Developing and Applying a Pricing Strategy

Evans & Berman
Chapter 21

Chapter Objectives
To present an overall framework for developing and applying a pricing strategy
To analyze sales-based, profit-based, and status quo-based pricing objectives, and to describe the role of a broad price policy
To examine and apply the alternative approaches to a pricing strategy
To discuss several specific decisions that must be made in implementing a pricing strategy
To show the major ways that prices can be adjusted

A Framework for Developing and Applying a Pricing Strategy

Objectives
Broad Price Policy
Pricing
Implementation of Pricing Strategy
Price Adjustments
Feedback

Pricing Strategies
Developing a pricing strategy is a continuous marketing process and is undertaken when:
- A new product is introduced
- An existing product is revised
- The competitive environment changes
- A product moves through its life cycle
- A competitor initiates a price change
- Costs rise or fall dramatically
- The firm’s prices come under government scrutiny

Indications of Poor Performance with a Pricing Strategy
- Prices are changed too frequently.
- Pricing policy is difficult to explain to customers.
- Channel members complain that profit margins are inadequate.
- Decisions are made without adequate marketing research.
- Too many different price options are available.
- Too much sales personnel time is spent in bargaining.
- Prices are inconsistent with the target market.
- A high percentage of goods is marked down or discounted late in the selling season to clear out surplus inventory.
- Too high a proportion of customers is price sensitive and attracted by competitors’ discounts. Demand is elastic.
- The firm has problems conforming with pricing legislation.

Pricing Objectives
Sales-Based
- Volume
- Market share

Possible Pricing Objectives
Profit-Based
- Profit maximization
- Satisfactory profit
- Return on investment
- Early recovery of cash

Status Quo-Based
- Favorable business climate
- Stability
Penetration Pricing
- This approach aims toward the mass market to gain high sales volume.
- Goals are volume and market share.

Skimming Pricing
- This strategy is aimed at the segment interested in quality, uniqueness, and/or status.
- Goals are profit maximization, return on investment, and early recovery of cash.

Alternative Ways of Developing a Pricing Strategy

Cost-Based Pricing
- A firm sets prices by computing merchandise, service, and overhead costs and then adding an amount to cover profit goal.
  - It is easy to derive.
  - The price floor is the lowest acceptable price a firm can charge and attain profit.
  - Goals may be stated in terms of ROI.

Price = Total fixed costs + Total variable costs + Projected profit
Units produced

Cost-Plus Pricing
- Prices are set by adding a pre-determined profit to costs. It is the simplest form of cost-based pricing.

Cost-Based Pricing Techniques

Traditional Break-Even Analysis
- Determines sales quantity needed to break even at a given price.

Price-Floor Pricing
- Determines lowest price at which to offer additional units for sale.

Target Pricing
- Seeks specified rate of return at a standard volume of production.

Markup Pricing
- Calculates percentage markup needed to cover selling costs and profit.

Markup Pricing Techniques

Cost-Plus Pricing
- Pre-determined profit added to costs.

Cost-Plus Pricing Techniques

Traditional Break-Even Analysis
- Determines sales quantity needed to break even at a given price.

Price-Floor Pricing
- Determines lowest price at which to offer additional units for sale.

Target Pricing
- Seeks specified rate of return at a standard volume of production.

Markup Pricing
- Calculates percentage markup needed to cover selling costs and profit.

Target Pricing
- Seeks specified rate of return at a standard volume of production.
Markup Pricing

A firm sets prices by computing the per-unit costs of producing (buying) goods and/or services and then determining the markup percentages needed to cover selling costs and profit. It is most commonly used by wholesalers and retailers.

\[
\text{Price} = \frac{\text{Product cost} \times (100 - \text{Markup percent})}{100}
\]

Some firms use a variable markup policy, whereby separate categories of goods and services receive different percentage markups.

