MASTERMIND
CONSULTING NETWORK
515 Tilton Drive, Tecumseh, MI 49286
Phone: 517-423-2943
www.mastermindconsult.net

YOUR MOST IMPORTANT DECISION!

Let me ask you a question. Do you think increasing your sales would be a good thing? If I told you that your price was too low, would you still think increasing sales would be good? In business, pricing is your most important strategic decision, and if you don't price properly YOU WILL FAIL!

PRICING STRATEGIES

There are five basic pricing strategies. They are listed below, and this paper will discuss each in some detail.

1. **Lowest Price** – Price the competition and then set your price lower.
2. **Cost Plus** – Cost of goods sold plus a % for profit.
3. **Value Price** – Set a higher price and sell on the basis of higher value.
4. **Skimming** – Command a premium price and skim the top off of the market. Works for new, stylish, or unique products when production capacity is limited.
5. **Blanket Pricing** – Offering products at a variety of price points covering the range of prices that consumers are willing to pay.

An important rule of thumb is to never sell your product or service for less than the buyer is willing to pay!

LOWEST PRICE

If you have the lowest price you will have the largest number of potential customers. After all, everyone wants the lowest price. To win with this strategy you must:

- be the low cost producer in order to generate a good margin at the lowest price.
- you will need a large production capacity in order to meet a large market demand.
- you will need substantial working capital to afford the advertising required to inform a large diverse market.
- your organization will have a large overhead structure to support its high volume business.

If these characteristics do not describe your business, you should carefully consider other pricing strategies. The lowest price strategy may be simple, but it is rarely **PROFITABLE.**

COST PLUS

The cost plus pricing strategy is conceptually simple. It involves calculating your product cost and setting an appropriate selling price. This is done in four basic steps. They are:

1. First calculate the cost of the materials that will be contained in the product.
2. Determine the man hours needed to produce your product and multiply by your labor rate.
3. Next multiply the number of man-hours by the hourly amount needed to cover your overhead.
4. Add these three numbers to determine your cost. Your price is then your cost plus your profit margin.

Thus the cost plus formula is simply material cost + direct labor cost + overhead allocation = Cost of Goods Sold. Your selling price is then equal to cost of goods sold + profit margin. *(See sample work sheet on the next page.)*

Sample Cost Plus Pricing Sheet

Item	Amount
Materials Cost (plus 2% for waste)	$5.00
Estimated Labor Hours	1.0
Labor Cost @ $10.00 / hour	$10.00
Direct Costs (Materials & Labor)	$15.00
Overhead cost @ 40% of direct labor	$4.00
Total Costs	$19.00
Profit @ 10% of total cost	$1.90
Projected Selling Price	$20.90

** Understanding overhead cost and its allocation is the key to applying this approach correctly.

In summary, your actual price may be higher than the calculated selling price, if conditions permit, but it should not be LOWER! To set a lower price is a very strategic decision in which the seller agrees to a price knowing it will involve losses but deems it necessary in order to partially cover overhead expenses at a time when the alternative would be to operate at even lower volume and incur even greater losses. When such a pricing decision is taken, it should be very limited in scope and for a short well defined period of time. The finer points of pricing strategy and some of the complications that the seller will encounter will be discussed further at the end of this paper.

UNDERSTANDING OVERHEAD

In business we have two types of costs. "DIRECT" costs are all items that can be directly attributable to producing the product. All other "INDIRECT" costs are overhead. These typically include telephone, insurance and auto expenses.

The simplest system totals annual overhead expense and divides it by the total annual billable hours to establish an amount of overhead dollars to be added to each labor hour charged.

