**, consumers feel annoyed about the increased costs.
- **Annoyance if prices go down** as consumers feel they could have gotten a better deal by waiting.

Given this, we want to make sure that we won't need to change our price in the short-to-medium term and therefore we need to calculate our variable costs one to three years into the future.

To calculate economies of scale, divide the percentage change in cost by the percentage change in output over the last one to three years of your operations. If the result is less than one, that means that economies of scale exist. Use this figure to project your true unit costs into the future.

The VitEasy example

VitEasy realizes that its delivery costs are projected to decrease by 20% over the next three years, given greater efficiencies of scale. The tech team believes that data storage and management costs will similarly decrease by 20% as the company moves to a better plan with its provider.

COGS of a delivered unit (Per unit in USD) in three years

- Purchase price: $0.20
- Delivery costs: $0.30 (-20%)
- Data storage and management: $0.05 (-20%)
- Returns and failed deliveries: $0.42

Marginal Cost: $0.90

Why we don't use cost-plus pricing

It is tempting to your marginal cost and add margin. There are several downsides to this:

- **It ignores market and demand conditions** such as the pricing sensitivity of customers
- **Provides the wrong incentives** for a business (cutting costs no matter the impact on customer utility)
- Uses an **arbitrary method of markup**

There are two situations when you should use cost-plus pricing:

- When cost-plus pricing is **required by the government**. For example, in some pharmaceutical markets, it is not possible to charge more than X% above your marginal cost.
- **When pricing thousands of different products repeatedly**. For example, in supermarkets or e-commerce websites with highly fluctuating prices.

Finding the perceived value

A quick note on what value you are providing

Before you can begin finding your price, you must ask yourself "*what is my customer paying for?*".

Theodore Levitt the economist and theorist famously said "*People don't want to buy a quarter-inch drill. They want a quarter-inch hole!*". **We recommend determining what problems you are fundamentally solving for your customers.** Some examples of this thinking are provided below:

What you provide…	… What a customer wants
Drill	Quarter-inch hole
Razor	Smooth chin
Automobile	Speedy transportation
Plumbing	Cleanliness
Luxury clothes	Feeling self-confident

<u>The VitEasy example</u>

VitEasy realizes that what it provides and what its customer's value are two different things. It offers good quality vitamin supplements that people can trust, but what customers value and what they are paying for is the ability to remain healthy and energized.

Willingness to pays

Having determined what your customer wants we are now able to assess **how much they are willing to pay for this value**. Before we get started there are a few things to bear in mind:

- **Individual perceived value** is known in pricing exercises as their **willingness to pay (WTP).**
- It is also important to note that **people usually differ in their willingness to pay for different product features** within a product or service. For example, some consumers might pay $1,000 for an iPhone with a big battery and a poor camera. Others would be willing to pay $1,000 for an iPhone with a small battery and a good camera.

Whatever research we do, needs to not only **assess the willingness to pay** for our current product but also help us **determine an optimal set of product features for extracting value from customers**.

About pricing sensitivity analysis

The best way to measure willingness to pay is through '**pricing sensitivity' analysis**.

- Price sensitivity - sometimes called price elasticity - means the **degree to which demand changes when the cost of a product or service changes.**