Traditional Break-Even Analysis

\[
\text{Break-even point (units)} = \frac{\text{Total fixed costs}}{\text{Price} - \text{Variable costs (per unit)}}
\]

\[
\text{Break-even point (sales dollars)} = \frac{\text{Total fixed costs}}{\text{Price} - \text{Variable costs (per unit)}} \times \text{Price}
\]

These formulas are derived from the equation: \( \text{Price} \times \text{Quantity} = \text{Total fixed costs} + (\text{Variable costs per unit} \times \text{Quantity}) \).

Demand-Based Pricing Techniques

- **Demand-Minus Pricing**: Works backward from selling price to costs. It is used by firms selling directly to consumers.

- **Price-Discrimination**: Sets two or more prices to appeal to distinct market segments.

- **Demand-Based Pricing Techniques**: Combines traditional break-even analysis with demand evaluation at different prices.

- **Modified Break-Even Analysis**: Extends demand-minus pricing back through the channel.

Demand-Based Pricing

A firm sets prices after studying consumer desires and finding a range of prices acceptable to target market.

- It begins with selling price and works backward to cost variables.
- It identifies a price ceiling or maximum customer will pay for a good or service.

Demand-Minus and Chain-Markup Pricing

- **Demand-minus pricing**: A firm finds the proper selling price and works backward to compute costs. It is used by firms selling directly to consumers.
  - It has three steps:
    - Selling price is determined via consumer surveys or other research.
    - The required markup percentage is set based on selling expenses and desired profits.
    - The maximum acceptable per-unit cost for making or buying a product is computed.
  - **Chain-markup pricing** extends demand-minus calculations all the way from resellers back to suppliers. Final selling price is determined and the maximum acceptable costs to each channel member are computed.
Price Discrimination

With price discrimination, a firm sets two or more distinct prices for a product. Higher prices are for inelastic segments and lower prices for elastic ones.

- Customer-based price discrimination—Prices differ by customer category for the same good or service.
- Product-based price discrimination—A firm markets a number of features, styles, qualities, brands, or sizes of a product and sets a different price for each product version.
- Time-based price discrimination—A firm varies prices by day versus evening, time of day, or season.
- Place-based price discrimination—Prices differ by seat location, floor location, or geographic location.

When a firm engages in price discrimination, it should use yield management pricing—whereby it determines the mix of price-quantity combinations that generates the highest revenues for a given time.

Competition-Based Pricing

In competition-based pricing, a firm uses competitors’ prices rather than demand or cost considerations as its primary pricing guideposts.

- With price leadership, one firm announces price changes and others follow.
- With competitive bidding, two or more firms independently submit prices to a customer for specific goods or services, for organizations such as government or nonprofits.

Implementing pricing strategies (1)

- How does a firm make decisions and determine goals and strategies based on VALUE preferences of customers—long term planning?

Implementing pricing strategies (2)

- Price lining
- Multiple-unit pricing
- Leader pricing
- Price-bundling
- Geographic pricing
- Purchase terms

Prestige Pricing

Consumers’ Price Ceiling
Range of Acceptable Prices
Consumers’ Price Floor

Q1 Q3 Q2

Quantity (Units)
The consumer has two choices. He/she can purchase the bookcase and have it delivered, assembled, and stained for $489, or he/she can purchase the bookcase for $379 and undertake all or some of the other functions himself/herself. Note: the total for unbundled price is $529.

**Bundled Pricing**
- Bookcase $489
- Includes delivery, assembly, staining

**Unbundled Pricing**
- Bookcase $379
- Delivery $50
- Assembly $35
- Staining $65

**Chapter Summary**
- The chapter presents an overall framework for developing and applying a pricing strategy.
- It analyzes sales-based, profit-based, and status quo-based pricing objectives, and describes the role of a broad price policy.
- It examines and applies the alternative approaches to a pricing strategy.
- It discusses several specific decisions that must be made in implementing a pricing strategy.
- It shows the major ways that prices can be adjusted.