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 a good thing? For those of you who still want to raise sales, we need to talk! 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 shop the competition and set a lower price.
2. **Cost Plus** – Cost of goods sold plus a % for profit.
3. **Value Price** – Set a higher and sell higher product 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 to cover the whole range of prices that consumers are willing to pay.

The best rule of thumb is to never sell your product or service for less than the buyer is willing to pay for it!


Copyright ©2008

**LOWEST PRICE**

If you have the lowest price, that means that you will have the most 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 with a low price.
- you should also have a large production capacity to be able to adequately serve this large market.
- you should have substantial working capital to be able to afford the mass advertising needed to inform a large diverse market.
- finally your organization should have the large overhead that requires a large revenue to support it.

If these characteristics do not describe your business, you should carefully consider choosing some other pricing strategy. The lowest price strategy may be simple, but it is tough to be **PROFITABLE** with it!

**COST PLUS**

The cost plus pricing strategy is conceptually simple. It involves calculating your product cost and setting a selling price. This is done in four basic steps. The 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 hours by the $ per hour needed to cover your overhead.
4. Add these three numbers to determine your cost. Your price should be your cost plus your profit margin to establish a target selling price.

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

 Copyright ©2008 

## Sample Cost Plus Pricing Sheet

| | |
|---|---|
| Customer Name<br>Address<br>Phone No.<br>E-mail | |

Description

| | Item 1 | Item 2 |
|---|---|---|
| **Materials Cost (plus 2% for waste)** | $5.00 | $7.00 |
| **Estimated Labor Hours** | 1.0 | 0.5 |
| **Labor Cost @ $10.00 / hour** | $10.00 | $5.00 |
| **Direct Costs (Materials & Labor)** | $15.00 | $12.00 |
| **** Overhead cost @ 40% of direct labor** | $4.00 | $2.00 |
| **Total Costs** | $19.00 | $14.00 |
| **Profit @ 10% of total cost** | $1.90 | $1.40 |
| **Projected Selling Price** | $20.90 | $15.40 |

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

In summary, your actual price may be higher than the target 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 called 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 cost with burden used in pricing is $17/hour. Forgetting overhead in your pricing is the difference between profit and 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)** | #DIV/0! |

*Driving Business to Peak Performance!*

**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 billable hours and capacity utilization is less than 70%, your overhead will not be fully covered eating up your profit.

On the other hand, if capacity utilization exceeds 70%, overhead will be more than fully covered, with the excess dropping 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 | #DIV/0! |
| Average Fixed Cost / Month | |
| Average Monthly Sales Break Even Point | #DIV/0! |

| **Variable Costs** | |
|---|---|
| Description | Current Budget |
| Advertising | |
| Entertainment | |
| Professional Services | |
| Office Supplies | |
| Outside Services | |
| Taxes | |
| Miscellaneous | |
| Interest Paid | |
| Shipping | |
| Total | $0 |
| Monthly | $0 |

| **Fixed Costs** | |
|---|---|
| Description | Current Budget |
| Depreciation | |
| Insurance | |
| Rent | |
| Wages | |
| Telephone | |
| Total | $0 |
| Monthly | $0 |


Copyright ©2008

**MANAGING OVERHEAD**

When breakeven analysis tells us that our capacity will be underutilized, our only recourse is to reduce overhead and capacity.

In our overhead category, we have both variable and fixed overhead. Variable overhead fluctuates with sales volume and is more or less self regulating. Fixed does not naturally change with volume and must be consistently reduced to bring our capacity and breakeven point into alignment with actual market requirements.

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 should be followed in order 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 se4ll on the basis of his value proposition which justifies the higher price point.

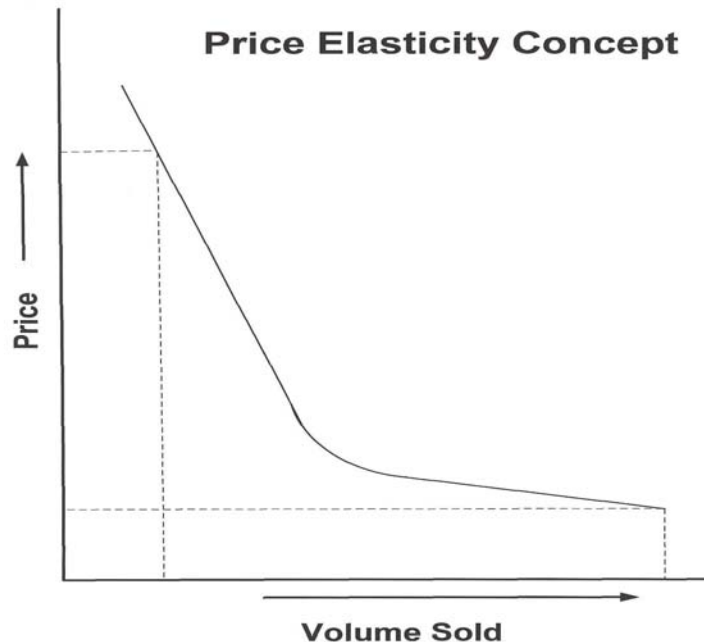
Value pricing is successful because the market place is not homogeneous and is in fact composed of many individual buyers who have a variety of financial and emotional buying motives. This characteristic is known as "Price elasticity." It can be summarized as higher price means fewer prospects while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

**PRICE ELASTICITY**

In any market there are prospective customers available to the seller at several price points. These same people in the automotive market buy BMW's, buy Chevrolets and others buy KIAs. Any of these would provide adequate transportation, but the higher priced makes have differentiated themselves and sold consumers at a higher price based don having greater value.

