How to price what you sell

Expert knowledge means success

Contents

Note: This publication has not been updated since it was last published. Some of the hyperlinks may have changed and may need updating. In addition, some of the information in this publication may be out of date.

Introduction

The basic rule in business is that, if you do nothing else, you must be able to charge for what you sell (whether it's a product or service) at a price that exceeds your cost. This sounds so obvious that you might believe that everyone knows it - surprisingly, some people don't.

People often forget that the primary goal of most businesses is to make a profit. There are many factors that affect the profitability of your business, such as management, location, cost of labour, quality of your products or services, market demand and, of course, competition. Although the right to set the price of what you sell is yours, the simple fact is that pricing is perhaps the most complex marketing decision of all. There is no one best formula to use to establish prices. A price strategy is only effective if the customer is willing to pay the price and a profit is generated by the sale. To succeed, a marketing strategy must set prices that are both satisfying to customers and profitable to the business.

This Publication is concerned with Pricing - both of products and services - and the different strategies that a business can adopt according to its own particular circumstances. "Price" is the amount of money charged for a product or service or the value exchanged for the benefits of the product or service. Larger businesses may use product pricing in a predatory or defensive fashion, to attack or defend against a competitor. Smaller, and start-up businesses may use an introductory strategy to gain market share and in doing so offer low prices as an alternative to heavy marketing costs to securing new customers. As we will see in this publication, price is derived ultimately from three things: costs, customers and competitors.

Deciding on the right price to charge is a difficult problem when a business is in a start-up mode, particularly the case in service-focused businesses or those with custom-made products. For a new product, before you set a price you must understand how you are going to position yourself in the market. Make sure it is not too low, or the product will not be taken seriously. If it is too high, the potential customer will not take the risk.

Setting the right price for your product or service is much trickier than it sounds. Many start-ups and businesses launching new products or services find this particularly difficult - get the price right and success is for the taking whilst failure is the result of getting your sums wrong. The art of pricing means achieving what you need by delivering the goods and services your customers want.

"The art of pricing means achieving what you need by delivering the goods and services your customers want."

The Bank of England conducted a survey[1] in the autumn of 1995 to investigate the price-setting behaviour of 654 UK companies. The survey sheds light not only on the extent of price rigidity in general, but also on the form this rigidity takes, and the characteristics of companies and markets that influence it. The survey showed that:

- Although market conditions are of primary importance in price determination, many companies set prices on the basis of cost plus a mark up.
- There was evidence of considerable price rigidity. In the year preceding the survey, the average company reviewed its prices once a month.
- Retailers reviewed and changed their prices more frequently than manufacturers did.
- Companies operating in more competitive markets reviewed prices more often than companies with few direct competitors.
- The top preference for almost 40% of respondents in the survey was that prices were set at the highest level that the market could bear. The importance of market conditions in price formation is reinforced by the fact that an additional 25% of respondents stated that they set prices in relation to their competitors.

"Price is the amount of money charged for a product or service or the value exchanged for the benefits of the product or service."

It's a fact that in most cases, people tend to under-sell themselves. They assume that their customers and clients are most interested in paying the lowest price. Whilst this might often be true, it doesn't always follow that this is the case at all. If you charge less and compete with your rivals solely on price, the chances are that you'll have to work much harder than necessary or you simply don't make as much money.

"Price is derived ultimately from three things: costs, customers and competitors."

If you sell or offer things at the wrong price, it can have a significant impact on whether people buy from you or not - and also whether your business is capable of surviving. For example:

- If your prices are too high or higher than are being offered by your competitors, why should customers buy from you?
- On the other hand, if your prices are too low, you might have customers beating a path to your door, but how long will your business last if your margins are insufficient to cover your running costs?
- The optimum price is one that gives the best margin with the highest volumes possible - selling more and making more money on each sale.

Your pricing structure will play a large part in what customers you obtain. You will have to make sure that your pricing is appropriate for your ideal customer - the financial position and price sensitivity of your ideal customers directly affects what you can charge.

Pricing Techniques

Common techniques arrive at a price based on:

- Evaluating product/service features and customer benefits and the value to the customer and charging accordingly.
- Asking key customers what they will pay.
- Marking up your cost of production by a fixed percentage.
- Undercutting competitors' prices by a fixed percentage
- Getting feedback from your sales team.
- Considering typical customers' "spendable income" and charging what they can afford.
- Obtaining advice from consultants, or business associates.

The list above may include something that's right for you, but think - if you keep undercutting competitors' prices, what will their response be? The easiest strategy to imitate is a cost-cutting strategy. Perhaps a "differentiator" strategy would be better - better prices and far more difficult for others to imitate.

Break-Even Analysis

One of the most important things you should do is to estimate how many units of your product you must sell to break even. A simple formula will tell you how many units of a given item you will have to sell to reach the point where you start making money. Calculating your break-even point is usually not too difficult - there are only three variables you need in order to calculate a break-even sales point:

- **Unit cost of each item you sell** - the manufacturing cost in the case of manufactured items, the bought in cost of each item if you are a reseller or the labour and directly associated costs of each assignment for a service-based business.
- **Gross profit margin** - the percentage margin you make on each sale. This is the difference (expressed as a percentage) between your unit cost (see above) and your selling price.
- **Operating expenses** - these are all your overheads and selling expenses. In other words, all the other costs you incur except the direct unit costs (see above).

