CHAPTER FIVE – What's in a Price?

Earlier in this program we discussed understanding the value you (or your product) bring to the customer. You took time looking at what drives your customers' behaviors, and how you can answer a need they have. You then started exploring ways to communicate the value of what you offer to those potential customers.

But how do we translate that into a price? How can we take the values and benefits of our product or service, and place a dollar value on it?

This is easily one of the biggest troubles for small business owners, and whether you've been in business for five minutes or twenty years, pricing is something that needs to be constantly re-evaluated and adjusted.

The freedom you have with setting prices can vary from industry to industry, but the general principles behind the strategy remain the same. To get started, let's examine some basic pricing strategies, and discuss the values and shortfalls of each. Then, we will discuss how to take the unique value proposition your product has and translate that into a pricing plan.

Cost Based Pricing

First, let's examine cost-based pricing. This strategy is typically how most new businesses develop a price for their product, and because of its structure, is typically not used in a service-based business with low materials cost. In cost-based pricing, one typically looks at the direct cost of producing an item. For instance, a single layered decorative cake would contain ingredients such as flour, eggs, milk, butter, salt, baking soda, etc. For cost-based pricing, one would determine the dollar cost of each ingredient, and add them together to get their total cost of production. (NOTE: this is not the *actual* cost of production, but rather what appears to be a common misconception).

Many times, a business owner would then look at this and say "ok, this costs me $13 to make. I would like to personally get $20 an hour for my time, so $40. Therefore, I need to sell this cake at $53"

To a hobbyist or individual starting out, this strategy might make sense. They covered their costs, and paid themselves what they desired, correct?

Take a moment and choose your most common product or service. Fill in the table below, and see what you would be setting your price at utilizing this method.

ITEM	COST PER UNIT	TOTAL COST

Table 1 - Costs

Total From Table 1	What you want to earn	Total Price

What did you think of the value you ended up with above? Does this seem reasonable?

While this method appears very straightforward, there are a number of pitfalls with utilizing this method.

Ignoring Costs
First and foremost, this method only looks at the cost of the actual materials used in producing this item. If you base your prices on this method, you are ignoring a number of expenses that are vital to running your business. If we look again at baking the cake, we don't take into account the electricity or gas to run the oven, the usage cost on the bowls and pans used, or any other utilities necessary to operating the business.

What other costs might be necessary to produce this? There might be some marketing cost incurred to even get the client in the door, and time spent in business administration tasks, such as bookkeeping, ordering supplies, customer relations, or networking.

The cost of materials used in producing an item are never the only costs. There are always operating expenses, non-direct costs required to operate the business effectively, and cost of time to manage the business to be able to create and deliver.

Forgetting Profit
The second issue with the above model is the assumption that the end goal is to pay yourself, as the do-er or maker. The pricing structure above evaluates what something costs to make, then has you determine what you personally want to get paid, and sets that as the price. Utilizing such a pricing structure ignores the funds necessary to grow a business into a full operation.

While this method is perfect for a single maker just starting out in an enterprise, it leaves no room for growth. When your capacity has been reached, it becomes necessary to hire assistance. However, based on this pricing structure, while you might be able to pay an employee an hourly wage, you won't grow the bottom line of your business. Where once you did all the work and paid yourself for the hours spent directly doing, now you'll be doing even more work and managing of the business, but without accounting for overhead in the pricing, you will have no way to pay yourself as a business owner.

Cost-based pricing is a fantastic tool to evaluate the lowest price you can ever handle for a product or service, but it is not meant to be the final number you present to a customer.

Customer Based Pricing

This method is a fantastic approach for operators who have been in business for a number of years. In the customer-based pricing method, you need to look back at our value proposition work, and evaluate how your customer translates your product or service's benefit or feature, into a dollar value.

Let's look back at chapter 2. Remember, you looked at customer segments, identifying who is coming to you, and what service they are searching for. A memories customer is coming to you because they want to print off pictures or scan a faded photo and they are coming to you because they want these memories preserved for them for a long time to come. While these items have a high intrinsic value to them, how do we translate that into a dollar value? Well, for the individual who is looking for restoration services of an old photo that is irreplaceable, they may value expertise and skill, looking to pay a higher dollar for someone who can take this image and digitally recreate it into looking almost brand new.

There is high value in the item and the skill, here. To understand the dollar value, it may be possible to do customer surveys. If you have been collecting customer data as was discussed in chapters 2 and 4, it should be easy to segment your "memories" customers, and send out a targeted email asking for their feedback on a photo restoration service. The responses will range from the absurdly low to one or two that look very high; but this will tell you how much your average memory customer is willing to pay for this service.

For some business owners it's not feasible to ask your customers directly what they will pay. It could be that responses are low, or you might be hesitant to have such an open conversation with them. In that case, explore other, passive ways of determining their behavior and spending trends. Social Media provides valuable insight on how customers behave, demographic information, and often the types of businesses they follow. This would allow you to see if they tend to interact with businesses that have high perceived value, or if they interact with economical brands. The way they react to your social media posts can also indicate how a customer might value your product.

Competition Based Pricing

This method is extremely effective for those who are in an industry with high competition. We're not telling you to go out and price your product to undercut your competition! Here, the focus is on studying your competition in comparison to yourself. In fact, this is probably one of the only times where it is ok to compare yourself to someone else.

