Pricing Models for a Successful Business

1.1 Introduction

The SBA Learning Center presents: Pricing Models for a Successful Business.

Produced by the SBA's Office of Entrepreneurship Education, this self-paced course expands on the topics in the Introduction to Pricing course by explaining the pricing models your business might adopt. In the Introduction to Pricing course, we introduced the various approaches to and methods of pricing, effect of costs on pricing, the marketing mix, pricing mistakes, and legal issues involved in certain pricing methods. In this course, we will focus on the pricing models a small business can adopt, and delve into how a small business owner can set prices, calculate costs, assess competitors, provide value to customers, and adapt pricing to changing market conditions.

The subject matter is indexed for quick reference and easy access. It will take about 30 minutes to complete the course. Additional time may be needed to review included resource materials and to complete the "Next Steps" suggested at the end of the course.

Audio is used throughout the training, so please adjust your speaker volume accordingly. A transcript and keyboard shortcuts are available to assist further with user accessibility.

When you complete the course, you will have the option of receiving a course completion confirmation from the SBA.

1.2 Course Objectives

The course has six key objectives:

1. Explain why pricing is important.
2. List the different pricing models.
3. Explain how to use a cost-based pricing model.
4. Explain how to use a customer-based pricing model.
5. Explain how to use a competition-based pricing model.
6. Identify the pricing model for a business.

1.3 Course Topics

Some of the questions answered in this course are:

- How do I set prices and succeed using the cost-based pricing model?
- How do I set prices and succeed using the customer-based pricing model?
- How do I set prices and succeed using the competitor-based pricing model?
- How do I perform a breakeven analysis?
- How do I determine which pricing model is best for my business?

Many additional resources are identified to help you. Visit the resource icon in the course player or locate additional tools, templates, and mentors on SBA.gov once you finish the course.

Let's get started!

1.4 Introduction to Pricing-Recap

Let's begin by reviewing the major points discussed in the Introduction to Pricing course. In that course, we discussed:

- Pricing as part of the marketing mix,
- Pricing as it relates to sales promotion,
- Common pricing mistakes, and
- Various pricing models.

1.5 Pricing as Part of the Marketing Mix-Recap

Pricing is one of the four Ps of the marketing mix, along with product, promotion, and place. Price is the only component that generates revenue. Product, promotion, and place are all cost centers. However, the determination of price is influenced by the costs incurred by creating the product, the product's promotion, and the place in which it is sold. Other pricing influences include competition, market conditions, brand, and quality of the product.

At various points in a product's life cycle, a firm needs to come up with a marketing model. This involves selecting the target market and performing product positioning. Usually, there has to be a balance between product quality and price. In this way, price plays an important role in the marketing mix.

Pricing will always be determined by these tradeoffs among the marketing mix elements.

1.6 Pricing and Sales Promotion-Recap

Pricing is very important in sales promotion because it determines the market positioning of a product. Select each of the major sales strategies based on pricing to learn more about it.

Skim pricing is where the organization sells at a high price, targeting the customers who are less price-sensitive at a time when the product is new to the market and there are fewer competitors.

Penetration pricing is where the organization tries to maximize the number of customers for one product - typically a new product - and to increase its market share by lowering the price. Profit is only considered for the long term in this strategy.

Leader pricing is where a product is sold at a lower price to attract customers with the assumption that, once attracted, they will also buy premium products. This is also called a loss leader because the product is often sold at a loss.

Premium pricing is where the product is priced at the high end of the possible price range to create a sense of perceived quality and attract status-conscious customers.

With differentiated pricing, products are sold to different customers at different prices.

With psychological pricing, pricing is set in such a way that, looking at the price, the customer feels it is low. For example-$3.99 instead of $4.

When using discounts and sales, pricing is based on attracting price-sensitive customers to the store.

1.7 Common Pricing Mistakes-Recap

Common pricing mistakes include:

- Not having a model or not sticking to the model you decided on
- Underestimating the costs involved in running the business
- Using only low prices to compete with other players
- Setting a pricing model and never modifying it to suit changing conditions

1.8 Legal Issue-Recap

In addition, some business owners make the mistake of being unaware of legal issues related to pricing. Select each button below to learn more about the legal issues business owners often confront.