Let's assume that the "unit" cost per item sold is £240, that you sell the unit for £400 at a gross margin of 40% on sales, and your operating expenses total £36,000 a year. You will have to sell 225 units to break even:

225 units sold at £400 =	£90,000
Unit costs: 225 at £240 =	£54,000
Gross margin at 40% on sales of £90,000 =	£36,000
Operating expenses =	£36,000
Break even - no profit, no loss	£Nil

In the above example, the break-even point is £90,000 sales a year - the sale of 225 units at £400 a time. However, if you change the gross margin percentage (by reducing or increasing your price) the position can change very quickly:

	10% Price increase	10% Price decrease
Number of units that need to be sold =	180	300
New selling price per unit =	£440	£360
Sales at new selling price =	£79,200	£108,000
Unit costs: Units sold at £240	£43,200	£72,000
Gross margin on sales =	£36,000	£36,000
Gross Margin percentage =	45.4545%	33.3333%
Operating expenses =	£36,000	£36,000
Break even - no profit, no loss	£Nil	£Nil

As you can see from this example:

- If you increase your selling price by 10%, the number of units you need to sell reduces from 225 to 180 and you achieve break-even on sales of £79,200 instead of £90,000.
- But, if you reduce your selling price by 10%, the number of units you need to sell increases from 225 to 300 and you achieve break-even on sales of £108,000 instead of £90,000.

Pricing Strategies and Tactics

When you start thinking about what price to charge for your products or services, the following groupings will help you to decide the approach you wish to use:

- **Competitive Pricing:** This means pricing your products/services at under your competitors' prices. Customers expect you to charge "the going rate" for your work. In rare situations, where you provide a distinctly different service, you may choose to price significantly differently than your competitors. With competitive pricing, a business will respond directly to market forces:

Example:

John Smith has set up a new printing business. He will specialise in business stationery for small businesses. He believes that the "going rate" for letterheadings is £300 per run of 5,000 sheets. He undertook a survey before deciding to go into business for himself and the figure of about £300 was what people said they would pay for this amount of business stationery. Most competitors charge this figure.

John decides to charge £280 plus VAT for 5,000 letterheads, thereby undercutting the competition by £20.

Whilst John may get new business because he offers low prices, how long can he sustain this approach to getting new business? Unless the gross margin contribution (the difference between the direct costs of production and the selling price) from all sales is sufficient to cover fixed and indirect costs, John won't make a profit.

- **Cost-Based Pricing:** This method uses pricing based on what it costs you to make and deliver your products or services, plus the margin you need to cover your overheads and make a profit. If your cost-based price is too high for the current market, you need to find a more efficient way to deliver or manufacture your product or service.

Example:

Sally Holding manufactures garden furniture.

Sally has decided to use the cost-based approach to the pricing of the furniture she sells.

Taking one item of furniture (a pool-side lounger chair in teak), she analyses her costs very carefully. She uses outside freelance labour to cut and polish the wood but assembles the furniture herself in the store at the back of her retail shop. She finds that the costs of each chair are:

	£
Wood used (shipped from abroad)	65.32
Inward shipping costs	10.00
Cutting and shaping labour – 5 hours at £10	50.00
Polishing, per chair	25.00
Brass hinges etc, per chair	14.50
Chair cushion (bought in)	28.00
Total cost	*192.82*
Mark up on cost 75%	144.61
Cost and Margin	*337.43*
VAT at 17.5%	59.05
Total cost-based price	*£396.49*

Based on the above, Sally decides to set a selling price of £396.49. It provides a gross margin percentage profit on the pre-VAT selling price of 42.856%. Since Sally hasn't taken her own labour into account, she thinks that this is a reasonable approach to setting a selling price for this teak chair.

- **Value-Based Pricing:** This pricing method is tied to the value you create for the customer - it's the most appropriate for service businesses that have years of experience to provide expertise, insight and practical advice.

Example:

Roger Davis is a financial consultant specialising in identifying investment opportunities for his clients. Most of Roger's clients are employed in large media agencies in London in senior positions and on average earn in excess of £500,000 a year.

Roger carries out a large amount of research before making any investment recommendations to his clients. Sometimes, the research can take several months.

Roger has identified what he believes to be an excellent investment opportunity in investment in film partnerships. The investments have little risk and provide significant tax benefits to investors. Investment returns of 20% are expected and the tax benefits make these investments even more attractive. Roger's research time on this project has been 500 hours.

Most investors will invest, on average, £125,000 and expect to make a net return after 5 years of £75,000 of which £50,000 is guaranteed by the special tax reliefs due.

Roger has 1,000 clients who decide to take Roger's advice. Roger decides that to charge each client 30 minutes to recover his research time of 500 hours would not be appropriate in this case. He decides to charge each client £250 plus 1% of the investment value. On average, Roger charges each client £1,500 in total. Given the excellent investment returns and tax reliefs due, each investor is very happy with this arrangement and can see the value in what Roger has achieved for them. Roger could have adopted a different approach - charging an annual percentage of the gains each investor makes over the 5-year period. Either way is a good example of value-pricing.

Main Pricing Strategies

The main pricing strategies are:

- **Product Line:** Setting price steps between product line items or groups.
- **Optional Product(s):** Pricing optional or accessory products to accompany the main item sold - such as extended warranty insurance on electronic equipment.
- **Captive Product(s):** Pricing products that must be used with the main product - such as batteries of a particular size (and difficult to buy elsewhere) to be used with radios, personal stereos etc.
- **By-Product(s):** Pricing low value by product simply to get rid of them - particularly if a new model has been launched or is due to be launched soon.
- **Product Bundle(s):** Pricing bundles of products sold together - such as a birdcage, bird food and instruction book to accompany the parrot purchased at the local pet shop.

You will need to identify any special circumstances that might affect your pricing strategy. How will you deal with these special circumstances - such as the need for payment terms or extended credit, cancellation clauses, performance guarantees and minimum/maximum quantities?

In any marketplace, there usually exist what is known as "barriers to entry". These are obstacles that make it difficult for competitors to enter a market and capture customers. The more difficult the barrier, the greater is the competitive advantage of the current players who "own" their part of the existing market - and the greater share of the market will be theirs, often at premium prices.

For example, if your business owns patents that enable a widget to be manufactured at a higher quality and lower cost than any of your competitors, you have a massive advantage and could probably charge high prices for what you sell - provided, of course, that customers recognise and want the better quality of your widgets.

