

# Pricing your product or service



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**How much are you going to charge your customers for your product or service? Getting your pricing right could double your profits at a stroke.**

Many start-up businesses work out a cost figure for each product and add a modest mark-up — known as cost-plus pricing. While this method is common, it is not the only way to arrive at a price. Invest serious thought into your pricing methodology at an early stage — it can pay big dividends later.

Pricing is based on three critical points:

- What your product or service will be worth to your customers — its value.
- What it costs you to produce your product or provide your service.
- The price your competitors charge.

## 1 Cost and price versus value

**1.1** Successful businesses maximise their profits by matching their pricing with the **value** customers put on their products or services.

- The cost is the total outlay required to create a product or service.
- The price is your financial reward for providing the product or service.
- The value is what the customer thinks the product or service is worth.  
For a plumber to fix a burst pipe, it may be £5 for travel, £3 for materials and £10 for one hour's labour. But the value to the customer is far greater than the £18, so a plumber may charge up to £50.  
Computer printer ink cartridges can cost less than £5 to manufacture. However, to

the user who can't print without them, their value is much higher. And so is the price.

**1.2 Product pricing** is often built on a 'cost-plus' basis (see **4**), while service pricing is generally created on perceived value (see **6–8**).

However, both methods require a complete understanding of costs and the competition.

## 2 Building a cost structure

Your cost structure provides a basis for what you need to charge. But it will not necessarily show you what you can — and should — charge.

**2.1 Divide** your costs under two headings: variable and fixed.

- Variable costs will increase when your sales increase (eg goods and materials).
- Fixed costs remain largely constant, regardless of how much or little you sell (eg rent, salaries, business rates).

**2.2** As long as the price you sell at is higher than the variable cost, each sale will make a **contribution** towards covering fixed costs — and making profits.

- For example, a car dealership has variable costs of £9,000 per car sold and total fixed costs of £200,000 a year.  
The contribution required depends upon the volume of sales. If the company sells 80 cars each year, it needs a contribution of at least £2,500 per car (ie £200,000 divided by 80) to avoid making a loss.

**2.3** Based on this cost structure, the company can assess the **consequences** of different price levels.

- Selling the cars at less than £9,000 (the variable cost per car) is suicidal. The more you sell, the more money you lose. Selling 80 cars at £9,000 will mean a loss of £200,000 per year, as none of the fixed costs will be paid for.  
Selling cars at £11,500 will result in breakeven, assuming the target 80 cars are sold. If more or fewer than 80 are sold, profits will be correspondingly higher or lower.

### 3 Checking the competition

It is certain that you will face competition in some form. This gives you an opportunity to benchmark your potential pricing.

**3.1** Phone your rivals and ask for a price **quote**.

- If your competitors know you, get someone else to call.

**3.2** Use this **information** as a framework. It is probably unwise to set your prices too much lower or higher without good reason.

- Too low and you will throw away profit.
- Too high and you will lose customers, unless you can offer them something not available elsewhere.

#### Dangers of cost-plus pricing

While cost-plus is the model employed by many start-ups, be aware of its pitfalls.

- Cost-plus pricing ignores the image and market position you will be aiming for.
- Cost-plus pricing ignores demand.
- Some hidden costs are usually forgotten, so true margins may be lower than you realise.
- Common oversights include holiday pay, depreciation and costs of handling waste.
- Cost-plus pricing assumes that you will achieve a sales target to breakeven or better.
- Competitors can lower prices to win business from you by having a lower cost base or working on lower margins.

## 4 Marking up

**4.1 Cost-plus** pricing is a traditional method, usually based on two elements:

- The mark-up you must add to the cost to make the desired profit, and
- The mark-up used by competitors.

The mark-up is usually expressed as a percentage of the cost.

**4.2** Ensure all your costs (see **2**) have been factored in **before** applying the mark-up.

- If the final price looks uncompetitive, review the size of the mark-up. Never obliterate the mark-up to make the price competitive. Try to change the cost base rather than give up potential profit.

**4.3** Different products and businesses apply hugely different mark-ups. For example, **retail mark-ups** include:

- Fridges: cost plus 25 per cent.
- Branded clothing: cost plus 135 per cent.
- Jewellery: cost plus 250 per cent or more.

## 5 Margins

**5.1** Margins indicate the percentage **profit** a business makes after applying a mark-up.

- For example, if a business buys a product for £10 and marks it up by 50 per cent, thus selling it for £15, the margin is 33 per cent (the value of the mark-up, divided by the selling price x 100).

**5.2** Margins are **good barometers** of how important particular products or services are to the profitability of your business.

- The higher the margin, the more lucrative it could be.
- Low-margin, low-volume products should not occupy large chunks of your time or storage space at the expense of higher-margin products.

## 6 Value-based pricing

The alternatives to cost-plus pricing focus on what customers are willing to pay.