Anti-trust law prohibits:

- Conspiring between firms to fix prices
- Corporate mergers that can result in marked reduction in competition in a particular market, and
- Hostile acts with the goal of achieving or maintaining monopoly power in a market

If you are using a loss leader pricing model, you have to make sure that the advertised product is in stock and sold at the advertised price.

Various laws prohibit price discrimination, which gives customers the advantage. Also, if a dominant player in the industry forces some buyers to pay a higher price than others, it can be considered a violation of anti-trust laws.

1.9 Pricing Models-Recap

In the Introduction to Pricing course, we introduced three pricing models:

- Cost-based Pricing: Cost-based pricing only considers the costs needed to produce the product and the desired profit margin. There are many ways to calculate cost-based pricing, but all of them are based in costs and include a markup for profit. For example, if the cost to produce a product is one dollar, and the company needs a 10 percent profit margin, the price will be set at $1.10.
- Customer-based Pricing: Customer-based pricing is also called value-based pricing. In this, the firm first analyzes the customers to understand what they may be willing to pay for a product or service for the transaction to be profitable. The firm then charges the price each customer is willing to bear. A garage sale is a good example of the use of customer-based pricing, where a set price may be negotiated by the buyer.

- Competition-based Pricing: In the competition-based pricing model, prices are set using the price of the competitors' products. This model is used in industries with one or two dominant companies. Sometimes this model is referred to as "follow the leader."

In the remainder of this course, we will explore these price models in more detail, and explain some of the ways you can evaluate which price model is most appropriate for your business. We'll start by discussing cost-based pricing.

1.10 Using Cost-based Pricing

As we mentioned, the cost-based pricing model sets a price by calculating the costs for a product and then adding mark-up. As a business owner, you will need to know what your costs are in order to use this model to set prices.

1.11 Separating Costs

To implement a cost-based pricing model, you need to calculate the costs incurred by producing, marketing, and distributing your product or service. By calculating costs correctly, you can eliminate unprofitable services and set the prices to maximize profits. When evaluating your costs, you should separate them into two categories, variable costs and fixed costs.

Variable costs are costs that change depending on the number of units you sell. Typical examples are raw material or labor, depending on your business model.

Fixed costs are costs that are not directly related to creating a product or providing a service. Fixed costs may include overhead costs like taxes, rent, insurance, and marketing.

By separating your costs into these categories, you can perform different calculations to discover what factors are most influential on your prices. By changing these factors, you can reduce costs and increase profit, or you can decrease prices to increase sales and market share.

1.12 Determining Variable Cost

The first step in determining your price based on costs is to calculate the variable cost per unit. If your company produces crackers and sells them by the box, you will need to figure out how much the ingredients-which are the raw materials for the crackers, cost you for each box. You must also add in the cost of each box and any variable, meaning hourly, wages. As an example, let's assume the following numbers on an annual basis:

- 50,000 boxes of crackers are sold
- The cost of raw materials is $5,000
- The cost of the boxes is $1,000
- Waged labor costs are $10,000
- Shipping costs are $1,000
- In this example, you have a total of $17,000 of variable costs.

Divide the total variable costs by the number of units you produce a year. This is your variable cost per unit. In this example, each box of crackers costs you 34 cents to produce.

Now, you can add a markup to this cost to set a price. Let's say you decide to add a markup of 100%. In this case, you would set the price as sixty eight cents per box.

100 percent of 34 cents equals 34 cents; and, 34 cents plus 34 cents equals 68 cents.

Note that this example, your price does not consider your fixed costs. You'll have to be sure that this price will cover your long term fixed costs as well. This is usually done by a breakeven analysis, which is covered later in this course.

1.13 Adding Fixed Costs to Your Price

To make sure your price also covers your fixed costs, you need to calculate the average fixed cost per unit. Let's continue with our previous example, and assume our annual fixed costs are 20,000 dollars. To calculate average fixed costs, divide your total fixed costs by the number of units. In this example, we have an average fixed cost of 40 cents per unit.

Now add your average fixed cost to the variable fixed cost of each unit, which we've already calculated as 34 cents. Our total cost per unit in this example is 74 cents per box.