Your business image is conveyed is through your pricing strategy and the confidence with which you communicate what you charge for your products and services. If you charge premium prices, you are sending out a message that you have a premium offering or that you consider you have some form of competitive advantage. On the other hand, if you decide to offer low prices, your marketing message is that you provide a product or service with fewer frills at an economic cost.

It's crucially important that your marketing plans do not ignore the other elements of the marketing mix when selecting a pricing strategy. Pricing should support the overall marketing strategy for the products or services you sell. For example, if you were shopping for used cars and found one Ford Mondeo advertised at £750 and another at £7,500, what might you assume? You might think either that the more expensive one was produced more recently or that it was simply in better shape. Price can serve as a signal regarding unseen attributes as well as a cost to the consumer.

Should you offer discounts or make price adjustments?

Discounts and allowances can be introduced to reward customers for certain responses with the objective of maintaining sales during difficult trading periods or increasing them at other times - for example:

- **Seasonal discounts** - to stimulate demand at off-peak times.
- **Cash discounts** - to reward customers who pay their accounts early (or even on time).
- **Quantity discounts** - to reward customers who purchase in large volumes.
- **Trade-in allowances** - price reductions to encourage customers to exchange an old product for a new one.
- **Promotional allowances** - to reward dealers or distributors for taking part or supporting advertising and sales support initiatives.

The following are price adjustments arising in different situations:

- **Discriminatory pricing** - Discriminatory pricing involves selling a product (not so often with services) at several different prices when the difference in price is not based on the cost of producing the goods but allows for differences in customers, products, and locations.
- **Psychological pricing** - In using psychological pricing, vendors consider the psychological impact the price will have on the consumers. For example, customers often relate higher priced products with higher quality. Also, buyers carry prices in their mind that they compare when looking at the price of a product - such as keeping the cost below a certain threshold. It explains why many prices are quoted at say £99.99 instead of £100.
- **Promotional pricing** - With promotional pricing, a business temporarily reduces its prices to encourage short-term sales. This can take several forms including loss leaders, special event pricing and cash rebates.
- **Geographical pricing** - This involves adjusting prices to account for the geographic location of customer.
- **Value pricing** - This involves adjusting prices to offer the right combination of quality and service at a fair price that creates value in the mind of the customer.

The 4 Ways to Grow a Business

Did you know that there are only four ways to grow a business? Many business owners/managers say that their strategy is to "increase sales". But this is usually a meaningless statement since without knowledge of the dynamics of the existing business, it's nearly impossible to increase it. Actually, "sales" itself is a product of other things:

A X B X C (where A= number of customers, B= the frequency they buy from you and C= the average sale value). These three factors and a fourth (effectiveness) are part of the "4 Ways to Grow a Business":

1. INCREASE the number of customers you want (but they must be the right sort of customer)
2. INCREASE the frequency that they buy from you.
3. INCREASE the value (in £s) of every sale you make.
4. INCREASE the effectiveness of your organisation through reliable and consistent systems.

"Pricing should support the overall marketing strategy for the products or services you sell."

9 Steps to a Pricing Strategy

The following Table[2] shows the necessary steps that need to be taken in arriving at a pricing model for your business.

9 Steps to a Pricing Strategy	
1. Define target markets.	All marketing decision-making should begin with a definition of segmentation strategy and the identification of potential customers.
2. Estimate market potential.	The maximum size of the available market determines what is possible and helps define competitive opportunities.
3. Develop product positioning.	The brand image and the desired niche in the competitive marketplace provide important constraints on pricing decisions as the firm attempts to obtain a unique, competitive advantage by differentiating its product offering from that of competitors
4. Design marketing mix.	Design of the marketing mix defines the role to be played by pricing in relation to and in support of other marketing variables, especially distribution and promotional policies.
5. Estimate price elasticity of demand.	The sensitivity of the level of demand to differences in price can be estimated either from past experience or through market tests.
6. Estimate all relevant costs.	Pricing decisions need to take into account necessary plant investment, investment in R&D and investment in market development, as well as variable costs of production and marketing.
7. Analyse environmental factors.	Pricing decisions are further constrained by industry practices likely competitive response to alternative pricing strategies and legal requirements.
8. Setting pricing objectives.	Pricing decisions must be guided by a clear statement of objectives that recognizes several environmental constraints and defines the role of pricing in the marketing strategy while, at the same time, relating pricing to the firm's financial objectives.
9. Develop the price structure.	The price structure for a given product can now be determined and will define selling prices for the product (perhaps in a variety of styles and sizes) and the discounts from list price to be offered to various kinds of intermediaries and various types of buyers.

Understanding what your customers want

Few businesses enjoy the luxury of having all the customers they want and have no competition. Whenever competition exists, there is rivalry. With it comes a compulsion to gain as many customers as possible - price cutting is often seen as an easy way to gain market share and at the same time put a competitor out of business.

If your product or service is part of a product or service mix, your pricing strategy needs to take this into account. It may or may not be right to maximise margins over your entire range. Flexibility in pricing is important, but admittedly, difficult to administer, if products and services have varying levels of demand and competition.

Competitor Analysis

Before you start worrying about the price for your own product or service, you should gather as much information as you can about your competitors, such as:

- Who are they and where are they located?
- What are they offering?
- When and how do they offer it (make it available)?
- How do they deliver?
- How good (or bad) is their reputation?
- What are the key features and benefits of what they offer?
- Why do their customers choose them?
- Do they have a "differentiator" advantage?
- What price do they charge and do their prices vary according to different circumstances - if so, how?

Your response to what your competitors are doing can come from any combination of the following elements of your marketing mix:

- Price.
- Through advertising or marketing to enhance brand existence and brand attribute awareness.
- Through distribution and delivery.
- Through your sales team.
- Through promotional activities.
- Through repositioning of existing products.
- Through the introduction of new products.

As you can see from this, Price is top of the list, but it's only one part of the overall equation.