So if your labor cost is $15/hour and your overhead is $2.00/hour, the labor rate with burden used in pricing is $17/hour. Forgetting overhead in your pricing is the difference between profit and significant loss. *(See sample burden rate calculation sheet below.)*

Overhead Expenses	***Current Budget***
Purchases – Consumable Supplies	
Automobile	
Fuel - Auto	
Electricity	
Heat	
Capital Equip	
Facility Improvements	
Insurance	
Professional Expenses	
Rent	
Office Supplies	
Outside Services	
Computer / Internet	
Telephone	
Selling Expenses	
Interst Paid	
Shipping	
Miscellaneous	
Loan Payment	
Total Overhead Expense	
Billable Hours (Annual)	
Burden Rate ($/hour)	

BREAKEVEN ANALYSIS

Every business should understand its breakeven point. This calculation enables the owner to evaluate whether his overhead amortization assumption is sound.

For instance, if you amortize your overhead over 70% of your available hours and actual utilization is less than 70%, your overhead will not be fully covered thereby eating up your profit.

On the other hand, if actual utilization exceeds 70%, overhead will be more than fully covered, with the excess going to the bottom line as profit.

(See a sample Breakeven Calculator below.)

Break Even Analysis	
Description	Current Budget
Average Sales / Month	
Variable Costs / Month	
Average Variable Cost Ratio / Month	
Average Fixed Cost / Month	
Average Monthly Sales Break Even Point	

Variable Costs	
Description	Current Budget
Advertising	
Entertainment	
Professional Services	
Office Supplies	
Outside Services	
Taxes	
Miscellaneous	
Interest Paid	
Shipping	
Total	
Monthly	

Fixed Costs	
Description	Current Budget
Depreciation	
Insurance	
Rent	
Wages	
Telephone	
Total	
Monthly	

 Copyright ©2008

MANAGING OVERHEAD

When breakeven analysis tells us that our capacity will be under utilized, our recourse is to either reduce overhead or to increase sales.

In our overhead category, we have both variable and fixed overhead. The variable overhead fluctuates with sales volume and is more or less self regulating. Fixed overhead does not normally change with volume and must be consistently managed to bring the breakeven point into alignment with actual revenues. In a time of declining sales volume, managing overhead is essential to protecting profit.

VALUE PRICING

When a business has favorable product cost and is able to deliver high value to customers, a Value Pricing strategy must be followed to maximize profit. In this scenario, the seller is able to meet or exceed the needs and wants of prospective buyers. The seller understands the exceptional value he offers and is able to sell on the basis of his value which justifies a higher price.

Value pricing is successful because the market place is not homogeneous and is in fact composed of many individual buyers who have a variety of financial and emotional buying motives. This characteristic is known as "Price elasticity." It can be summarized as higher price means fewer prospects while a lower price equals many more prospective buyers. If your business doesn't require high volume to fully utilize productive capacity, you should sell your "value" to the smaller number of prospects who are willing and able to pay at a higher price to buy a better product or service.

