

The Secrets Of Pricing For Profit

Economists claim that prices are set by markets. But they are wrong.

Prices are set by people running businesses. People like you. And they are among the most important decisions you will ever make. Get them right and you could be on the road to fame and fortune. But get them wrong and your business will be doomed to failure.

Why so many businesses get it wrong

To prove that setting your prices is one of the most important things you will ever do, let's start by looking at an example.

Example

Last month WidgetCo made £500 profit selling 1,000 Widgets.

Last Month's Profit and Loss Account

		£
Sales	(1,000 Widgets at £10 each)	10,000
Deduct: cost of sales	(1,000 Widget at £7 each)	(7,000)
Gross profit		<u>3,000</u>
Deduct: fixed overheads		(2,500)
Profit		<u><u>£ 500 profit</u></u>

WidgetCo has commissioned some market research, which suggests that they have two options:

Option A - They could increase their sales volume by 20 per cent if they reduced prices by 10 per cent to £9, or

Option B - They could put up their prices by 10 per cent to £11, but then would lose 20 per cent of their sales volume.

When we ask them what WidgetCo should do, most entrepreneurs have no hesitation in saying something like: "Go for option A. It is always worth selling more, and anyway, WidgetCo gains more in volume than it loses in price, so it must be profitable".

Are they right? Unfortunately not. And it's precisely because so many people get this question wrong that their businesses get into very real trouble.

So let's continue with our example by seeing what WidgetCo's profits will be next month under each of the two options.

Next Month's Profit and Loss Account – Option A reduce price

		£
Sales	(1,200 Widgets at £9 each)	10,800
Deduct: cost of sales	(1,200 Widget at £7 each)	(8,400)
Gross profit		<u>2,400</u>
Deduct: fixed overheads		(2,500)
Loss		<u><u>£ (100) loss</u></u>

Next Month's Profit and Loss Account – Option B increase price

		£
Sales	(800 Widgets at £11 each)	8,800
Deduct: cost of sales	(800 Widget at £7 each)	(5,600)
Gross profit		<u>3,200</u>
Deduct: fixed overheads		(2,500)
Profit		<u><u>£ 700 profit</u></u>

As you can see, under option A (i.e. the price cut) WidgetCo makes a loss and is heading for disaster. It is actually worse off than it was before the price cut. And it is much worse off than it would have been if it had increased its prices.

There is nothing very special or unusual about this example. It simply illustrates a fundamental point that is all too often overlooked: *stimulating sales by cutting prices may boost your top line turnover, but it can just as easily devastate your bottom line profits.*

Like many other companies, WidgetCo will not only be able to generate bigger profits by increasing its prices. But by reducing its sales it will also need less cash to finance debtors and stocks, and by eliminating customers at the cheaper end of the spectrum, it will probably reduce the amount of money it loses as bad debts.

As a result, when it increases its prices WidgetCo becomes a leaner, fitter business, providing a higher rate of return using less working capital. In contrast, when it cuts prices under Option A it becomes a lame duck. Choosing the right pricing strategy can be the difference between success and failure. Is your business an Option A or an Option B company?

There may, of course, be times when you can *prove* that lower prices will lead to higher profits. For example, in the case of WidgetCo, Option A's 10 per cent price cut could have been more profitable than Option B's 10 per cent price rise, but *only* if it led to at least an 80 per cent increase in the number of Widgets sold! Ask yourself, is that likely?

All of this illustrates the general rule very nicely: if you can *prove* that the demand for your products is very sensitive to changes in price, then cutting your prices may increase your profits.

But never, never, never simply accept the naïve equation much loved by salesmen that:

Lower prices = Higher sales = Higher profits.

The truth is that convenience, habit, concerns over quality, and the "better the devil you know than the one you don't know" syndrome, all make many customers reluctant to switch allegiances for the sake of a few pence or per cent in price. If you don't believe it, ask yourself a few questions. How often do you switch your allegiances from a favourite supermarket, garden centre, pub or restaurant just because a new one has opened up offering slightly lower prices? How often do you even realise that they do offer lower prices? How often are you prepared to pay just that little bit more for a product or service that you know, understand and are happy with?