This perceived-value pricing takes a number of forms:

- 6.1 Convenience** — a late-night convenience store can charge much more than a supermarket for a pint of milk.
- 6.2 Brand** — there may be little to choose in technical terms between a branded and an unbranded product, but big spenders will go straight for the expensive product if the brand is well marketed.
- 6.3 Fashion** — some people will pay a premium for hot items (eg the latest trainers or cars).
- 6.4 Monopolies and cartels** — if one company, or group of companies, exclusively supplies a product or service, it can set its own prices.
- 6.5 Pure perceived value** — fine art is a good example. A sculpture is priced at £20,000 or £60,000 based on its estimated value to the purchaser, rather than simply the cost of its creation.
- 6.6 Supply and demand** — tickets for top-level sports events can be highly priced

as there will be more committed potential customers than available seats.

- Higher prices can give you fat profits. But beware — they may also alienate customers and draw in new competitors who fancy a share of the spoils.

## 7 Flexible pricing

**7.1** Should you use **different margins** for different items, as department stores do?

- You may want higher margins on products with low unit costs or slow turnover, and on products that take up a lot of space.

**7.2** Is demand **seasonal**?

- It costs more to go on holiday in the summer and over Christmas than in March.

**7.3** Will some customers pay a **premium**? This strategy can be extremely profitable.

- For example, a plumber may offer low daytime prices (to ensure a full workload), but charge heavily for emergency call-outs (when customers will pay much more).

### Discount with care

Offering too many discounts can lead customers to question your full-rate pricing. But, used sparingly, discounting can work if it achieves one of the following objectives:

- A** Capture big orders with a **bulk** discount.
- It may cost you a little extra to process a much larger order.
- B** Persuade customers to buy during your quiet period with an **off-peak** discount.
- C** Encourage your customers to stick to one supplier through a **cumulative** discount (or retrospective discount).
- Your records should show a rolling total, indicating how much each major customer has bought.
- D** Match the competition, for example by offering the standard **trade** discounts.
- E** Get rid of old stock (and improving cashflow) with **clearance** discounts.
- F** Encourage early payment with discounts for **cash** or payment within 30 days.

## 8 Vanishing opportunities

Some goods and services are valuable today and worthless tomorrow. Your pricing should reflect the situation.

**8.1 Perishable** goods are worthless after their sell-by date.

- If you sell off goods cheaply, ask yourself if the same customers would have bought full-price items.

**8.2** Many products gradually become **obsolete** as improved models become available or as fashions change.

**8.3** If you have to sell off goods cheaply, explain the reason for the special offer. If your story is plausible, your customers will still have **faith** in your everyday pricing.

- Offer the goods at special prices to regular customers first to generate goodwill.

## 9 Aim high

**9.1** It is easier to **reduce** prices than raise them.

- If in doubt, try higher prices first.
- Be prepared to lower prices if the required sales volume is not achieved and your cashflow is under pressure.

**9.2** Low prices often go hand-in-hand with poor quality and service. Is this the **image** you want to create?

- Some companies can win more customers (as well as boosting their margins) by putting their prices up.

**9.3** For a start-up, competing on price is often a **mistake**. Low pricing is more often a strategy of big companies that cannot compete on service.

- What you will be able to offer is a string of benefits such as convenience, speedy delivery and specialist skills.
- Many small firms underprice in order to 'build up sales'. Aim to build up profits instead — the buying decision is rarely made purely on price.

## 10 Special tactics

There may be times when the right price is dictated by factors other than cost or perceived value. Tactical pricing can be used to achieve many different objectives.

**10.1 Odd value** — the retailer's habit of selling something for £9.99 instead of £10.

- This signals price awareness and is useful in creating a favourable impression to cost-conscious customers.

**10.2 Loss leaders** — selling some products cheaply to win new customers.

- You may include a couple of zero mark-up products in your range for this purpose. Or you may offer lower prices to new customers, reverting later to normal prices.

**10.3 Price war** — deliberately undercutting rivals to win market share from them.

- Will it hurt you more than it hurts them? If you are a start-up, the competition may have deeper pockets than you.
- Will your new customers stay with you when the prices go back up?

**10.4 Skimming** — selling a unique product at a high price until all customers who need it have bought it.

**10.5 Penetration** — the opposite of skimming.

- This tactic involves starting a product at a low price and getting the market sewn up before competitors can catch up with you.
- With significant market share under your belt, you find ways to raise prices later.

## 11 Trading up

**11.1** Work out realistically how your customers would react to **higher** prices.

- Would you lose volume — or customers? (Remember lower volumes at higher margins can still magically improve profit.)
- Discuss it with customers beforehand. The key to success is having a good relationship with them in the first place.

**11.2 Sell yourself.**

- Make sure customers know why they are buying from you rather than a competitor.

**11.3 Explain** the reasons behind your prices.

- Remember to attribute part of your price to the cost of providing high-quality back-up and after-sales service.

**11.4** Unreasonably high prices can destroy **goodwill**, especially if the customer has no immediate alternative supplier.

## 12 Other considerations

**12.1** Would more **marketing** muscle help?

- Would sales rise if you increased prices by 5 per cent and spent the extra revenue on promotional activity?

**12.2** Control your **variable** costs.

- Are there cheaper supplies elsewhere?
- Would the suppliers you have already lined up be prepared to drop their prices?

**12.3** Can **fixed** costs be pared down?

- What could you negotiate?

**12.4** Should you alter your **product mix**?

- If you cannot make enough profit on a product, consider dropping it.

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