1.14 Adding Markup

In the first example above, after we calculated the variable costs, we added a 100 percent markup to the variable costs. 100 percent of $0.34 equals $0.34, and, $0.34 plus $0.34 equals $0.68.
There are many ways to calculate costs, but suppose we wanted to wait to calculate both fixed AND variable costs first, before adding markup? Not a problem.

We've already calculated Variable Costs at $0.34 per box plus Fixed Costs at $0.40 per box, for a total of $0.74 per box. We still haven't added markup.

The final step is to add your mark up. Let's assume we want to add 100 percent markup on our costs. What is 100 percent of $0.74 ? $0.74.

So, our total price per unit in this example would be $0.74 plus $0.74 - one dollar and forty-eight cents.

1.15 How to Succeed with Cost-based Pricing

Let's look at some tips that will help you succeed with the cost-based pricing model.

You can:

- Decrease waste,
- Increase the efficiency of inventory management,
- Set a clear process and guidelines, and
- Increase your markup

Carefully analyze your how your price might need to change based on sales.

1.16 Customer-based Pricing

The Customer-based pricing model involves using information about your customers to set a price. This model is sometimes called value-based pricing. Ultimately, the price your customer is willing to pay is what determines how much your goods or services are worth. To implement a customer-based pricing model, you need to study the market in order to understand how much your customers can and are willing to pay. You also need to know the different types of customers in the market, since the value placed on your product may vary depending on the type of customer. Finding this out requires you to do some research.

1.17 Performing Research

Traditional customer research done by large businesses is an expensive affair. As the owners of a small business with a customer-based pricing model, you will need a cheaper alternative. How can small businesses perform customer research? Select each button to learn more.

Perform customer satisfaction studies. This can be as simple as asking a person on the street how they feel about your product or service, or as complex as conducting large-scale, formal surveys. You can also:

- Conduct professional or informal focus group research
- Send product samples to customers and ask for their feedback
- Ask your customers what they feel about your products and services
- Use free survey tools available online

Perform research on customer decision-making processes. You can perform your own survey or use data from other market researches to figure out how your customers decide to purchase products.

Measure the effect of your prices on customer behavior. Analyze how prices affect customer behavior at two different price points. The simple way to do this is to set your product at two different prices. Then calculate out the total revenue that you made at each price and compare them.

- (No. Items sold at Original Price) x (Original Price) = Revenue 1
- (No. Items sold at New Price) x (New Price) = Revenue 2
- Compare Revenue 1 to Revenue 2 to see which price earned you the most revenue.

Monitor social media. Customers often give feedback about products or services on social media. Find out what they say about your prices and make adjustments if required. You can also use social media to conduct surveys and even to market your products.

Research customer perception of your product. To do this, you need to find out the sales figures for various market segments. You also need to analyze the attitudes of your customers in different segments.

1.18 Price Elasticity

Price elasticity is the measure of how much customer demand changes as a result of a price change. Determining price elasticity requires using various research methods like test markets and analyzing historical market data. As a small business owner, you may not need to know the specific price elasticity numbers for your product or service; however, you should have a general awareness of how much of a price change will affect customer demand. Will a price increase of fifty cents seem like a big deal to your customers, or will they barely notice?

1.19 Market Segmentation

Often times in the Customer-based pricing model, you will offer your product at different prices to different segments in your target market. These segments are divided based on the customers' requirements, attitudes, culture, and various other characteristics.

To identify the market segment correctly, you need to:

- Clearly identify the segment you need to target
- Measure the size of the market segment accurately and determine the impact it will have
- Assess how effectively you could promote your product or service in the segment
- Assess the sustainability of the market segment

Markets may be segmented based on:

- **Geographic segmentation**, where you segment the market according to geographic criteria such as nations, states, and regions.
- **Demographic segmentation**, where the marketed is segmented based on variables such as age, gender, occupation, and education level.
- **Behavioral segmentation**, where the market is segmented based on the customers' attitude, use of the product, and knowledge levels.
- **Psychographic or lifestyle segmentation**, where you divide segment the market based on the customers' lifestyle.
- **Benefits-based segmentation**, where you segment the market based on the benefits expected by the customer.
- **Cultural segmentation**, which is segmenting the market based on the cultural origins of the customers.
- And **Buyer Type segmentation, where you** segment the market based on buyer type such as direct consumers, business -who may purchase in bulk quantities, or governments-who may offer long term contracts.