Van Westendorp pricing sensitivity

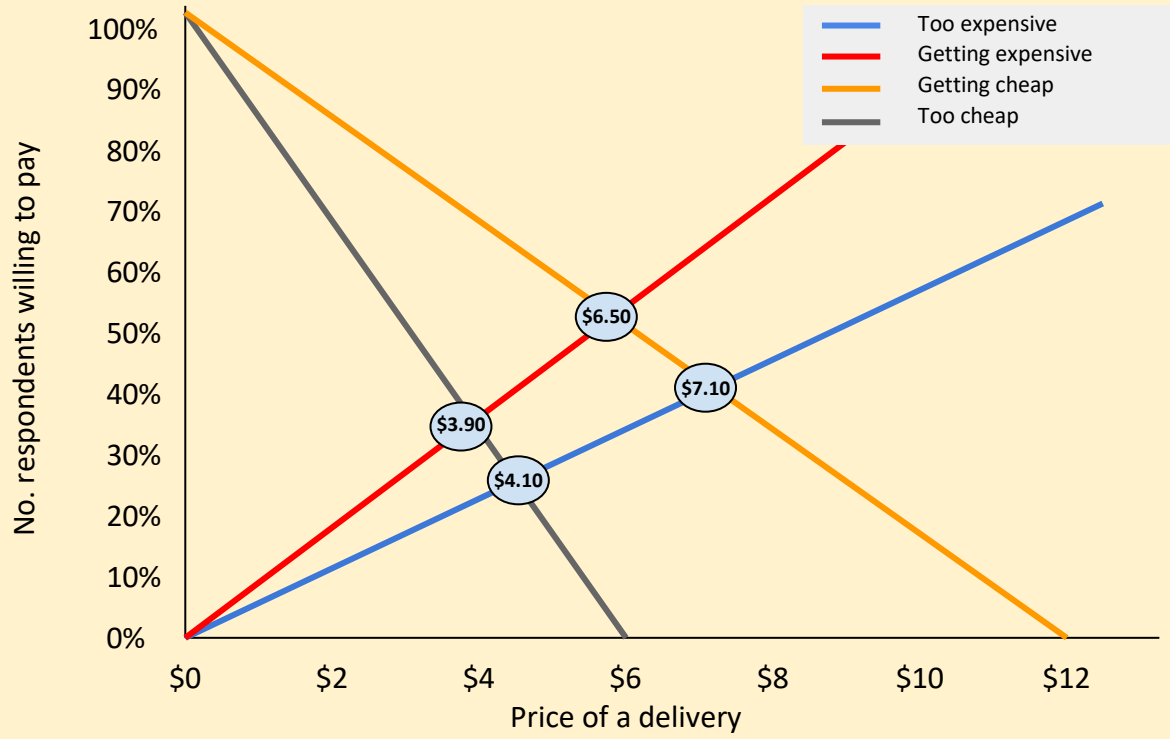
The traditional Van Westendorp approach asks four price-related questions, which help to set **four important limits** on your potential pricing.

- At what price would you consider the product to be so expensive that you would not consider buying it?
- At what price would you consider the product to be priced so low that you would feel the quality couldn't be very good?
- At what price would you consider the product starting to get expensive, so that it is not out of the question, but you would have to give some thought to buying it?
- At what price would you consider the product to be a bargain—a great buy for the money?

Results to these questions are usually plotted either as line graphs or box plots. It is important not simply to look at the median or mean of the responses. But rather look at the outliers and distribution of the plots:

VitEasy Example

VitEasy runs a Van Westendorp survey. The company realizes that the product is too expensive for customers at $7.10, getting expensive at $6.50, getting cheap at $4.10, and too cheap at $3.90. It knows that it should price between $4.10 and $6.50.



Conjoint analysis

We recommend using a **Conjoint Analysis** approach to determine pricing sensitivity. There are **six steps** to a successful conjoint analysis:

1. Identify a set of relevant product attributes
2. Define reasonable levels for these attributes
3. Create product profiles
4. Obtain consumer preferences for profiles
5. Analyze the data
6. Simulate market-level outcomes

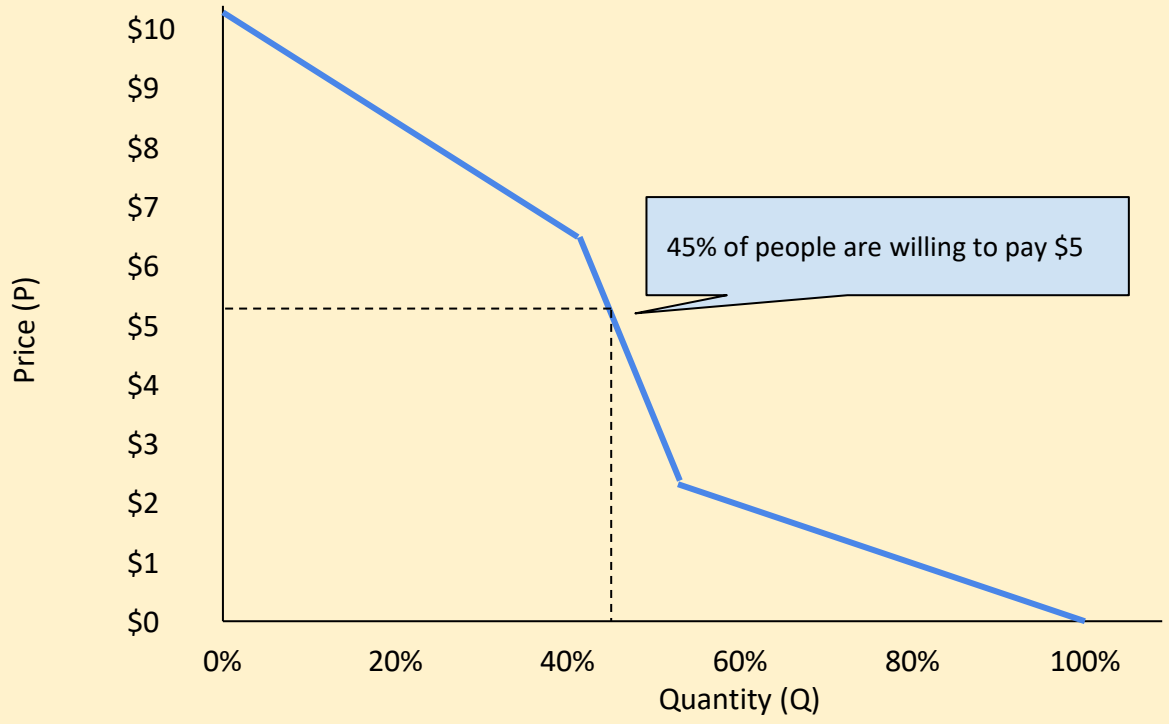
Conjoint analysis provides a uniquely dense and accurate view of customer willingness to pay. But it can be complicated to perform. Luckily there are various online tools that help you set up and analyze conjoint exercises.