Customer Analysis

Knowing what your competitors do is only part of the story. You also need to know everything possible about your present and prospective customers, such as:

- Who are they?
- What do they need?
- What problems do they have?
- Why do they have these problems or challenges?
- Why do they need products or services similar to those you offer?
- What do they do with products or services similar to those you offer?
- When do they need products or services similar to those you offer?

Product or Service Analysis

There's still one more thing you have to do before you start work on deciding how to price your products or services. You have to analyse what it is you are offering. You need to think about all the different components of your offering, such as:

- How many parts are there?
- What are they?
- Do your customers know everything there is to know about what you offer and how you deliver?
- How does what you offer compare to what your competitors are selling?
- How reliable is what you offer?
- What happens when things go wrong - in delivery, useage etc?
- How convenient do you make it for customers to buy from you?
- How flexible and comprehensive is your offering in areas such as delivery times, customisation, spare parts, additional parts or services, financing options etc?
- Do you need to offer different things to different customers at different times in different locations?

Pricing is part of your Business Strategy

Whatever type of business you're in, your pricing strategy is generally the product of two things:

- Who you do business with (your existing and prospective customers)
- What the market (that is, the customers in your market) will pay.

The overall objective is usually to price what you sell at what the market is prepared to bear but there's a big problem with this. How do you find out what price exactly what the market will bear? The price you charge probably needs to be comparable to what your competitors charge – unless your offering has some unique differentiation and advantage to the user, in which case you can charge considerably more than your rivals do.

After all, if you have unique differentiation in what you offer, you have a superior product. But that's rare. Usually, so far as customers are concerned, an offering from one company is perceived as similar to that offered by another and the buying choice is made simply on the basis of price. If you have a premium-quality product, with premium packaging, graphics, and unique features and benefits, perhaps a premium price is necessary to reinforce the premium brand image. High prices confirm perceptions of high value in consumer minds.

Price is an important part of marketing - don't forget what marketing is[3]: "The management process responsible for identifying, anticipating and satisfying customer requirements profitably." Marketing is all about what is called the "4 Ps": Product, Place, Promotion and Price.

The following table explains the importance of these 4 Ps and the importance of price setting as part of the marketing approach.

"The price you charge probably needs to be comparable to what your competitors charge – unless your offering has some unique differentiation and advantage to the user, in which case you can charge considerably more than your rivals do."

The 4 Ps of Marketing		
Product	Individual goods, product lines, or services	• What is the physical product? • What additional features or accessories are needed? • What are the functions or uses of the product? • What services need to be provided? • Do customers expect guarantees or warranties? • How should the product be packaged for shipment? • How should it be packaged for consumers? • What images should the product project? • What brand name should be used?
Place	The physical distribution of goods - getting the product/service to the customer.	• How will the product reach the customer? • How will products be handled, stored, displayed and controlled? • How will orders be processed? • Who will be responsible for products that are damaged or not sold? • What kind of traffic patterns fit the buying patterns of target customers?
Promotion	Communicating with the customer	• What information do customers need? • Should promotions be informational, persuasive or merely reminder messages? • Do all customers need the same information? • What combination of advertising, personal selling, sales promotion and publicity is needed? • Will mass or individual promotion be most effective? • What media should be used? • How often must information be communicated customers?
Price	This is about setting profitable and justifiable prices.	• What price is needed to make a profit? • What price will customers be willing to pay? • Who determines the price customers will pay? • Should discounts and allowances be provided? • Should coupons, rebates, markdowns or sales be used? • Should credit be extended to customers? • How should the business respond to competitors' prices?

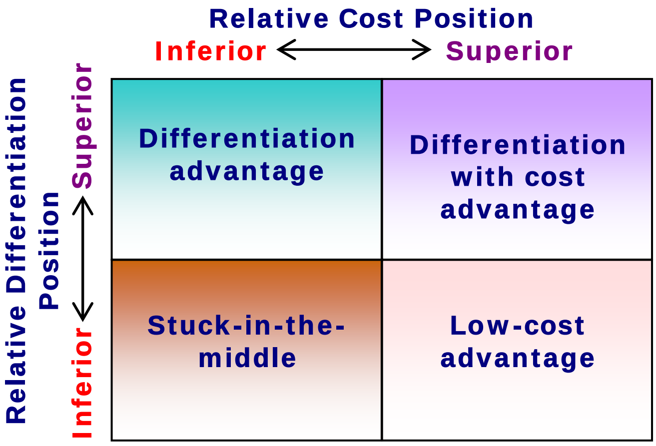
Different categories of Business Strategy - with different pricing considerations

Everywhere, businesses are trying every conceivable way to attract customers and to retain their loyalty whilst at the same time enabling the company to out-compete rivals to win and maintain an edge in the marketplace. But there are five categories of competitive strategy, which stand out above all others[4]:

- **A low-cost leader strategy** – here, the business aims to be the overall low-cost provider of a product or a service that appeals across a broad range of customers.
- **A broad differentiator** - the business seeks to differentiate the organisation's product or service from that offered by rivals, across a broad range of customers.
- **A best-cost provider strategy** – giving customers added value for money via a low- cost plus an emphasis on additional features/differentiation from competitors.
- **A focussed or market niche based on lower cost** – focussing on a narrow market segment and out-manoeuvring rivals with lower costs.
- **A focussed or market niche based on differentiation** – focussing on a narrow market segment and out-manoeuvering rivals by offering products or services customised to their specific needs.

The low-cost advantage business[5], enjoys a relative cost advantage if its costs are less than the industry average – when it has this advantage, a company has two choices – to price what it sells at a lower price than rivals to gain volume market share increase or match the price offered elsewhere and thereby enjoy additional profit margins. This is demonstrated in the table below.