Think about how the customers in each of these segments might value your product or service differently. Remember, charging different prices to your market segments is generally legal (except, of course, for cases like race, gender, religion, etc.), but can be considered illegal if it is determined to have anticompetitive implications. As always, if you're unsure whether you are complying with the law, consult your legal professional.

1.20 Examples of Setting Price with the Customer-based Model

As an example, let's say Sherin runs a consulting service and charges $200 per hour. After some time, she finds that she is losing customers. Sherin sends out some customer satisfaction surveys to her former clients and finds that, while the customers are happy with her services, most have not returned because they find that paying for one or two hours of her time is not cost-effective. She contacts those customers and renegotiates her rate with them, ranging from $125 to $150 per hour. She also creates a pricing schedule that offers a lower rate per hour to new customers who purchase ten hours up front.

1.21 How to Succeed with Customer-based Pricing

How do you ensure that your customers continue to purchase your product when your competitor is charging lower prices? With the customer-based pricing model, the key is finding ways to get customers to value your product or service over alternatives. How do you add value to your business and communicate it to the customer?

Customers are usually willing to pay extra for a quality product. Here are a few tips to add value:

- Create a signature customer experience.
- Analyze your competitors and decide what will make you stand out.
- Devise marketing strategies to ensure that customers perceive this value.
- Finally, anywhere you go, remember that you are the face of your business, and keep promoting it.

When pricing your product, also consider that the price paid by the customer is more than just monetary. To the customer, the price includes the time spent purchasing, researching, or learning the product, the anxiety caused by misplaced orders or faulty products, and other factors. To add value to the customer, the product or service itself, the impact of the product or service on the customer's life, and the buying experience are all part of the product or service's value.

Think about house painting services. Customers rarely choose a service provider based only on cost. Customers are usually willing to pay more for the services of a provider who has a reputation for quality. Perhaps a painter provides a value added service like tarp coverage for an entire room to avoid property damage if paint drips or sprays around. The painter may also have an on-time guarantee.

Developing a high perceived value and actually providing that value to the customer is the way you avoid price wars with competitors who charge lower prices.

1.22 Competition-based Pricing

When using the Competition-based pricing model, a business sets its prices based on where its competitors set theirs. Usually this model is used in industries where there are only a few competitors vying for the same market.

Like the Customer-based pricing model, the Competitor-based model relies heavily on research. However, instead of analyzing your potential customer base, you should evaluate your competitors' prices and what contributes to those prices. This could include your competitors':

- Capabilities
- Market segments
- Revenue
- Pricing models
- Marketing strategies
- Value-added services
- Future plans
- Work culture
- Strengths and weaknesses

You can learn about your competitors from their promotional materials, trade shows, conventions, vendors, government reports, trade publications, newspapers, blogs, website, or simply by visiting their establishments. Once you've done the initial research you will be able to make better decisions about pricing to compete.

1.23 Setting the Right Price to Compete

Deciding whether you want to price above, below, or on par with the competition depends on what your goal is.

You can price above the competition if you want to cater to customers who are status-conscious and want exclusivity. The higher price may signal to the customers that your service or product is for the high-end customer. However, you will have to come up with strategies to market your product or service effectively for this group of customers.

If your goal is to increase your market share as soon as possible, you can try setting a price below that of your competitors. In this model, you don't care about your profit margins. Your plan is to increase the prices once you have captured a major share of the market. However, this model can backfire, because you could start a price war with your competitors. If you are a small business, competing with larger businesses on price is not an option, because they can always price lower than you and put you out of business.

If you want to avoid a price war, you can price on par with your competitor. Then, you can try competing based on value. Small businesses can offer customized services and better customer support, because of the relatively fewer customers and fewer employees to manage. A large business will mostly have standardized customer support, which cannot be as flexible as the support offered by a small business.

1.24 Examples of Setting Price with the Competition Based Model

Cherok has an established software company that delivers financial-tracking solutions. He has only two other competitors in his market, and each of these competitors sells their software for $49.95. He sets the price for his software at $49.95 as well because he can still cover his costs and make a profit at this price.

One day, Cherok finds that his competitors have lowered the price of their software to $39.95. Since there is little variability in his product compared to his competitors, Cherok suspects his customers will not see significant value in his product over the others at the original price. He opts to also sell his software for $39.95, and uses marketing and cost-cutting strategies to improve his profits.

