CHAPTER 5

Developing Pricing Strategies and Programs

CLASS NOTES

OBJECTIVES—

- Define the internal factors affecting a firm's pricing decisions.
- Identify the external factors affecting a firm's pricing decisions.
- How do consumers process and evaluate prices?
- How should a company set prices initially for products/services?
- How should a company adapt prices to meet varying circumstances and opportunities?

I. Price, the second "P"— it is the sum of all the values that consumers exchange for benefits of having the product/service.

- It has been the major factor affecting buyer choice.
- But nonprice factors have become increasingly important due to the increasing affluence of developed economies.
- Price is the only element in the marketing mix that produces revenues as the other represent costs, thus it is CRITICAL to understand thoroughly.
- Common pricing mistakes:
  1. Too cost-oriented rather than customer value-oriented.
  2. Not revised often enough to reflect market changes.
  3. Not taking the other 3 "Ps" into consideration.
  4. Not varied enough for different products (in the mix), market segments, or purchase occasions.

II. Factors affecting pricing decisions – **the Five Cs of Pricing**

A. **Step 1:** Selecting the pricing objective - internal factors

1. Organizational considerations; who should set the price???
2. Marketing/Company Objectives; such as, Survival, Current Profit Maximization, Market Share Leadership, or Product Quality Leadership. (See Exhibit 5.2)
3. Marketing Mix Strategy; customers typically seek products that provide the best value in terms of benefits received.
   - Customer Value = Benefits / Price or Relative Benefits/Relative Price
4. New product pricing: Market-skimming: setting a high price to "skim" maximum revenues from the target market, however probably will result in fewer, but more profitable, sales.
   - Product's quality and image must support the higher price.
   - Costs must be reasonable.
   - Market entry for competitor(s) should be limited.

5. New product Pricing: Market-penetration: setting a lower price to "penetrate" the market quickly and deeply.
   - Market should be highly price sensitive so a low price produces rapid market growth.
   - Experience curve attributes must be operable.
   - Competition must be kept to a minimum.

B. **Step 2** – Determining demand - external factors

1. Reference price – how is this “set”?
2. Price-Quality inference – how does pricing affect value perception?
3. Nature of the market and demand; generally set the upper limit for pricing considerations.

- Demand curve— How is the curve determined? Effective pricing requires understanding of how much value a consumer places on benefits received.
- Price - demand relationship— normally price and demand are inversely related.
- Price Elasticity— how responsive demand is to a change in price. (Exhibits 5.3 and 5.4)
  Price elasticity: **=** -1 (revenue same and revenue is maximized)
  Price inelastic: **between 0 and** -1.0 (revenue goes up with an increase in price)
  Price elastic: more negative than **<** -1 (revenue goes down with an increase in price)

- Price sensitivity is low when:
  Product is high in quality, prestige, or exclusiveness.
  Substitutes are hard to find.
  Product price is low compared to consumer's income.
- Price sensitivity has intensified, therefore marketers must differentiate:
  Deregulation.
  Internet.

4. Environmental factors
5. Summary: somewhere between product costs and market demand - tempered by consumers' perception of value. (Figure 5.1– Five C's Model for Price Setting)

III. **Step 3** – Estimating costs

1. Cost-Based pricing— adding a standard dollar markup to product cost.
   - Simplest pricing method.
   - Ignores current demand and competition.
   - Much fairer to buyers and sellers???
2. Costs; generally set the floor for pricing considerations.
   - Fixed Costs + Variable Costs = Total Costs
   - Experience Curve; which way does it flow? Is it a great strategy?

IV. Step 4 – Selecting a pricing method

Average Unit Cost = variable cost + fixed costs / unit sales See Chapter 13
Average Unit cost is often called the Breakeven Price (BEP) see the game manual
Classic Markup Pricing method
Set the Price = Unit Cost / (1 — desired return on sales price) or BEP/(1-ROS)
(Markup pricing truly works only if the expected level of sales is reached.)
Or you can use this formula as explained in handout: COST + (%) BASE = SELLING PRICE
(markup)

- Break-even analysis (Exhibit 5.5)

BEQ or Break-even volume = fixed costs /(price — variable cost/unit)
Quantity to be sold = F/(P-V)
BER or Breakeven Revenue = Fixed Cost/(markup on price)
BER = F/((P-V)/P)

1. Value-based pricing— uses buyer's perceptions of value as the key to pricing.
   - Cost-based: based on product considerations ending with the customer.
   - Valued-based: begins with the customer and ends with the product.
   - Marketer should continually strive for "More for Less."
   - EDLP: what does it mean to the consumer?

2. Competition-based pricing/going-rate —price represents the collective wisdom of the industry concerning the price when the demand elasticity is difficult to measure.

MARKUP CONSIDERATIONS

Markup Pricing Methods
1) Set the price = Average Unit Cost / (1 – Desired Return on Sales) = BEP/(1-ROS ratio)
Used mostly by manufacturers
2) Set the price = (variable cost per unit)/(1- Markup on price ratio) = V/1-Mp)
used mostly by retailers

These are basic and acceptable formulae for markup pricing. However it can be confusing when we consider the pricing factors from the manufacturer to the retailer. Most of the time a retailer will markup based upon **Selling Price**. There is a specific operational reason for this because at times retailers do mark down prices (and as consumers we enjoy those marked down prices.) So you can use the above formula to work the problems if you so desire.

But the following equation is easier to understand because it is a simple equality or as one accounting professor stated – it is a basic profit formula. Using this equation may require a little extra work, but I believe the simplicity is worth the effort.

BASIC EQUATION to understand the relationships of— selling price, cost, and markup.

