Pricing for Profit: Cost-Based Pricing

After you've determined your break-even points which establish "floors" for your price, there are strategies for establishing pricing based upon additional financial objectives, such as:

- Establishing a high price to make high profits initially. This strategy is used to recover high research and development costs or to maximize profits before competitors enter the market. (Pharmaceutical companies often use this strategy when introducing new drugs.)
- Setting a low price on one or more products to make quick sales to support another product in development. (Some companies also employ this strategy when they need to increase cash flow.)
- Setting prices to meet a desired profit goal. For example, if the desired profit per unit is 20 percent and unit costs are $10 (taking into account your fixed and variable costs), set your price at $12.

You may also determine how many units you'll need to sell to meet a profit goal by using the following formula.

$$\text{Break-Even Unit Volume} = \frac{\text{Fixed Costs}}{\text{Unit Contribution Margin*}}$$

* Again, remember Unit Contribution Margin =
Selling Price per Unit - Variable cost per unit.

Pricing for Profit: Value-Based Pricing

How high can a price be before the product or service is priced out of the market?

To understand the customer's perception of the value of your product or service, look at more subjective criteria such as customer preferences, product benefits, convenience, product quality, company image and alternative products offered by the competition.

- How do your customers describe what they get for their money?
- Do they save a great deal of money or time by purchasing your product or service?
- Do they gain a competitive advantage from using your service?
- Is it more convenient to use your service rather than try to do it themselves?
- What are the customer's choices?
- What does the competition charge?

With this information, you can begin to understand the maximum price the customer will pay for the benefit received. Often, a customer may think it's worth paying $75 per hour for the convenience and security of dealing with a local business, rather than a paying an impersonal chain $30 per hour. If the customer, however, is only willing to pay $30 per hour, you have to ask yourself whether you can make any money in this business.

A few value-based pricing strategies are listed below that take into account the break-even point, but are heavily weighted with subjective judgments–not just the numbers.

- Price the same as competitors. This strategy is used when offering a commodity product, when prices are relatively well established (such as with professional services) or when you have no other means to set prices. Your challenge then becomes to determine how to lower your costs so you can produce a higher profit than your competitors.
- Establish a low price (compared to the competition) on a product in order to capture a large number of customers in that market. This strategy may also be used to achieve non-financial objectives such as product awareness, meeting the competition or establishing an image of being low-cost. It works if you are able to maintain profitability at the low price, or if you're able to maintain an acceptable level of sales should you later raise prices.
- If your product has a mystique and uniqueness that is valuable to customers, you might have the ability to charge a very high price relative to your cost. Also, if your target market is affluent and you are positioning your product as a "prestige" product, an especially high price could be in order. (For example, do Rolex watches cost *that* much more to make than other brands? The high cost, however, brings a "status" benefit to Rolex's affluent market.) This strategy of charging "what customers are willing to pay"–even though it's high–requires alertness and a willingness to change on your part because customers (and competitors) might decide that you're making too much of a profit!

Discounts

Your pricing strategy might include discounts to customers who offer you a business benefit.

- You may offer cash discounts to customers who pay promptly. This rewards those who help your company maintain a steady, positive cash flow and reduce credit-collection costs.
- Offering quantity discounts for large orders often makes economic sense when the cost-per-unit to sell or deliver a product declines as the quantity increases. For example, a caterer might fill an order for 12 dozen cupcakes for one customer at 10¢ each, while cupcakes sitting in the bakery display rack might be sold to several customers throughout the day for 20¢ each. This is because the possibility that some of the cupcakes won't sell has to be taken into account, there are costs associated with having the store open for random customers' convenience, etc.
- Seasonal discounts given to buyers who purchase during a product's slow season reward customers who essentially assist a company in balancing its cash flow and in meeting production demands.

- Trade-in allowances for returned old products that you may either re-use or re-sell for a profit may benefit both a company and customers.
- Promotional allowances often make economic sense. For example, if your product is sold by a retail chain which includes your product in its ads or in promotional activities, those activities leverage your marketing efforts. If so, you might choose to discount your price to this retail chain.