1.25 How to be Successful with Competition-based Pricing

If you are using a competition-based pricing model, a "set-it-and-forget-it approach" will not work. You need to constantly observe your competitors' strategies, analyze market trends, and continuously adjust your pricing and promotional strategies.

From the *Introduction to Pricing* course, you learned that a small business cannot engage in a price war with large businesses. Initially, you can use lower prices to garner market share, but in the long run you will not be able to compete on price. There will always be someone who will sell at a lower price. In the long run, you can only compete by providing value-added services. So the best strategy is to set a price that is competitive enough, while still allowing you to cover the value-added services you provide, recover your costs, and make a profit.

1.26 DeterminingWhich Method Is Right for Your Business

Now that you have learned about the three basic pricing models, how do you choose which one is best for your business? Here are some guidelines for successfully setting prices for your small business:

- Calculate your costs and price your products or services correctly. Make sure that you don't under-price your products or service. At the very least, you must cover all of your costs in the long run.
- Find out your competitors' prices and ensure that you set a price that will maintain your competitiveness.
- Take advantage of tiered pricing. You can set a front-end price and then add options for which the customer will be willing to pay more.
- Analyze your conversion rates. For example, if you are making a sale to only one out of 10 potential customers, then it may be sign that your prices are too high.
- Focus on your product or service, make sure it is the absolute best you can offer at the price your target market is willing to pay.
- The advantage of a small business is that customers have direct access to the owner. You have to be the face behind the product or service you offer. Use this as a value-add for your business over others.
- Create a brand, analyze the market, and then set prices that the customers are willing to pay.

1.27 Breakeven Analysis

Regardless of the pricing method you chose, a breakeven analysis helps you ascertain the volume of sales you need to achieve to recover your costs at a certain price.
You will need information about the following:

- Fixed costs: Fixed costs are expenses like monthly rent, salaries to be paid, and insurance premiums to be paid at regular intervals. Make sure you calculate the monthly cost of each of these items for this analysis. If you pay certain fixed costs only once per year, make sure you are adding the monthly portion of that cost.

- Variable costs: Variable costs include the costs for producing your product or delivering your service, maintaining inventory, transporting products, and buying additional equipment, which keep changing with sales volume.
- Price: Price is the amount of money your customer pays for a specific product or service.

The Breakeven Quantity, or B-E-Q is the quantity of products you will have to sell per month to recover your costs. To calculate B-E-Q, subtract your price per unit from your cost per unit. Then divide your fix costs per month by that number.

Note that the timeframe can change to suit your needs. For example, if you want to know how many units you'll have to sell each year, calculate your yearly fixed costs and use them in the formula instead of your monthly fixed costs.

1.28 Example of Breakeven Analysis

Here is a sample breakeven analysis calculation.
Suppose that you have started a business of assembling computers. Your fixed cost is $1,000 a month, including rent and utility charges. The variable cost for each computer assembled is $500. You would like to charge $550 per computer.
At that price your B-E-Q is 20.

This means you will have to sell 20 computers a month at that price to break even.

1.29 Breakeven Analysis Calculator

Use the calculator on this screen to try inputting some of your own data and see what the breakeven quantity for your business would be at that price. You may enter information into any three of the boxes, then hit “Calculate” to see what the value for that box would be.

1.30 Industry Considerations

Setting the appropriate price also depends on the industry you are in.

For example, if you are selling used cars, you will probably use customer-based pricing. You can assess the customer and sell the car at a price the customer will be able to pay or is willing to pay.

If you are in a retail business, you can try to decrease your costs and sell at the lowest price.

If you are providing an exclusive service, like designer clothes, you can set a price high enough to make your business exclusive to the customers at the high end of the market.

Also, the cost structure and customer behavior vary from industry to industry. What you have learned in this course is a starting point for how you can set your prices. You can adjust your pricing model based on the industry you are in and your specific situation.

1.31 Mixing Models

By now, you have probably realized that no pricing model is perfect. In the *Introduction to Pricing* course, you learned about the disadvantages of the three pricing models.

The best way to set your price is to use a unique mix of each pricing model, which means you don't stick to one pricing model, but mix elements from three pricing models-cost-based, customer-based, and competitor-based.