So if you want simple equations, try these two instead:

Lower prices = Lower profits (until proven otherwise)

Higher prices = Higher profits (until proven otherwise)

Pricing for maximum profit

Customers care about prices. But they are certainly not the only thing they care about - and your business and marketing strategy should mirror that fact.

In other words, you should never compete on price alone. Instead you should start by making sure that what you are offering exactly meets the needs of your customers. And then you should sell it to them on the basis of "best value" rather than "lowest price".

What is "best value"? As we see it, "value" is the gap between the benefits a customer perceives he is getting and the price he perceives he is paying. So offering "best value" means offering a bigger gap than anyone else.

The three keys to offering best value are to make sure that:

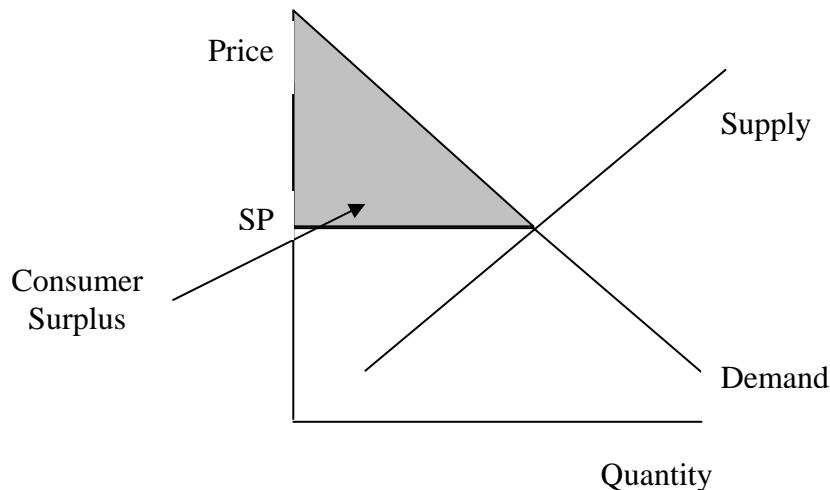
- 1 Your products and services are exactly what your customers need and want – i.e. they offer the best and most appropriate combination of benefits
- 2 Your customers fully understand those benefits – i.e. because unless they understand that what you have to offer is special, they will assume it is average, and that means that you'll only be able to charge an average price
- 3 Your prices are presented in the best possible light

Get these 3 things right and customers will happily pay you more than ever before.

Different prices

How do you cope with the fact that some customers are willing to pay more than others?

Economists tell us that the market price is set by supply and demand. We can show this graphically...



In the above graph, SP is your standard selling price. But the problem is that having only one selling price causes you to lose out in 2 different ways...

1. for some customers that price is too high – so they don't buy, and you lose them as a customer, and
2. for other customers that price is too low – so you end up charging them less (and earning less profit) than they are willing to pay. Which means you lose again.

Economists call the amount by which you lose in this second scenario the “consumer surplus” – and it is shown by the shaded area on this graph.

The consumer surplus represents the individuals who are both willing and able to pay more for your product or service than you are charging them.

One of the keys to dramatically improving your profits is to claw back some of this consumer surplus by charging different customers different prices. This is often called ‘price discrimination’. And this is exactly what publishers do with hardcover and paperback books.

Many people believe that hardcover books are about twice the price of paperback books because it costs twice as much to print a hardcover book. In fact the difference in production costs are minimal. Publishers have recognised that some people are prepared to pay substantially more for a book in order to buy it as soon as it is published. But more price sensitive consumers are prepared to wait for the paperback version.

Ask us about our *Business Edge* programme to discover 9 ways to charge different customers different amounts so that you can tap into the consumer surplus and make more profit.

Pricing according to the value you give

Many businesses set their prices using a cost-plus method. For example, many service businesses use hourly rates to set price. Cost-plus methods, such as hourly billing, can seriously affect your profit potential. And these methods are not in the best interest of your customers.

Some of the many disadvantages of this method of pricing include...