Table: Relative Cost / Differentiation positions



The distinctive features of these competitive strategies are shown in the next Table which makes the comparisons easier to understand[6]:

Table: Features of competing strategies

Type of feature	Low-cost leadership	Broad differentiator	Best-cost provider	Focussed low-cost and focussed differentiator
Strategic target	A broad cross-section of the market.	A broad cross-section of the market.	Value conscious buyers.	A narrow market niche where the needs of the buyer are distinctively different from the rest of the market.
Basis of competitive advantage	Lower costs than rivals.	Able to offer customers something different from rivals.	Give customers more value for money	Lower cost in serving the niche or the ability to offer niche customers something to meet their customised requirements and tastes.
Product line	A good basic product with few frills, acceptable quality, and limited selection.	Many product variations, Wide selection, strong emphasis on the selected different features.	Good to excellent attributes; Several-to-many upscale features.	Customised to fit the specialised needs of the market segment.
Production emphasis	A continuous search for cost reduction without sacrificing acceptable quality and essential features.	Invent ways to create vale for buyers; strive for product superiority.	Incorporate upscale features and attributes at low cost.	Tailor-made for the niche.
Marketing emphasis	Try to make a virtue out of product features that lead to low cost.	Build in whatever features buyers are willing to pay for; Charge a premium price to cover the extra costs of differentiating features.	Under price rival brands with comparable features.	Communicate the company's unique ability to satisfy the customer's specialised requirements.
Sustaining the strategy	Economical prices/good value; All elements of strategy aim at contributing to a sustainable cost advantage – the key is to continue to drive costs down in every area of the business.	Communicate the points of difference in credible ways; Stress constant improvement and use innovation to stay ahead of would-be imitative competitors; Concentrate on a few key differentiating features and tout them to create a reputation/brand image.	Unique expertise in managing costs down and product/service calibre up at the same time.	Remain totally dedicated to serving the niche better than other competitors; Don't be distracted and thus blunt the company's image and efforts by entering other segments or adding other product categories to widen market appeal.

Competitive strategy is about being *different*[7] - either in the nature of the products or services that an organisation sells as compared to rivals, or in the manner in which those products or services are sold. The more different a business is to that of its rivals, the more prospect there is for achieving a premium pricing advantage.

The whole essence of competitive strategy is in the performance of activities in different ways to that of competitors. But it isn't something that you do and hope it will last forever. Choosing a "position" is one thing. But choosing a unique position that guarantees a sustainable advantage without attracting attack from rivals wishing to imitate may be hard to do. With focus on one thing, there's a good chance of success. Spreading the net too widely with conflicting messages about what an organisation actually does, can be courting disaster. A sustainable strategic position requires trade-offs because they create the need for choice and they purposefully limit what a company offers[8].

Different industries offer different competitive opportunities and thus, successful strategies vary from one industry to another[9]. They capture the whole sense of strategy when they advise that a company ought not to be thinking about competing in *an industry* but rather within a *business system* – in the same way a chess player uses his resources (the chess pieces). You should be able to identify which strategies can lead to competitive advantages by looking at:

- **Defining the industry** – and its boundaries. What are the rules for each industry?
- **Identifying possible competitive moves** – the degree of effectiveness depends on many factors and evolves with the industry life cycle – and is influenced by the moves of rival firms.
- **Selecting among generic strategies** – one thing leads to another – successful strategies rely on a sequence of competitive moves and the room for manoeuvre varies from industry to industry

As in wars, in a competitive, vigorous and dynamic market, companies can expect and are subject to challenge (attack in military terms) from competitors. So, how does a company protect its competitive position? Harvard Business School guru and writer Michael Porter[10] believes that there are several ways for a company to protect itself, or rather its competitive position, from the attacks of rival companies, such as:

- **Shutting off routes that rivals can take in mounting offensive actions** - positioning the company so that its capabilities provide the best defence against the competitive force.
- **Signalling to rival challengers the consequences of an attack with strong retaliation** - influencing the balance of the forces through strategic moves, thereby improving the company's position.
- **Dissuading rivals from attack by foregoing short-term profitability (reducing margins to make the market less attractive) or using a different accounting treatment or policy to obscure real profitability** - anticipating shifts in the factors underlying the forces and responding to them, with the hope of exploiting change by choosing a strategy appropriate for the new competitive balance before opponents recognise it.

"The more different a business is to that of its rivals, the more prospect that there is for achieving a premium pricing advantage."

Table: Examples of the strategic importance of an industry's key economic characteristics

Factor/ Characteristic	Strategic Importance
Market Size	• Small markets tend not to attract big/new competitors; large markets often draw the interest of companies looking to acquire competitors with established positions in attractive industries.
Market Growth Rate	• Fast growth breeds new entry, growth slowdowns spawn increased rivalry and a shake-out of weak competitors.
Capacity surpluses or shortages	• Surpluses push prices and profit margins down; shortages pull them up.
Industry profitability	• High-profit industries attract new entrants; depressed conditions encourage exit.
Entry/exit barriers	• High barriers protect positions and profits of existing firm; low barriers make existing forms vulnerable to entry
Product is a big-ticket item for buyers	• More buyers will shop for lowest price.
Standardised products	• Buyers have more power because it is easier to switch from seller to seller.
Rapid technological change	• Raises risk factor; investments in technology facilities/equipment may become obsolete before they wear out.
Capital requirements	• Big requirements make investment decisions critical; timing becomes important; create a barrier to entry and exit.
Vertical integration	• Raises capital requirements; often creates competitive differences and cost differences among fully versus non-integrated firms.
Economies of scale	• Increases volume and market share needed to be cost competitive.
Rapid product innovation	• Shortens product life cycle; increases risk because of opportunities for leapfrogging.

Factors that affect competitive advantage, and thus the prices you can charge

Factors that affect competitive advantage, and thus the prices you can charge for your products or services, are:

- Competitive jostling for position among rival firms is a dynamic ever-changing process as new organisations initiate new offensives and defensive moves and emphasis swings from one mix of competitive weapons to another.
- The competitive threat that outsiders will enter the market is stronger when entry barriers are low, when firms already in position are lazy or just not inclined to fight vigorously to prevent a new comer from gaining a market foothold and when a new comer can expect to earn attractive profits.
- The competitive threat posed by substitute products in strong when prices of substitutes are attractive, buyer's switching costs are low and buyers believe substitutes have equal or even better features and benefits.
- The supplier to a group of rival firms are a strong competitive force whenever they have sufficient bargaining power to put certain rivals at a competitive disadvantage based on the price they can command, the quality and performance of the items they supply or the reliability of their deliveries.

