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THE ART OF PRICING

How to Find the Hidden Profits to Grow Your Business

RAFI MOHAMMED

RAFI MOHAMMED is a director of Simon-Kucher & Partners, a consulting firm which specializes in international pricing strategy. Dr. Mohammed, a graduate of Boston University, the London School of Economics and Cornell University, has previous experience as a government economist. He also worked on pricing issues for the Federal Communications Commission during the deregulation of the telecommunications industry and as a fellow at the University of Virginia School of Business.

The Web site for this book is at www.rafimo.com.

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MAIN IDEA

Price is never one-size-fits-all. If you think that way, you're leaving money on the table in the form of hidden profits you can and should access to grow your business. Instead of looking for the "perfect" price where consumer demand is optimized and your profits are maximized, try a more multi-dimensional approach instead.

In particular, there are three different tools you'll need to approach pricing decisions more effectively:

1. You'll need the right mind-set – where you look at pricing not as the search for a single optimum price point but as a multiple price point exercise in profit maximization. The key is to understand the value which exists in the mind of buyers should dictate and drive your pricing decisions, not other factors like what competitors are charging or your costs plus a set margin.

2. You'll need a methodology by which your pricing decisions can be made – a decoder which breaks down value into its various components so you can better understand how your customers are thinking.

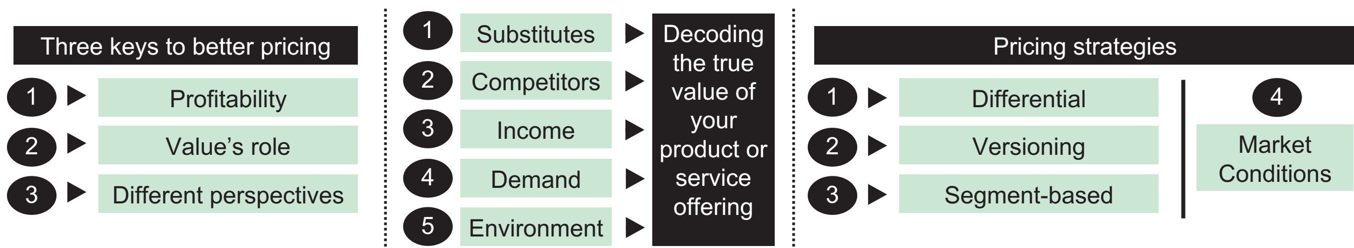
3. You'll need some pricing strategies which will enable you to maximize your company's profits – strategies which are easy to create and to implement in the real world where you deal with customers day-in and day-out.

"For every product in the world, there are at least two people who are willing to pay different prices. If your company thinks about pricing primarily as an either/or, $18 or $31 type of decision, you are leaving a lot of money on the table. Pricing is not about setting numerical prices, it's about creating a set of strategies to maximize your company's profits. Pricing is more than a number; it's a series of integrated strategies."

– Rafi Mohammed

"I think the quickest and easiest route to growing profits is to adopt a pricing for profits and growth philosophy. For most companies, pricing is an underutilized strategy that holds the potential to generate big new profits. The reason new profits can be uncovered so quickly is they currently exist in your product. Since most companies think about (and implement) pricing in the wrong manner, their products are loaded with hidden profits."

– Rafi Mohammed



1. Three keys to better pricing . . . . . Pages 2 - 3

Many businesses are not very good at making pricing decisions. They end up using a price which is based partly on what competitors are charging, partly on their costs and partly on market demand. As a result, companies end up leaking the profits they should be capturing. Fortunately, there is a better approach to pricing. To understand it, you'll first need to understand three key concepts:

1. You need to create a business environment that will allow you to benefit from better pricing.
2. You'll need to understand the linkages between value and pricing.
3. You'll need to appreciate that different customers are always willing to pay different prices.

2. Decoding the true value of your product or service . . . . . Page 4

Before you can develop a worthwhile pricing structure, you have to understand how customers actually calculate the value of your product or service and what factors influence this valuation. Once you know this, you can then go to work on increasing your product's value and translating this information into the right market price or range of prices to be charging. Value is always changing and you need to know these fluctuations and allow for them if you're to have any chance of maximizing your profitability.

3. Pricing strategies . . . . . Pages 5 - 8

The traditional search for the perfect price has to be replaced with a multi-price mindset if you're to capture missed profit opportunities. One price simply is not optimal. What is required is a series of strategies which will enable you to benefit from each customer's unique valuation of your product.