COST + (Dollar MARKUP) = SELLING PRICE
(Dollar Markup on price)/Selling Price = percentage of Markup on Price
(P-V)/P = Mp 9see chapter 13

Example:
Cost of a product to the retailer = $11 per unit
Retailer has a 35% Markup on Selling Price, Mp = 35%
The dollar markup = 35% x price
What is the ultimate selling price, P?

COST + Dollar MARKUP = SELLING PRICE
$11 + .35 P = P
$11 + .35SP - .35P = P - .35P (added -.35P to both sides of the equation)
$11 = P-0.35P
$11 = P(1-0.35)
$11 = 0.65P
$11 / 0.65 = .65P / 0.65 (multiplied both sides by 1 / .65)
$11 / 0.65 = P
$16.92 = P
Remember
The basic definition of the markup on price ratio is
Mp = (P-V)/P
The exam question has to give you two of the three variables, Mp, P, V
And asks you to solve for the one that is not given

Example of markup of markup on cost:
Cost of a product V=$15
Wholesaler has 45% Markup on Cost, Mv = 45%
The definition of markup on cost, Mv is dollar markup, P-V, divided by the variable cost per unit, V
Mv = (P-V)/V
What is the ultimate selling price, P?

COST + MARKUP on cost = SELLING PRICE
$15 + 0.45 (variable COST) = P
$15 + 0.45($15) = P
$15 + $6.75 = P
$21.75 = P
(This is only an example calculation. Probably only seen in a discussion of return on a dollar of inventory.)
Unless otherwise stated the slang term "markup" should be read as the "percentage of the dollar markup on the selling price."

The pricing challenge is not confined solely to the retail level. Prices must be determined from the Manufacturer level to the ultimate consumer purchase transaction. Manufacturers must determine whether a product can be produced plus a profit earned at his/her level. Then considerations must be made for the complete channel of distribution through the wholesale level (sometimes only an agent) through the retailer with an eventual price that is acceptable to a consumer. In other words, all parties of the channel – manufacturer, wholesaler, and retailer – must be able to cover their cost plus earn a profit.

Markups are figured on the selling price or cost at each level of business in a channel of distribution. A manufacturer applies a markup to determine its selling price. The manufacturer's selling price then becomes the wholesaler's cost. The wholesaler must determine its own selling price by applying it usual markup percentage based upon either its (wholesaler's) selling price or cost. The same procedure is carried out by the retailer, using the wholesaler's price as its (retailer's) cost.

The following calculations can illustrate this point. Practice before looking at the answers.
See Chapter 13 for more examples of using markup in the channel of distribution

Manufacturer's cost	$7		
		Manufacturer's markup =	30% of **selling price**
Manufacturer's selling price			
Wholesaler's cost			
		Wholesaler's markup =	16.67% of **selling price**
Wholesaler's selling price			
Retailer's cost			
		Retailer's markup =	40% of **selling price**
Retailer's selling price			

ANSWER SET

Manufacturer's cost	$7		
		Manufacturer's markup =	30% of **selling price**
Manufacturer's selling price	$10		
Wholesaler's cost	$10		

		Wholesaler's markup =	16.67% of **selling price**
Wholesaler's selling price	$12		
Retailer's cost	$12		
		Retailer's markup =	40% of **selling price**
Retailer's selling price	$20		

Now try working back from the marketplace viewpoint (consumer) versus the manufacturer. But do this calculation based upon COST and not SELLING PRICE.

Manufacturer's cost			
		Manufacturer's markup =	30% of **cost**
Manufacturer's selling price			
Wholesaler's cost			
		Wholesaler's markup =	16.67% of **cost**
Wholesaler's selling price			
Retailer's cost			
		Retailer's markup =	40% of **cost**
Retailer's selling price	$20		

ANSWER SET:

Manufacturer's cost	$9.42		
		Manufacturer's markup =	30% of **cost**
Manufacturer's selling price	$12.25		
Wholesaler's cost	$12.25		
		Wholesaler's markup =	16.67% of **cost**
Wholesaler's selling price	$14.29		
Retailer's cost	$14.29		
		Retailer's markup =	40% of **cost**
Retailer's selling price	$20		

BREAKEVEN PRACTICE PROBLEMS
Chapter 5

Using the cost-based approach, what is the unit total cost given the following:
Variable cost: $15.25; Fixed cost: $125,000; expected sales in units: 25,000.

What is the breakeven volume for a product given: fixed costs: $5,000; variable cost per unit: $2.10; Selling price per unit: $8.25.

What is the breakeven volume for a product given: fixed costs: $1,200,000; variable cost per unit: $35.73; selling price per unit: $70.00.

The marketing team of *Midnight Snack Restaurant* reduced the price of their special triple-decker with double cheese Gut Bomb from $4.35 to $3.75 in the hopes of stimulating sales during the month of March. The total fixed costs of *Midnight Snack* were increased to $5,700 for the month due to the addition of the promotion of the special. The variable costs of the Gut Bomb remained the same at $1.47.

1. How many Gut Bomb specials must be sold during March to breakeven with this new program?
   A. 1311
   B. 1520
   C. 1980
   D. 2500
   E. 3876

2. What dollar profit would Midnight Snack Restaurant achieve if 2350 Gut Bombs were sold during March?
   A. $1068 PROFIT
   B. $1068 LOSS
   C. $342 PROFIT
   D. $342 LOSS
   E. This would be a total disaster

3. What is the average <u>total cost</u> per unit at breakeven?
   A. $1.47
   B. $3.75
   C. $4.35
   D. $5.22
   E. Cannot calculate it.