This willingness of the market to purchase product at a variety of price points is known as "Price Elasticity".

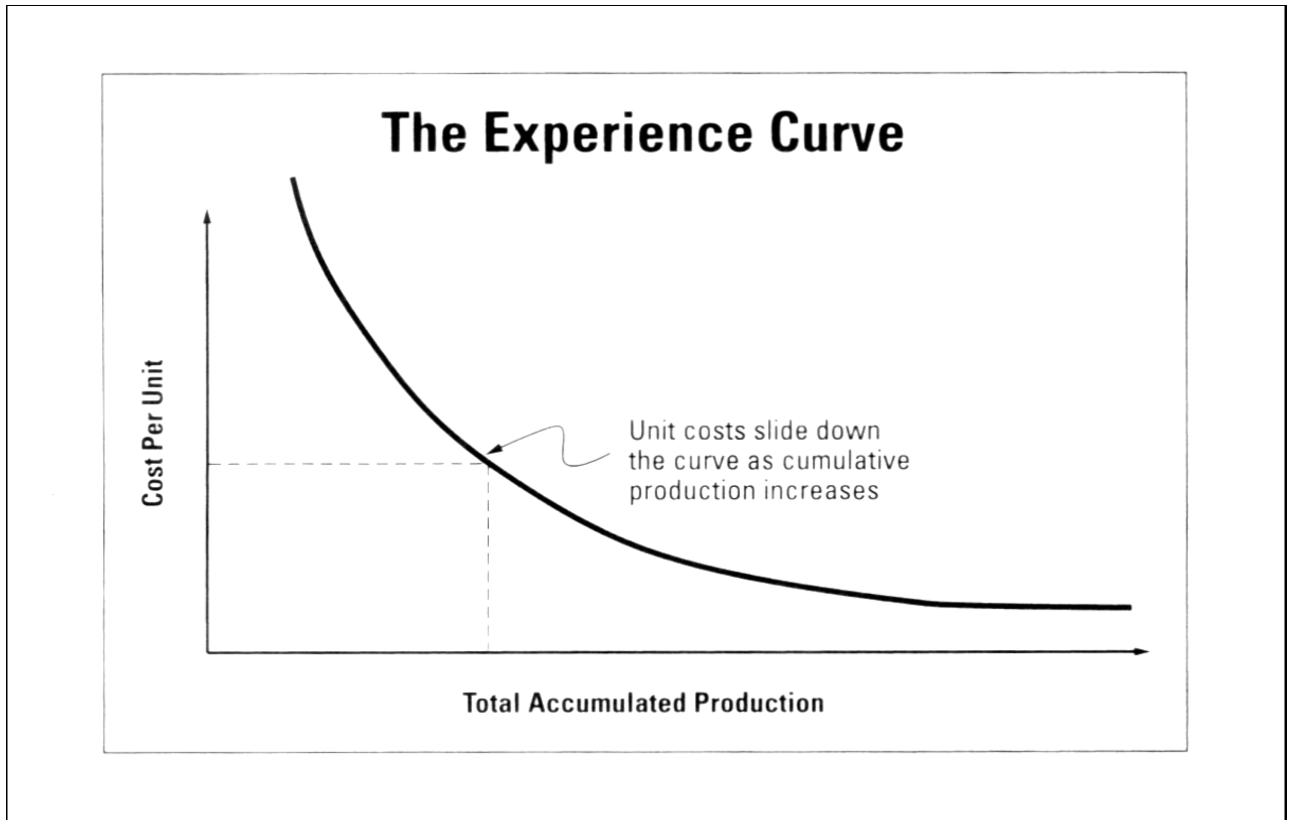
A good marketing activity will segment the market and creates a chart of price vs. volume against which we can evaluate our product and set a strategically optimized price. *(See sample chart below.)*




**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 builds and experience builds, the manufacturing cost decline as shown in the *"Experience Curve"* shown below:




At the same time competitors are attracted by your large margin and enter the market. The result of these changes is that the price must be lowered to generate the higher volume required to sustain the additional available production capacity. Ultimately, these pricing adjustments continue to lower the market price until the product becomes a commodity where "lowest price" is it's primary selling point!

**BLANKET PRICING**

This marketing strategy seeks to fully cover a large market with substantial price elasticity with a range of products covering numerous price points from high to the bottom of the spectrum. General Motors made this strategy famous in the automotive industry by offering products from low to premium price and thereby covering a major portion of the 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 your 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 and do affect a company's pricing strategies. These can 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 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 very risky because it can lead to spectacular FAILURE! *(See Strategic Pricing Balance illustration below.)* This chart illustrates that too low a price will result in 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**