- Buyers become a stronger competitive force the more they're able to exercise bargaining leverage over price, quality, service, delivery or other terms of sale.
- A company's competitive strategy is increasingly effective the more it provides good defences against the five competitive forces outlined by Porter as well as them influencing the industries competitive rules in favour of the company and it helps to creative sustainable competitive advantage. Industry conditions change because important forces are driving industry participants (competitors, customers or suppliers) to alter their actions – the driving forces in an industry are the major underlying courses of changing industry and competitive conditions.

The task of driving forces analysis is to separate the major causes of industry change from the minor ones – usually no more than three or four factors qualify as driving forces. Managers can use environmental scanning to spot new trends and clues of change that could develop into new driving forces. The macro-environmental perspective is important - for example, if the economic outlook is for a depression, it's no good thinking about launching a range of luxury goods.

Different Strategies for Different Businesses

There are fundamental differences when identifying strategies for a single business company compared with the larger multi-business or diversified company.

The single business company

The basic competitive approach for a single business company[11] should be:

- Do we want to be a cost differentiator - low cost and low price?
- Do we want to be a differentiator - how can we be different other than on price?
- Do we want to focus on a specific market niche?

These are essentially marketing issues as much as they are strategic business issues. With the answers to the above, the business has to be able to respond to changing industry and market conditions as well as other influencing factors such as political and environmental changes. It also has to take into account *how* it intends to make moves to secure its competitive and sustainable advantage in the marketplace.

The key functional strategies for a single business company will be concerned with:

- Manufacturing and operational issues.
- Marketing, sales, promotion and distribution.
- Technology and research and development.
- Human resources, people management and their development.
- The financial implications.

The multi-business/diversified company

Since a diversified company is, by its very nature, a collection of different businesses, making strategy for it is a bigger-picture exercise than for a single-business organisation, because:

- In a single-business organisation, managers need to know about their own industry and their company's competitive position within it.
- In a diversified company, managers need to craft strategies on a multi-business and multi-industry basis and know about the business and industry environments of each element and their company's position in relation to each of them.

The basic competitive approach[12] for a multi-business and diversified company is somewhat different to that of a single business company, you must consider:

- How much diversification?
- What kind of diversification?
- How does the diversification impact on the corporate identity?

Factors that need to be taken into account are:

- How to allocate investment funds across various business units
- When to get out - divesting businesses that are either unprofitable or those that do not fit with the objectives for the organisation as a whole
- When to get in - what new businesses need to be added in industry sectors that are attractive to the organisation as a whole

Effect of Price Changes

Below, is a Table showing the effect of an ***increase*** in your present prices, based on different levels of current margins and amount of price increase proposed. It shows, depending on current margins and amount of the proposed increase, and ***how you can sell less*** but make the same bottom line profit.

	Present Margin on Sales																	
	10%	15%	20%	25%	30%	35%	40%	45%	50%	55%	60%	65%	70%	75%	80%	85%	90%	100%
Increase price by:	To produce the same profit, your sales volume (units, hours sold etc) can decrease by:																	
1%	9%	6%	5%	4%	3%	3%	2%	2%	2%	2%	2%	2%	1%	1%	1%	1%	1%	1%
2%	17%	12%	9%	7%	6%	5%	5%	4%	4%	4%	3%	3%	3%	3%	2%	2%	2%	2%
3%	23%	17%	13%	11%	9%	8%	7%	6%	6%	5%	5%	4%	4%	4%	4%	3%	3%	3%
4%	29%	21%	17%	14%	12%	10%	9%	8%	7%	7%	6%	6%	5%	5%	5%	4%	4%	4%
5%	33%	25%	20%	17%	14%	13%	11%	10%	9%	8%	8%	7%	7%	6%	6%	6%	5%	5%
6%	38%	29%	23%	19%	17%	15%	13%	12%	11%	10%	9%	8%	8%	7%	7%	7%	6%	6%
7%	41%	32%	26%	22%	19%	17%	15%	13%	12%	11%	10%	10%	9%	9%	8%	8%	7%	7%
8%	44%	35%	29%	24%	21%	19%	17%	15%	14%	13%	12%	11%	10%	10%	9%	9%	8%	7%
9%	47%	38%	31%	26%	23%	20%	18%	17%	15%	14%	13%	12%	11%	11%	10%	10%	9%	8%
10%	50%	40%	33%	29%	25%	22%	20%	18%	17%	15%	14%	13%	13%	12%	11%	11%	10%	9%
11%	52%	42%	35%	31%	27%	24%	22%	20%	18%	17%	15%	14%	14%	13%	12%	11%	11%	10%
12%	55%	44%	38%	32%	29%	26%	23%	21%	19%	18%	17%	16%	15%	14%	13%	12%	12%	11%
13%	57%	46%	39%	34%	30%	27%	25%	22%	21%	19%	18%	17%	16%	15%	14%	13%	13%	12%
14%	58%	48%	41%	36%	32%	29%	26%	24%	22%	20%	19%	18%	17%	16%	15%	14%	13%	12%
15%	60%	50%	43%	38%	33%	30%	27%	25%	23%	21%	20%	19%	18%	17%	16%	15%	14%	13%
16%	62%	52%	44%	39%	35%	31%	29%	26%	24%	23%	21%	20%	19%	18%	17%	16%	15%	14%
17%	63%	53%	46%	40%	36%	33%	30%	27%	25%	24%	22%	21%	20%	18%	18%	17%	16%	15%
18%	64%	55%	47%	42%	38%	34%	31%	29%	26%	25%	23%	22%	20%	19%	18%	17%	17%	15%
19%	66%	56%	49%	43%	39%	35%	32%	30%	28%	26%	24%	23%	21%	20%	19%	18%	17%	16%
20%	67%	57%	50%	44%	40%	36%	33%	31%	29%	27%	25%	24%	22%	21%	20%	19%	18%	17%
21%	68%	58%	51%	46%	41%	38%	34%	32%	30%	28%	26%	24%	23%	22%	21%	20%	19%	17%
22%	69%	59%	52%	47%	42%	39%	35%	33%	31%	29%	27%	25%	24%	23%	22%	21%	20%	18%
23%	70%	61%	53%	48%	43%	40%	37%	34%	32%	29%	28%	26%	25%	23%	22%	21%	20%	19%
24%	71%	62%	55%	49%	44%	41%	38%	35%	32%	30%	29%	27%	26%	24%	23%	22%	21%	19%
25%	71%	63%	56%	50%	45%	42%	38%	36%	33%	31%	29%	28%	26%	25%	24%	23%	22%	20%
26%	72%	63%	57%	51%	46%	43%	39%	37%	34%	32%	30%	29%	27%	26%	25%	23%	22%	21%
27%	73%	64%	57%	52%	47%	44%	40%	38%	35%	33%	31%	29%	28%	26%	25%	24%	23%	21%
28%	74%	65%	58%	53%	48%	44%	41%	38%	36%	34%	32%	30%	29%	27%	26%	25%	24%	22%
29%	74%	66%	59%	54%	49%	45%	42%	39%	37%	35%	33%	31%	29%	28%	27%	25%	24%	22%
30%	75%	67%	60%	55%	50%	46%	43%	40%	38%	35%	33%	32%	30%	29%	27%	26%	25%	23%