In this method, you'll want to compare apples to apples. So, choose a product or service you provide that a competitor also provides. Now, keep in mind that there are variations within apples. Honeycrisp sell for a lot more than Red Delicious, right? So even though we are comparing the same product or service, *we have our own variation of it.* Even if it feels like you offer the same exact thing, 100%, there are always going to be properties unique to you.

Choose a competitor that is well established and seems to have a customer base similar to yours, to ensure you are developing a plan that works for your demographic. Begin by identifying what makes you different. For instance, a daycare provider might look at one down the road and see that they price their services at $25 a day per kid. They are available from 8am-6pm every M-F, and provide all meals. Our daycare provider can look at that and say "well, I am available from 7am-6pm, and I think my customers would see value in that, and be willing to pay $4 more a day. However, I provide snacks but ask that they pack lunches, so they might see that as a $2 reduced value."

Here, the competitor is used as a baseline. You then add or subtract the perceived value your customers will have, to reach a potential price. In the above case, this daycare provider might tell customers that she's $27 a day.

This approach can be problematic in an industry that is undergoing significant devaluation. Many art and hand craft based businesses tend to be viewed as less worthwhile than mass manufactured items, and if you do not choose your baseline competition correctly, can run the risk of adding to the devaluing of your products.

Additionally, you risk getting trapped in a constant comparison mindset. While this is a great method to evaluate your product or services price, it does not mean you constantly watch your competition and panic every time their price changes.

The three methods above are great tools to use in combination with one another – each one has value but pulling them together in developing your pricing structure allows you to create a deeper profile into how things should be priced.

Next Steps

Of course, the purpose of running a business is to make a profit, correct? You want to be able to pay yourself a decent wage and have the potential to cover unexpected expenses or grow your business. How do we incorporate that into the price? When developing a final price, you want to ensure you've built in a suitable profit margin. For some products and businesses, you may find that you can really only have about 20% of your price be true profit. With other products however, it may be possible to structure it so that number is much higher.

Look at luxury handbags. While brands such as Kate Spade or Coach are high quality, chances are there are department store bags with similar or equal quality for a fraction of the price. The percentage of their price that can go to profit is higher than an identical bag without a designer name attached to it.

So how has Kate Spade convinced people to pay twice as much for what is essentially a basic bag found in mid-level stores?

They convince buyers that the name is worth more

That's right. The marketers at Kate Spade have become skilled at telling customers that their handbag has a classic, sleek design. That the materials are high quality, the work that goes into them is meticulous. When you walk into their store it is bright and bags are displayed individually like priceless jewels. When a customer holds a bag, the salesperson helps them imagine walking down the street, dressed like a model from a fashion magazine, feeling confident. When you have a Kate Spade bag, you are amazing, and you are worth treating yourself.

Does that sound a bit ridiculous? It may, but remember back to chapters 2 and 4. Our customers have a need (a bag), a want (that looks good), a fear (to not be noticed). Kate Spade provides them a durable handbag, that looks classy and timeless. When you have a Kate Spade bag, people notice you, and associate you with confidence and influence of certain socio-economic groups. They are told a story about the type of person they can become if they have this purse; about the admiration or respect they will get when people see them, that they can't afford to be seen with a nameless bag.

It's all about how you communicate your value to a customer.

Now, you also want to ensure that you are able to be a profitable business doing this. If, after going through the above pricing valuations, you come to the conclusion that no one is willing to pay what you need to sell these for to earn a living, it may be time to re-evaluate.

- Can you create the item or provide the service for less?

- Are you able to increase the perception of value surrounding your product or service?
- Is this product or service worth investing your time into?

Prices are never set in stone. A café in Williamsport recently looked at their operating costs and their revenue, and realized they needed to increase prices if they were going to succeed as a business. They agonized over how much they could possibly raise their prices, trying to estimate how many customers it might drive away, and what their break-even point would need to be at a price hike. At the end of it all, their customers did not blink an eye at a noticeable price increase. Why? It could be that the café was undervaluing themselves to begin with – they were pricing to be easily accessible, and while people would have gladly paid more, they enjoyed getting a deal. It could be that because they do such a great job of telling their story – of buying locally grown and harvested foods, supporting local agriculture, and reducing their environmental impact – that the individuals who value that would willingly pay a higher price to patronize a company whose views aligned with their own. They are able to charge a price that allows their business to grow *because they are communicating that value to their customers.*

Of course, you also can't just raise your prices as high as you want – in each industry the market has a ceiling price it will support. An accessory maker was developing a new clutch designed for products and people who they thought tended to have a bit more disposable income. So, given the time and materials and perception, they priced their product accordingly. After the product release however, it became apparent that the product, while a bit more time intensive than others in the line, catered towards a more economical customer, rather than one with freely available money to spend. They were pricing their ideal customers out of buying their product. They've since reduced the price slowly, until they found a price point that still met their profit goals, while also being accessible to the customers who have a use for it.

Pricing isn't an exact science. Each industry, each company, each location have variables that impact what will be an acceptable dollar figure. Your goal here is to pull all of this information together and develop a strategy for creating a sustainable business and proving the value of your business to your current and future customers.