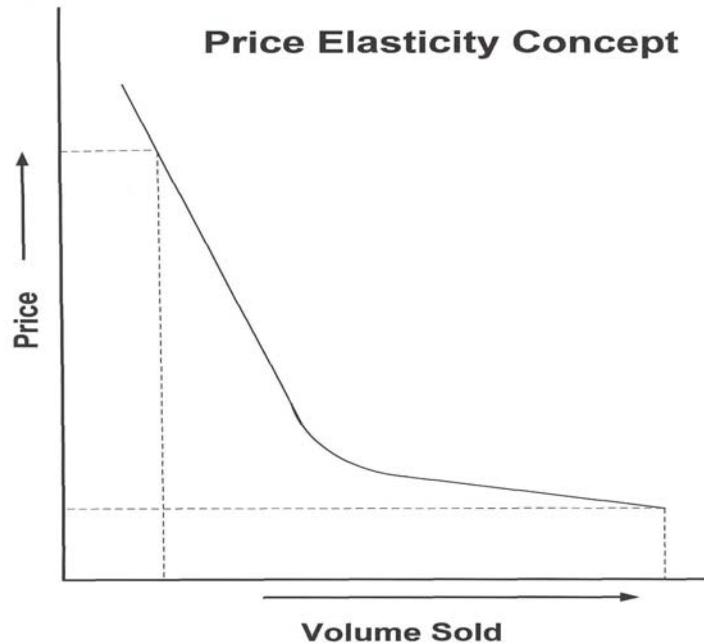
PRICE ELASTICITY

There are always a number of prospective buyers available to the seller at several price points. For instance in the automotive market there are purchasers for BMW's, Chevrolets and KIAs covering a wide range of prices. Any of these would provide adequate transportation, but the higher priced makes have differentiated themselves and sold consumers on a higher price based on their greater value.

The characteristic of markets to purchase similar products at a variety of price points is known as "Price Elasticity".

Copyright ©2008

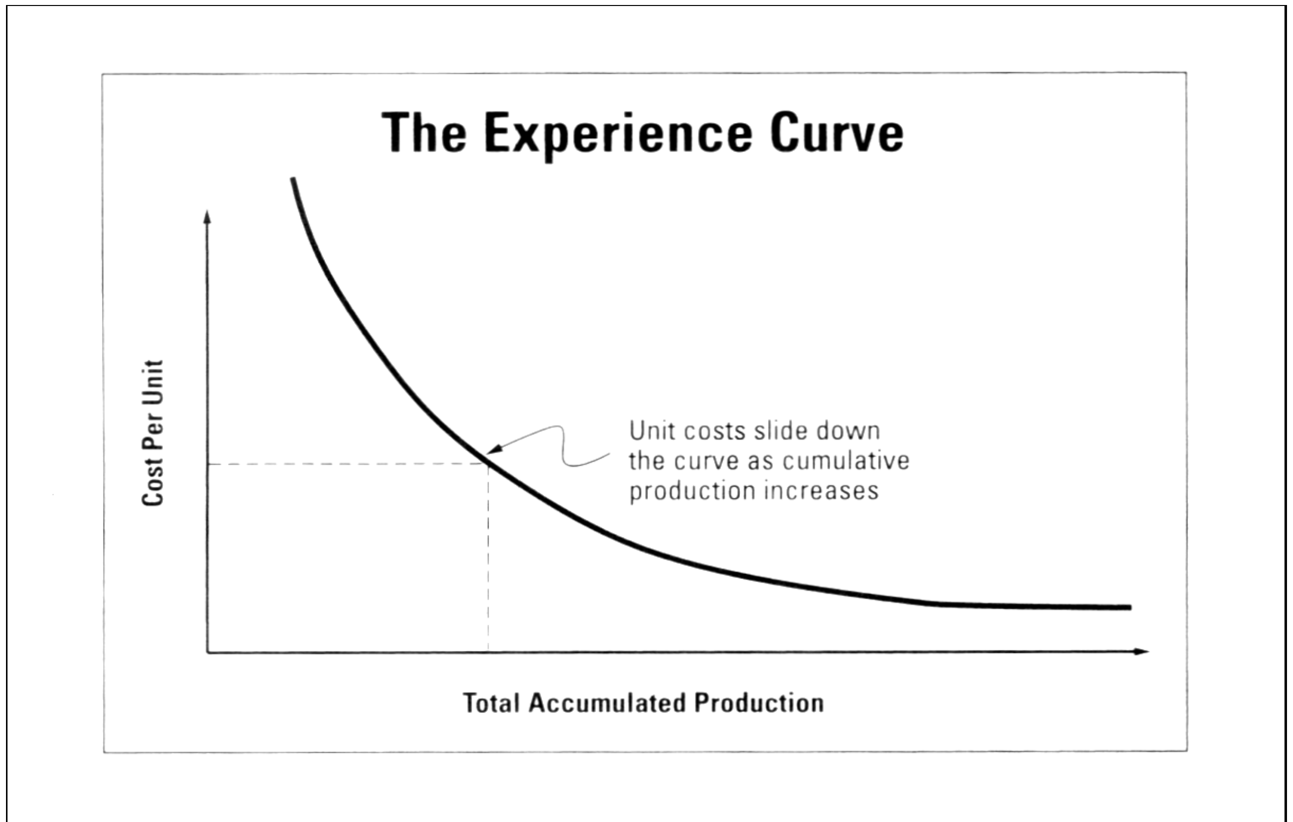
Good marketing, segments its prospects into groups by demographics and creates a price vs. volume chart of price elasticity. The marketer can then evaluate his product and set a strategically optimized price based on the sales volume he hopes to achieve. *(See sample chart below.)*