The Table below shows the effect of a ***decrease*** in your present prices, based on different levels of current margins and amount of price decrease proposed, and ***how you need to sell more*** just to make the same bottom line profit.

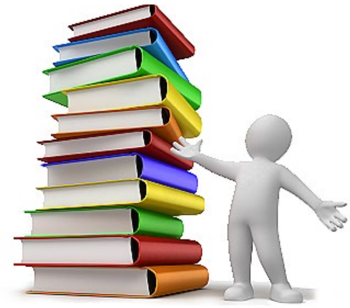
	Present Margin on Sales																	
	10%	15%	20%	25%	30%	35%	40%	45%	50%	55%	60%	65%	70%	75%	80%	85%	90%	100%
Decrease price by:	To produce the same profit, your sales volume (units, hours sold etc) must increase by:																	
1%	11%	7%	5%	4%	3%	3%	3%	2%	2%	2%	2%	2%	1%	1%	1%	1%	1%	1%
2%	25%	15%	11%	9%	7%	6%	5%	5%	4%	4%	3%	3%	3%	3%	3%	2%	2%	2%
3%	43%	25%	18%	14%	11%	9%	8%	7%	6%	6%	5%	5%	4%	4%	4%	4%	3%	3%
4%	67%	36%	25%	19%	15%	13%	11%	10%	9%	8%	7%	7%	6%	6%	5%	5%	5%	4%
5%	100%	50%	33%	25%	20%	17%	14%	13%	11%	10%	9%	8%	8%	7%	7%	6%	6%	5%
6%	150%	67%	43%	32%	25%	21%	18%	15%	14%	12%	11%	10%	9%	9%	8%	8%	7%	6%
7%	233%	88%	54%	39%	30%	25%	21%	18%	16%	15%	13%	12%	11%	10%	10%	9%	8%	8%
8%	400%	114%	67%	47%	36%	30%	25%	22%	19%	17%	15%	14%	13%	12%	11%	10%	10%	9%
9%	900%	150%	82%	56%	43%	35%	29%	25%	22%	20%	18%	16%	15%	14%	13%	12%	11%	10%
10%	Note	200%	100%	67%	50%	40%	33%	29%	25%	22%	20%	18%	17%	15%	14%	13%	13%	11%
11%	Note	275%	122%	79%	58%	46%	38%	32%	28%	25%	22%	20%	19%	17%	16%	15%	14%	12%
12%	Note	400%	150%	92%	67%	52%	43%	36%	32%	28%	25%	23%	21%	19%	18%	16%	15%	14%
13%	Note	650%	186%	108%	76%	59%	48%	41%	35%	31%	28%	25%	23%	21%	19%	18%	17%	15%
14%	Note	1400%	233%	127%	88%	67%	54%	45%	39%	34%	30%	27%	25%	23%	21%	20%	18%	16%
15%	Note	Note	300%	150%	100%	75%	60%	50%	43%	38%	33%	30%	27%	25%	23%	21%	20%	18%
16%	Note	Note	400%	178%	114%	84%	67%	55%	47%	41%	36%	33%	30%	27%	25%	23%	22%	19%
17%	Note	Note	567%	213%	131%	94%	74%	61%	52%	45%	40%	35%	32%	29%	27%	25%	23%	20%
18%	Note	Note	900%	257%	150%	106%	82%	67%	56%	49%	43%	38%	35%	32%	29%	27%	25%	22%
19%	Note	Note	Note	317%	173%	119%	90%	73%	61%	53%	46%	41%	37%	34%	31%	29%	27%	23%
20%	Note	Note	Note	400%	200%	133%	100%	80%	67%	57%	50%	44%	40%	36%	33%	31%	29%	25%
21%	Note	Note	Note	525%	233%	150%	111%	88%	72%	62%	54%	48%	43%	39%	36%	33%	30%	27%
22%	Note	Note	Note	733%	275%	169%	122%	96%	79%	67%	58%	51%	46%	42%	38%	35%	32%	28%
23%	Note	Note	Note	1150%	329%	192%	135%	105%	85%	72%	62%	55%	49%	44%	40%	37%	34%	30%
24%	Note	Note	Note	Note	400%	218%	150%	114%	92%	77%	67%	59%	52%	47%	43%	39%	36%	32%
25%	Note	Note	Note	Note	500%	250%	167%	125%	100%	83%	71%	63%	56%	50%	45%	42%	38%	33%
26%	Note	Note	Note	Note	650%	289%	186%	137%	108%	90%	76%	67%	59%	53%	48%	44%	41%	35%
27%	Note	Note	Note	Note	900%	338%	208%	150%	117%	96%	82%	71%	63%	56%	51%	47%	43%	37%
28%	Note	Note	Note	Note	1400%	400%	233%	165%	127%	104%	88%	76%	67%	60%	54%	49%	45%	39%
29%	Note	Note	Note	Note	Note	483%	264%	181%	138%	112%	94%	81%	71%	63%	57%	52%	48%	41%
30%	Note	Note	Note	Note	Note	600%	300%	200%	150%	120%	100%	86%	75%	67%	60%	55%	50%	43%

