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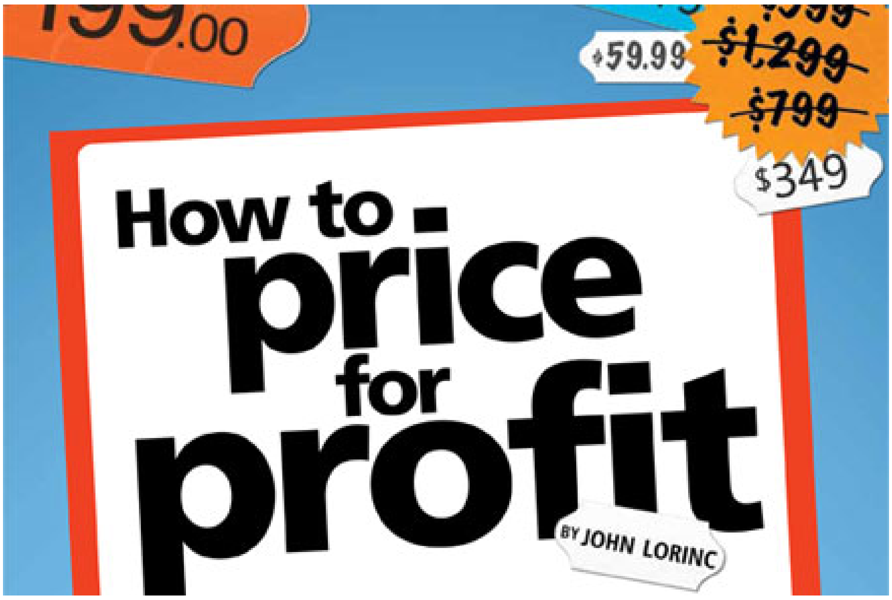
How to Price for Profit

Most companies have no idea what their products or services are really worth. Yet raising your price by just 5% can double your profits. Here is how to make sure your price is right

John Lorinc || February 11, 2013



In the age of Black Friday megasales, ubiquitous smartphones and "big data" mining, the pricing wars have shifted onto an entirely different battlefield. And both shoppers and vendors are turning to high-tech weapons.

On the consumer side, buyers have access to apps and websites that give them real-time price comparisons, but companies such as Decide.com are taking that up a notch. By grinding up historical pricing data for electronics, appliances and other goods, the Seattle-based app maker enables users to game out the timing of their purchases to coincide with low-ebb periods (which, as it turns out, don't necessarily occur during traditional sales blitzes).

Retailers like Wal-Mart and Target are responding by applying mathematical formulas to shopper psychology, luring us in with a $9.99 backpack but knowing we'll also buy two shirts and a lunch Thermos for our child. Amazon.com, one of the sharpest players in this arena, taps so-called "dynamic pricing" algorithms that adjust list prices to individual buyers based on such factors as the value of their past purchases.

Where does this leave small companies? Having to raise their game significantly in how they set prices for their goods or services.

Pricing tricks are nothing new, of course (and have, at times, attracted scrutiny from regulators). Wedding dressmakers and funeral homes have long trowelled on markups, knowing that emotionally charged occasions dull consumers' price sensitivity. Mattress retailers demand that their suppliers produce "exclusive" lines to make it tougher for buyers to compare deals on a given model. Restaurants sell the same high-end wines at wildly different prices, depending on the clientele they're serving.

But in the past few years, the rules of engagement have changed radically. "New competitors are coming out of the woodwork far more than in the past," says marketing consultant Lisa Shepherd, president of Toronto's Mezzanine Group. Often, they have more efficient business models that undercut existing services. Yet, pricing strategy tends to be treated with less rigour than it deserves.

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The problem is certainly not limited to small businesses. Only 15% of companies conduct pricing research, according to a McKinsey & Co. survey of businesses of various sizes. A 2012 study published in MIT Sloan Management Review pointed out that fewer than one in 20 Fortune 500 firms have departments responsible for price-setting strategy. Andreas Hinterhuber, an Austrian pricing expert and co-author of the MIT study, says that most SMEs tend to set their prices based on their costs or what the competition charges. By slavishly matching rivals' prices, he says, "you completely abdicate pricing [control] and let someone else dictate your destiny." In general, he continues, "pricing is undermanaged, in both small and large companies."

The biggest issue is businesses' failure to analyze systematically what customers are willing to pay. "Most people know they should price to value," observes Jean-Manuel Izaret, the global pricing practice leader at Boston Consulting Group, "but they have no clue how to get there."

To take more control over this aspect of your business, Hinterhuber suggests you start by clearly articulating the meaningful differences between your offerings and those of competitors. The process should involve asking clients about your firm's "unique strengths," he says, as well as their unfilled needs. Such feedback will help you determine if your firm has built a competitive advantage over its rivals and thus has room to raise prices without sacrificing market share.

When you do this kind of analysis, Hinterhuber cautions, you should include your sales team, in order to ensure your front-line reps are using techniques that reinforce the price points by focusing on the added value of your product or service. This also helps salespeople resist customer pressure for discounts, he says.

The payoff? Consultant Andrew Gregson, who runs Pricing Strategies in Kelowna, B.C., explains that because most companies aim for a 3% to 5% pre-tax margin, raising prices by just 5% can double annual profits. "If small firms could treat pricing as a science and a profit generator," he says, "they would do a lot better."

Herewith, a primer on the latest thinking about the art and science of pricing.