SKIMMING

In a market characterized by substantial price elasticity such as the automotive market, a "skimming" strategy can be considered. In this instance, the seller sets a very high price in order to "skim the cream" off the top of the market. The seller is wiling to settle for only a few sales in order to achieve an exceptional gross margin. This strategy works best for unique products, something new, different or very rare. Often these items are valued for their exclusivity and for the possibility of their value appreciating if they become collectables. Usually these goods are sold as "luxury" items.

Some products such as computer chips are brought to market with an initial "skimming" strategy while production capacity and competition are limited. As production and experience build, the manufacturing cost decline as shown in the *"Experience Curve"* shown below:



At the same time competitors are attracted by the large margin and enter the market. The result of these changes is that the price is lowered to generate higher volume and to utilize production capacity while adjusting for new competition. Ultimately, these adjustments lower the market price until the product becomes a commodity where "lowest price" is the only remaining selling strategy.

BLANKET PRICING

This strategy seeks to fully cover a large market with a range of products covering numerous price points from top to bottom of the spectrum. General Motors made this strategy famous by offering products from premium to low price and thereby covering most of its price elasticity curve. Part of this strategy is to move buyers "up the ladder" as they mature and their financial means increase.

When this strategy is used, it is important that product differentiation is maintained and a realistic "VALUE" proposition is established to support each price point in the product line.

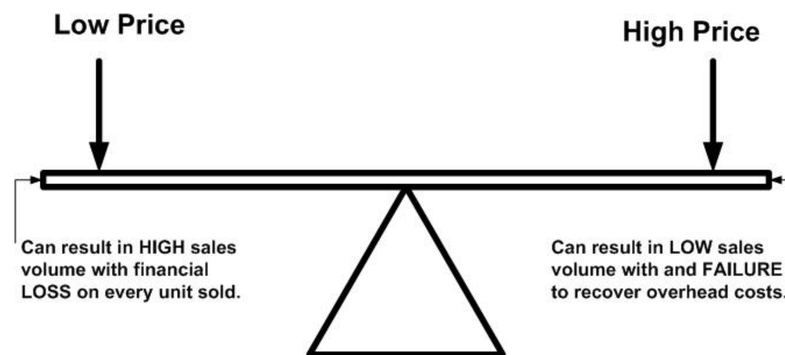
STRATEGIC PRICING

How you price your product is a strategic decision with far reaching and critical consequences. The preceding explanation of some pricing strategies has been simplified in the interest of clarity. In the real world many strategic issues can affect a company's pricing strategies. These include but are not limited to the following:

- Market Segmentation
- Physical Location
- The local economy
- Regulatory considerations
- Local Competition
- Environmental Factors
- Currency Fluctuations
- Others

In a large multinational / multi product company, the whole issue of overhead and its allocation across internal boundaries becomes extremely complex. To summarize, many businesses give little attention to the strategic nature of their pricing decisions. However, while pricing "TO SELL" is easy, it is actually risky because it can lead to spectacular FAILURE! *(See Strategic Pricing Balance below.)* This chart illustrates that too low a price will result in a financial loss with every sale, while too high a price will result in to few sales and failure to fully cover overhead costs.

Strategic Pricing Balance



 Copyright ©2008