- i. the interests of you and your customers are incompatible
- ii. you focus on costs – not the value to your customers
- iii. the customer takes the risk of your inefficiencies
- iv. creates a production mentality – not an entrepreneurial spirit
- v. focuses on effort – not results
- vi. penalises technological advances
- vii. rates are set by your competitors
- viii. does not differentiate you from your competition
- ix. limits your potential income
- x. creates a bureaucracy of recording costs

Traditional cost-plus pricing starts by finding out how much it costs to produce the product or service. A mark-up is then applied to set the price.

Value pricing starts by finding out how much the customer values the product or service. This determines the price. It is therefore fairer to the customer.

16 ways to charge more without losing customers

- 1 **Offer guarantees** - Customers will part with their money more readily, and pay a higher price, if they know that they can get their money back if something goes wrong.
- 2 **Provide sensational service** - Study after study has shown that customers are willing to pay more if you give them great service. Research also suggests that companies providing great service grow twice as fast as those with bad service.
- 3 **Make the price seem insignificant** - Perhaps by breaking it up into little bits and expressing it in terms of pence per day or pounds per usage. This “trick” is one of the keys to the success of the National Lottery – i.e. they have been able to persuade almost half the country to spend £100 a year by breaking the annual costs down into seemingly insignificant £1 tickets.
- 4 **Reduce discounts** - In many industries discounts off list prices are the largest single group of costs - and yet they are usually given with little or no senior management involvement or authorisation. Considerable savings can be usually be made by tightening up discount authorisation procedures. Savings that lead directly to higher net prices and profits.
- 5 **Use creative discounting** - For example, replace flat rate discounts (e.g. “10% across the board”) with step discounts (e.g. “5% on the first £1,000, 15% on sales above £1,000”). Not only do they look more impressive and encourage people to buy more, but they often also work out cheaper.
- 6 **Describe as investments** - Describing your price as an ‘investment’ rather than a cost can often go a long way towards persuading customers to buy.
- 7 **Less than expected** - Repeatedly tell your customers that you may have to put up prices by, say, 20% - but then only actually increase them by less than 20%. (how far below 20% you pitch the eventual price rise should depend on your assessment of the true depth of their “horror” when you make the initial suggestion). By making the eventual price rise less painful than your customers were expecting, you can turn a potentially damaging increase into a triumphant success.
- 8 **Soften the blow** - Try to reduce the prices of some items in your range at the same time as increasing the prices of most other items so that you soften the bad news with some good news, and make a point of dwelling on the latter.
- 9 **Explain why** - Be prepared to explain why prices have risen, perhaps as a result of cost increases, and point out that, had it not been for improvements in your own productivity and efficiency, the increase would have been even higher. Better still, explain that the price has increased as a result of improvements to the quality of the product. Emphasise the enhanced features, improved packaging, increased reliability, enhanced customer support, faster and more convenient delivery and any other factors that make the product better and therefore worth paying more for.
- 10 **Justify your prices** - It is vital to have a strong justification and defence for your high prices prepared in advance. This is likely to include knowing the prices of your most expensive competition, demonstrating the savings and benefits from your product and demonstrating that your product is hugely superior and therefore slightly more expensive because... Do you have a set of written scripts to help

you overcome price objections? And has every aspect of those scripts been tested to make sure that they are giving you the best possible results?

- 11 **Use "Non-price" increases** - For example, consider charging extra for installation, delivery, insurance, handling, storage, urgent orders or rapid delivery. You could also try increasing your minimum order size and introducing a surcharge for any orders below that threshold, revising your discount structure, slimming down the specification of your product and stripping out any expensive features that are of only limited value to the customer, and charging interest on overdue accounts.
- 12 **Change the package** - If a customer tries to knock you down on price, don't change the price, change the package. In other words, never simply crumble on price, Always trade a price reduction for some concession from the customer e.g. a larger order or cash up-front.
- 13 **Trade for referrals** - If all else fails, you can always trade a once off price cut for referrals. We have developed a brilliantly effective script to help businesses like yours do exactly that. So ask us and we'll explain how it works.
- 14 **Top down pricing** – Do you always show your customers the most expensive options first? Top down pricing is a simple but highly effective way of increasing the amount customers spend.
- 15 **And finally, use the...**

MAGIC FORMULA

Ask us to explain how the incredibly effective magic formula of pricing can help you to sell almost anything, to almost anybody at almost any price!

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