From a pricing perspective, a conjoint analysis will give you a readout in the form of a demand curve.

- A demand curve is a simple measure of how many people are willing to pay for our product and at what price. They are quite fundamental to micro-economics and are extremely helpful when we are designing our product strategy.
- A demand curve always has quantity demanded on the X-axis and price on the Y-axis.

VitEasy Example

VitEasy runs a conjoint analysis using key product attributes and receives readouts of different demand curves for different products.



PART 3: BUILDING A PRICING STRATEGY

Creating pricing options

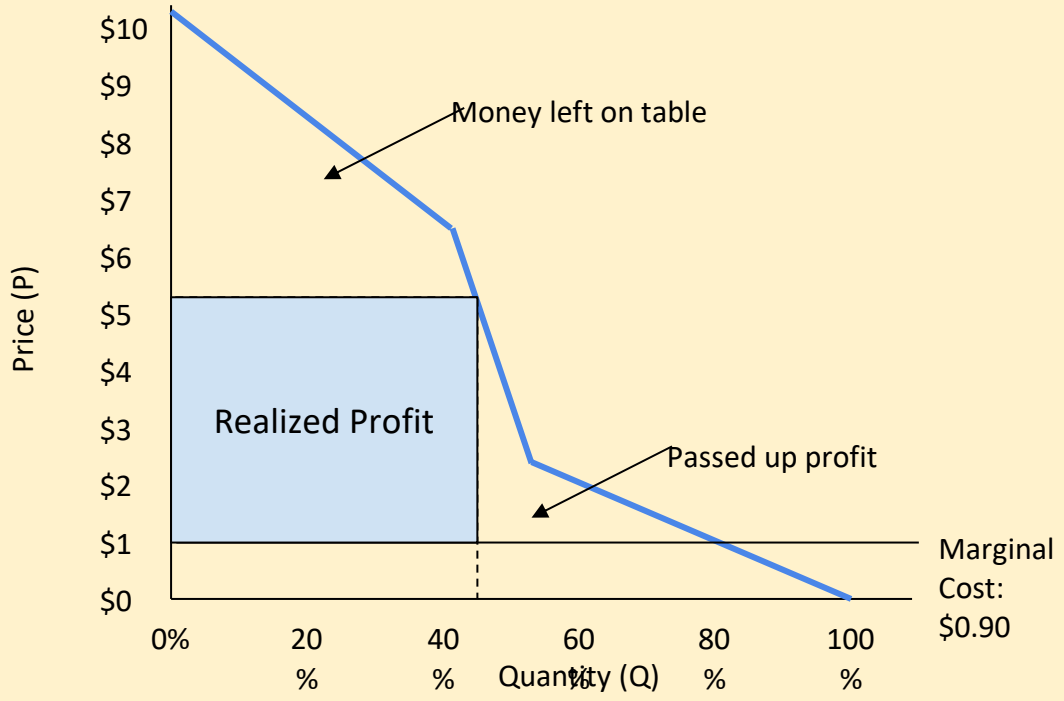
The problems with a single pricing strategy

With our conjoint readout it can be tempting to create a single price for our product. But there are two potential problems with this approach.

- **By setting a single price we are leaving money on the table** as some customers will always be willing to pay more than the price we are offering.
- **Conversely, we will also pass on some profit**, as some potential customers were not served even though the firm could have served them.

VitEasy example

VitEasy considers a price point that 50% of respondents might be comfortable with, but they are not happy with the missed value.