CUSTOMER-VALUE PRICING

Every moviegoer and commuter knows that for certain goods—theatre popcorn, gas on a long weekend—vendors will charge outrageous prices simply because they can. But there's another approach to charging what the market will bear, one that seeks to establish a strong link between your price and the value you deliver.

In fact, as much as any marketing program or advertising campaign, the price of a product or service provides your customer with a critical piece of information about brand and value, and acknowledges that psychology always plays a role. "Pricing often gets overlooked as a tactic for differentiating your product," says Brynn Winegard, a Toronto marketing consultant and professor at Ryerson University. "If your price is a little bit more [than the competition], people will believe you're a little bit better."

Consumer-goods manufacturers such as Apple or Canada Goose have perfected this tactic, charging lofty prices and refusing to discount. Others opt to segment their markets into different tiers of potential buyers. Many successful apparel brands, for example, produce low-cost, mid-range and high-end lines, and then funnel them through the appropriate distribution channels (outlet malls, department stores and high-end boutiques, respectively).

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In the service, technology and business-to-business sectors, the value-pricing strategy is more complex. Shepherd says that once you have benchmarked your company against its direct competitors, you should ask three key questions:

How much will my customers save if they opt to purchase my service?

What will it cost me to deliver that service?

What is my customer's ability to pay?

She cites the example of a consulting firm whose project promises to save the client millions of dollars each year. In such a case, the supplier would be wise to align the price with the expected savings to the client, to reinforce the message about the value being delivered.

But you may have other strategic objectives besides maximizing your margins, such as signing up a prestigious client. If you want to build market share or do business with a customer that can't afford your listed fee, says Shepherd, you may have to drop or segment your price.

BUNDLING & PRICING WATERFALLS

Telecom and fast-food giants have relied for years on bundling as a price strategy: if you package a low-margin product (cellphone, hamburger) with a high-margin one (minutes plan, soft drink), the result is an acceptable profit.

For smaller firms, successful bundling often takes the form of a product tied to a service contract that delivers ongoing and predictable revenue. Shepherd mentions a client that manufactures hospital equipment. The firm's problem was that it made only one-time money on the product sale, which included installation. Shepherd's company persuaded the firm to lower its product price, from the $50,000 range to just $20,000, but then bundle the equipment with a one-year maintenance package. That shift allowed the client to win new sales in markets where it hadn't been successful previously, such as smaller hospitals. "The target market couldn't swallow the capital outlay," says Shepherd.

Read: **Case Study: Distility—A nebulous service? Charge a concrete price**

The reverse of this strategy is to unbundle things you give away for free. Many SMEs could learn pricing tactics from the airline industry, says Gregson. In the past decade, most carriers have responded to intense competition by trying to lower prices, but then charge optional fees for extra baggage, meals and so on.

The point is that many companies give away little things, such as tech support, a no-hassle, money-back exchange policy or free shipping. This is known as the "pocket pricing waterfall," which, in the aggregate, can gobble up about 1% of realized prices. "If you pick those apart," Gregson says, "you will be able to improve your profits without changing your prices."

VARIABLE PRICING

Once upon a time, travellers used to wait for last-minute seat sales in the knowledge that airlines would slash prices to fill their planes. But easyJet, the European discount carrier, changed that equation with a simple pricing rule designed to push customers to make bookings. Over time, the price of a ticket would always rise, thereby providing customers with a financial incentive to be decisive.

In theory, says Brock University marketing professor Eric Dolansky, such "dynamic pricing" can allow consumers to feel a greater sense of control over the purchase price, knowing, for example, that buying now instead of later will yield savings. Yet after studying the response to variable pricing, Dolansky found that consumers will tolerate changes only if they are predictable. "If customers can't make sense of prices, they're more likely to disapprove."

The variable approach has gained traction in a range of sectors in recent years. Among them are sports and entertainment venues, car-rental agencies, hotels and seasonal attractions such as theme parks or ski resorts.

THE GROUPON EFFECT

Bikes on Robson is a modest storefront in a slightly out-of-the-way location in Vancouver's west end. When Sam Shah bought the shop a little over a year ago, he played it safe by sticking close to prevailing rates in his prices for rental and gear. As he looked to spread the word, he decided to promote the business through Groupon, the massive e-couponing site. So, early last spring, he offered a limited number of 50% off deals for $50 tune-ups, restricting the number of purchases to one per customer (plus two coupons that a customer could hand out as gifts). He sold a respectable 130.

But big sales weren't the point. Shah sees Groupon as free advertising, as well as a means of driving business into the store during the off-season. "It's great for starting companies, so they can get the word out there," he says.

Pricing experts say Groupon and other group-buying services are useful for creating word-of-mouth buzz and building market presence. But you should ensure that your offers are limited, so customers don't develop an entirely discount based relationship with your business. Many companies have been burned by Groupon, partly because consumers come to expect deep discounts on each encounter, but also because a small business may have trouble handling the traffic generated by the high-volume site.

Groupon, says Izaret of Boston Consulting, allows small operators to tell enormous numbers of potential customers about their business, but such influx is only sustainable if the company is earning a profit on each sale or has a strategy for shifting the new customers to a higher price point. "It depends on where you are in the life stage of a small business," he says. He cites the example of struggling restaurants that offer Groupon deals and end up losing money on each discounted meal while turning off loyal customers who don't like the resulting crowds. "For many businesses," says Izaret, "it would be a big mistake."