To set the right price, you need to consider your costs and perform research on your customers and competitors. Even while following a customer-based or competitor-based pricing model, you must ensure you are covering your costs. If you are following a cost-based model, you will still need to ensure that your customers are willing to buy your product at that price. Sometimes, you may have to lower your prices, sometimes you may have to provide value-added services, and sometimes you may to have to introduce a product or service at a very high price to ensure that it is perceived as premium.

1.32 Summary

You have reached the end of the course. Now you should be able to:

- Explain why pricing is important
- List the different pricing models
- Explain how to use a cost-based pricing model
- Explain how to use a customer-based pricing model
- Explain how to use a competition-based pricing model
- Identify the pricing model for a business

1.33 Next Steps

Now what should you do? Follow these steps to begin applying your knowledge of pricing models.

Step 1) Calculate your costs.
Step 2) Check whether any of the scenarios described in this course is applicable to you.
Step 3) Apply the pricing models you learned in this course to set the price for one of your products or services.
Step 4) Check whether any your current pricing models needs to be revised based on what you learned in this course.
Step 5) Revise the models if required.

1.34 Resources

SBA has a broad network of skilled counselors and business development specialists. Below is a short description of our resource partners:

- There are more than 1,000 **Small Business Development Centers (SBDCs)** located around the country. SBDCs provide management assistance to current and prospective small business owners.

- **SCORE** is a powerful source of free and confidential small business advice to help build your business. More than 10,000 SCORE volunteers are available to share their experience in lessons learned in small business.
- **Women's Business Centers (WBCs)** assist women and men in achieving their dreams by helping them start and run successful businesses. Over 90 WBCs are located around the country.
- The **SBA** has over 60 D**istrict Offices** located throughout the country to help you start and grow your business.
- The **SBA Learning Center** is a powerful virtual campus with online training, videos, tools and links to local resources.
- The SBA's **Office of Women's Business Ownership (OWBO)** serves as an advocate for women-owned businesses. The office oversees a nationwide network of 110 Women's Business Centers that provide business training, counseling and mentoring geared specifically to women, especially those who are socially and economically disadvantaged. The program is a public-private partnership with locally based nonprofits.
- The **Veterans Business Outreach Program (VBOP)** is designed to provide entrepreneurial development services such as business training, counseling and mentoring, and referrals for eligible veterans owning or considering starting a small business. The SBA has 15 organizations participating in this cooperative agreement and serving as Veterans Business Outreach Centers (VBOC).
- **Procurement Technical Assistance Centers (PTACs)** provide local, in-person counseling and training services for you, the small business owner. They are designed to provide technical assistance to businesses that want to sell products and services to federal, state, and/or local governments. PTAC services are available either free of charge, or at a nominal cost. PTACs are part of the Procurement Technical Assistance Program, which is administered by the Defense Logistics Agency.

Find your local resource using our handy zip-code tool.

1.35 Have a Question?

- Call SBA at 1-800 U ASK SBA (1-800-827-5722)
- E-mail SBA at answerdesk@sba.gov
- Locate a SCORE counselor, SBA district office near you, or an SBDC office near you at www.sba.gov/local-assistance.
- To provide feedback, comments or suggestions for other SBA online content, please email learning@sba.gov.

1.36 Certificate

Congratulations on completing this course. We hope it was helpful and provided useful information on pricing models for your business. Click the certificate to receive a course completion confirmation from the U.S. Small Business Administration.

2.0 Recommendation

A.C.T. NOW!

The Article, Course, and Tool listed below are related to the course you just completed. They are provided to help you take action on your path to entrepreneurial success. You can also get in-person assistance for all of your business needs through a local resource center. And if you liked the course, please help spread the word by sharing it with your friends!

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Read an SBA Article
The article *Understanding Gross Margin and How it can Make or Break your Startup*, explains how gross margin directly impacts your ability to effectively manage a growing business, price your products, and make a profit.

Take Another Course.
SBA's course, *Competitive Advantage*, explains what sets you apart from your competition. Learn how to leverage the uniqueness of your business to create a real competitive advantage.

Try a Tool.
Check out SBA's **SizeUp** tool to help you assess how your business stacks up against the competition.

Find local assistance!
SBA has a broad network of skilled counselors and business development specialists.