Types of pricing discrimination and when to use them

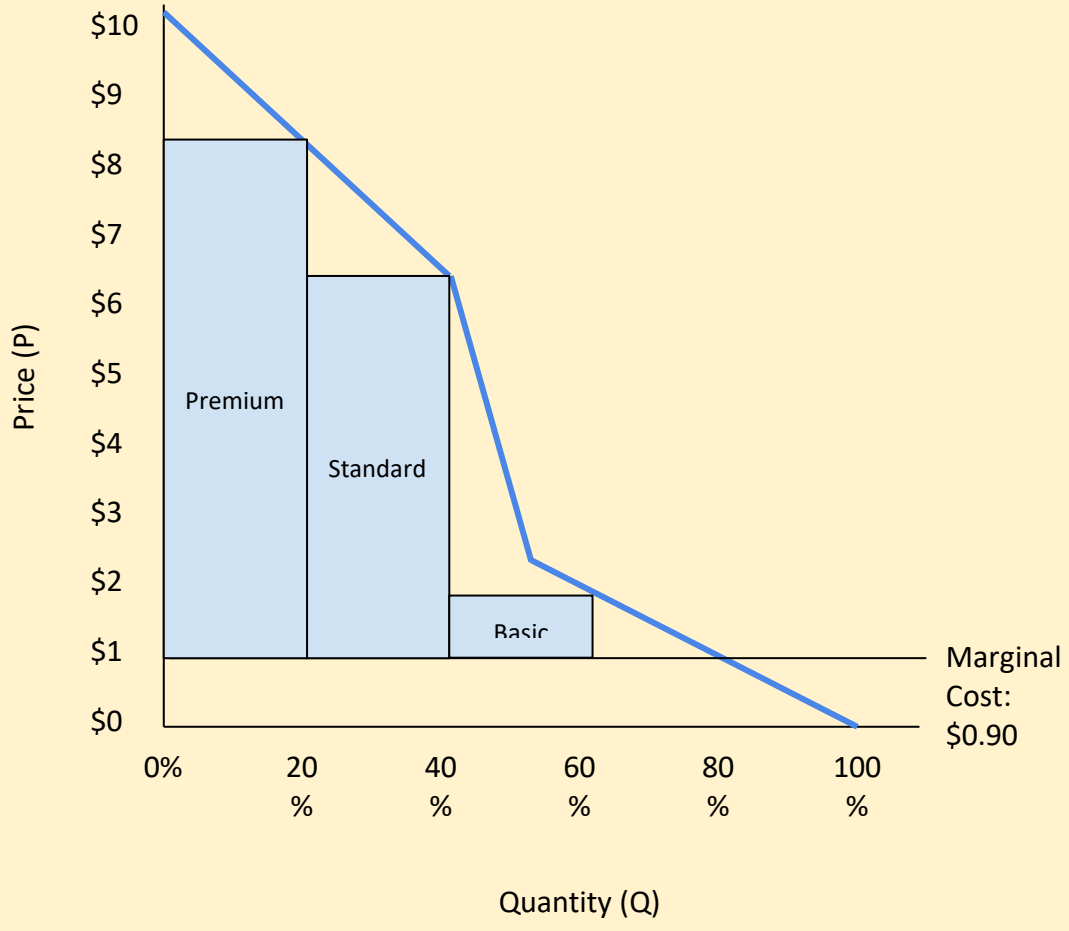
So how do we extract the remaining value from the demand curve? In pricing, we use a tool called '**pricing discrimination'**. There are two key types of pricing discrimination:

1. **First degree (Perfect) discrimination**: Involves the charge of a **different price against all the different units of a commodity**, in such a way that the price equals each consumer's willingness to pay, and no consumers' surplus was left to the buyers. For example, a second-hand car salesperson is able to accurately determine the WTP of every customer that enters their store.

2. **Second-degree discrimination or 'versioning'** is the usage of **multiple products are multiple price points** to capture additional revenues. This ensures that you are able to capture customer preferences and potential value.

VitEasy example

The pricing team at VitEasy goes back to management and explains. We need three separate products targeted at different customers with different willingness to pay. We should have a premium product priced at $8.10 (20% will buy this), a standard product priced at $6 (20% will buy this), and a basic product priced at $1.60 (20% will buy this). We will lose 20% of potential customers, but that can't be helped.



Issues to avoid

Pricing discrimination has several risks. We advise you to watch out for the following pitfalls, some of which, depending on your location may be illegal:

- Make sure that you are **not discriminating** against any customer segment **based on race, gender, sexuality, or any other visible marker.**
- Ensure that you are **not capitalizing on ignorance amongst consumers**. It is only a matter of time until customers realize you are overcharging.