Note: Where the narrative states "See Note", the business is in crisis as either no margin on sales is enjoyed at all or sales are made at less than cost

Recommended Reading

The following books will provide additional learning and advice on the question of how to price what you sell:

- **The Strategy and Tactics of Pricing: A Guide to Profitable Decision Making** - by Thomas T. Nagle, Reed K. Holden, published by Pearson; ISBN: 0136693768
- **Power Pricing: How Managing Price Transforms the Bottom Line** - by Robert J. Dolan, Hermann Simon (Contributor), published by Free Press; ISBN: 068483443X
- **How Much Should I Charge?: Pricing Basics for Making Money Doing What You Love** - by Ellen Rohr, published by Max Rohr, Inc.; ISBN: 0966571916
- **Pricing: Policies and Procedures** - by Robert Dodge, Robert & Nessim Hanna, published by Palgrave (formerly Macmillan Press); ISBN: 0333694139
- **Pricing for Profit** - by M Pullen, published by Kogan Page ISBN: 0749408324
- **Making Pricing Decisions** - by Adamantios Diamantopoulos and Brian Mathews, published by International Thomson Business Press; ISBN: 0412492407
- **Rule of Thumb (The Standard of Pricing in Small Businesses)** - by Chad Simmons, published by Partners Publishing Group; ISBN: 0966192311
- **Value Pricing (How to Price Products and Services)** - by Tony Fletcher and Neil Jones, published by Kogan Page; ISBN: 074942043X



Final Comments and Further Information

The pricing of goods and services in all types of business is similar in several basic ways. Most businesses arrive at pricing decisions based on cost-plus, that is, adding together the costs of providing the product or service and adding to it a sum for profit.

Cost-plus pricing techniques don't take customer demand into account, so this approach may not be successful as the price may not be what customers are willing to pay. The key to success is to have a well-planned strategy, establish your policies, and constantly monitor prices and operating costs to ensure you make adequate profits. Keep a watchful eye for changes in the marketplace because they can affect your competitiveness and profit margins.

No one pricing formula will produce the greatest profit under all circumstances - to price for maximum profit, as a business owner or manager you must understand the different types of costs and how they behave. You must have a clear knowledge of current market conditions at all times since the "right" selling price for a product under one set of market conditions may be the wrong price at another time. The "best" selling price should be cost orientated and market orientated. It should be high enough to cover your costs and help you make a profit. It should also be low enough to attract customers and build sales volume.

Perhaps the smartest pricing strategy of all is to offer customers a unique bundle of products and services that exactly meet their needs - thus making it nearly impossible for them to make price comparisons with your competitors' offerings.

This guide is for general interest - it is always essential to take advice on specific issues. We believe that the facts are correct as at the date of publication, but there may be certain errors and omissions for which we cannot be responsible.

References:

[1] The paper published by the Bank of England can be found at: www.bankofengland.co.uk/workingpapers/wp67.pdf

[2] Derived from Marketing Management: Knowledge & Skills, by J. Paul Peter and James H. Donnelly, published by McGraw-Hill Higher Education; ISBN: 0072315571

[3] The definition of "Marketing" from the Chartered Institute of Marketing

[4] See: “Competitive Strategy: techniques for analysing industries and competitors”, by Michael E Porter, published by Free Press, New York, 1980, Chapter 2.

[5] See: “Value chain analysis”, a Good Practice Guideline, published by the ICAEW Faculty of Finance and Management, December 1997, ISBN 1-85355-648-3, page 4; and “Strategic cost management”, by J S Shank and V Govindarajan, published by Free Press, New York, 1993.

[6] See: “Strategic Management: Concepts and cases”, by Arthur A Thompson and A J Strickland, published by Irwin, 1996, ISBN 0-256-16205-0, Page 118, Chapter 5. Another perspective of this is provided in: “Strategic Management: Concepts and cases”, by P Wright, M J Kroll and J Parnell, published by Prentice Hall, 1996, ISBN 0-13-362815-9, pp 174-175.

[7] See: "What is Strategy", an article in Harvard Business Review, by Michael E Porter, November/December 1996, p 64.

[8] Ibid pp 68/9.

[9] See: “The Handbook of Business Strategy: 1986-87 Year Book”, by Xavier Gilbert and Paul Strebel et al, edited by D Guth; and “The Strategy Process: Concepts, Contexts and Cases”, by B J Quinn, H Mintzberg, and R M James, published by Prentice Hall, 1988, ISBN 0-13-850892-5 01.

[10] See: “Competitive Advantage”, by Michael E Porter, published in 1985 by Free Press, New York, pp 489-494. See also “Strategic Management: Concepts and cases”, by Arthur A Thompson and A J Strickland, published by Irwin, 1996, ISBN 0-256-16205-0, pp 141-142, Chapter 5.

[11] See Page 41, "Strategic Management: Concepts and cases", by Arthur A Thompson and A J Strickland, published by Irwin, 1996, ISBN 0-256-16205-0

[12] See Page 40, "Strategic Management: Concepts and cases", by Arthur A Thompson and A J Strickland, published by Irwin, 1996, ISBN 0-256-16205-0

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