If in doubt, Tesla recommends the following acid test:
"The acid test is that if you cannot explain to a customer who paid full price why another customer didn't without being embarrassed, then it is not right. We either win in a way that is fair and right, or we lose with our honor intact and accept the consequences."

PART 4: DESIGNING THE FINAL APPROACH

Designing a product stack

Rules to stick by

- We recommend sticking to no more than five different pricing options and ideally no more than three.
- When designing your product offering clearly and visually demonstrate why they are priced differently. Lists of benefits (longer for more expensive products) can play a key role in demonstrating the added value of more expensive products.

VitEasy example

VitEasy comes up with a premium, standard and basic package and adds features that clearly differentiate each product.

Basic	Standard (MOST POPULAR)	Premium
$1.60 Per delivery	**$6** Per delivery	**$8.10** Per delivery
Basic vitamin selection Free returns	Basic vitamin selection Free returns Video consultation Premium packaging	Basic vitamin selection Free returns Video consultation Premium packaging Luxury selection of products Tailor made selection with consultant

Moving towards subscriptions

One-off pricing has natural advantages. But, charging on a **subscription basis** has several advantages in **smoothing your cash flows, retaining customers,** and **increasing the lifetime value** of customers**.** We recommend assessing whether any of the following approaches fit your business:

- Pay-per-time - e.g. consulting
- Pay-per-use - e.g. metering usage.
- Pay-per-result - e.g. investment services.

- Pay-per-value - A new field and more of a concept at the moment

Two rules to stick by:

- When you are defining your subscription tiers it is **important that the price per unit must decrease with more expensive tiers.**
- When customers are presented with multiple options for pricing, they are likely to **compromise** between the least expensive and most expensive and choose the **middle one.**

VitEasy example

VitEasy decides to move to a subscription pricing strategy.

Basic	MOST POPULAR Standard	Premium
$1.60 Per month	**$6** Per delivery	**$8.10** Per delivery
1x box of VitEasy vitamins delivered to your door. *Price per box: $1.60* *Marginal cost: $0.90* *Gross margin: $0.70 pm*	4x box of VitEasy vitamins delivered to your door. *Price per box: $1.50* *Marginal cost: $3.60* *Gross margin: $2.40*	6x box of VitEasy vitamins delivered to your door. *Price per box: $1.35* *Marginal cost: $5.40* *Gross margin: $2.70*

Promotions & incentives

What kind of promotions can I offer?

One commonly used tool to push customers towards higher value price plans is the use of promotions. These can typically be separated into push and pull promotions:

Push promotions	Pull promotions
Off-invoice discounts Slotting fees Bill-backs Rebates Volume discounts	Coupons Sales Sweepstakes Rebates Trials

Co-marketing Discretionary funds	Financing Loyalty programs

Classic issues with promotions

There are two key problems you need to be aware of before launching a promotion:

1. **Short-run 'leakage'**: When lower prices are available to all customers loyal buyers who would otherwise have purchased your product are now doing so for less. This may lead people to stockpile during a sale and accelerate purchases they would otherwise have made.
2. **Long-run risks:** In the long-run promotions can make customers more price-sensitive and less brand-focused as well as change customer expectations of your brand.

Characteristics of a well-executed promotion

Doing a promotion right is challenging. Here is our checklist to ensure you are using promotions strategically:

Checklist	Explanation
Is it a conversation starter?	A price cut is much more than an incentive. It is the perfect vehicle to grab the consumer's attention and start a discussion on anything but price.
Is it selective?	Companies are generally hesitant to turn customers away. In many instances, the discount is offered indiscriminately to anyone willing to purchase. By doing so, however, we miss a great opportunity to separate the customers we want from those we do not.
Is it contingent?	Don't give money away too easily. Make consumers sweat for it by asking them to perform some ancillary behavior that reduces your costs.
Does it enhance the brand?	Promotions only destroy brand value if the consumer sees the price cut as an attempt at persuasion rather than a reward. Think of all the behaviors that capture the essence of your brand (and your ideal customer) and offer discounts to consumers willing to excel on those dimensions.
Is it exclusive?	To the extent that you can infuse a tangible benefit -- in this case, saving money -- with the intangible values of your customers, you have created differentiation also at the campaign level.

PRICING CHECKLIST

- ☐ **Define your unit of business**
- ☐ **Work out your marginal cost (factor in time horizons)**
- ☐ **Define your perceived customer value**
- ☐ **Measure your perceived customer value through a conjoint analysis**
- ☐ **Create a product list (versioning)**
- ☐ **Consider a subscription approach**
- ☐ **Develop strategic promotional activities**