There are four primary strategies which can be used to create a workable multi-price mindset:

1. *Differential pricing* – where you sell your product at different prices to different customers.
2. *Versioning* – where you have a line of products offered at different levels and corresponding prices.
3. *Segment-based pricing* – strategies that activate otherwise dormant customers.
4. *Pricing to the market conditions* – where you run with high prices to create high expectations of value or low prices when it makes sense for strategic or fairness reasons.

1. Three keys to better pricing

Many businesses are not very good at making pricing decisions. They end up using a price which is based partly on what competitors are charging, partly on their costs and partly on market demand. As a result, companies end up leaking the profits they should be capturing. Fortunately, there is a better approach to pricing. To understand it, you'll first need to understand three key concepts:

1. You need to create a business environment that will allow you to benefit from better pricing.
2. You'll need to understand the linkages between value and pricing.
3. You'll need to appreciate that different customers are always willing to pay different prices for the same product because they have different valuations for it.

Three keys to better pricing 1 ▶ Profitability

Strange as it may sound, many firms don't have a culture based around making a profit. Instead, the frontline staff go out of their way to offer discounts to customers in the belief this is necessary to steal sales away from competitors. As a result of these well intentioned actions on the part of staff, the company ends up leaking the profits it would normally have generated. This may not be a problem on an individual transaction, but when this occurs thousands of times over, the drain on overall profitability can be severe.

So what can you do to create a culture where profitability is enshrined as not just nice to have but absolutely essential?

- *Empower your employees to make you more money* – by sharing with them accurate information about product profitability. If they know some of your products generate higher margins, they can steer customers towards those higher margin items whenever feasible. This will only happen if they have the information to work with.
- *Provide consistent guidelines on when to cut prices* – so you close the door on unnecessary discounts. In practical terms, discounts should be offered only in a few circumstances:
  • To match a competitor's limited time offer.
  • To customers who are aware of other alternatives.
  • To customers who have good reasons not to pay full price.
- *Create confidence in your product* – so when employees are interacting with customers, they understand and feel good about the value your products offer. This confidence is vital because it enables your employees to look customers in the eye and assure them they are getting a great deal at the price offered rather than feeling obliged to make additional goodwill discounts.
- *Make it possible for your best customers to provide you with additional profits* – perhaps by offering products with different levels of quality. You might differentiate your products as being good/better/best/very best. Customers who are not willing to buy your premium products can then be down-sold to the other products which are cheaper to produce and priced correspondingly rather than always being offered unsustainable price discounts. And equally, loyal customers can br cross-sold or up-sold into premium products which generate more profits for your company.

Creating a culture centered on maximizing profitability is a challenge. You have to be careful to use the right metrics to measure your success. Pursuing greater market share is meaningless when you're operating in a highly competitive industry because you may end up selling a lot of volume but with little profit on each transaction. Equally, telling front-line sales staff they can offer a $1,000 discount on the set price to secure a sale is also counterproductive if the same discount is applied to entry-level models and high-end products. You have to use the right metrics to measure success and find ways to coordinate activities right across your organization, so one part of your company doesn't inadvertently give away all the profits generated elsewhere.

Three keys to better pricing 2 ▶ Value's role

Many companies base their thinking about pricing primarily on their costs, whereas in reality they could make more if they focused instead on the value they deliver to customers. To take some simple examples:

- In Washington D.C., street vendors sell umbrellas. At the first hint of rain, they double their prices. They know tourists and visitors will value their umbrellas more highly when it's raining and there is an immediate need.
- Baseball fans are willing to pay over $100 for a ticket stub for the baseball game in which Cal Ripkin broke Lou Gehrig's mark of playing 2,160 consecutive games. These tickets have a collector's value which far exceeds the admission cost charged that day to enter the ballpark.

In reality, a product's costs simply represents the floor or minimum price you should charge. Everything charged above that floor is derived from the perceived value in the mind of the purchaser. If you want to charge more for your product or service, you can. All you have to do is find ways to add perceived value in ways your competitors cannot match.

The three most commonly used ways to add value are:

1. *Offer enhanced service* – quicker responsiveness perhaps or services customized just the way you want them rather than being limited to generic service bundles.
2. *Provide peace of mind* – perhaps by offering insurance, an extended warranty or a technician who can come to your office and fix any problems which arise.
3. *Arrange financing* – which makes it easier to buy by providing an extended period to pay.

If you review how customers value your products, you can often unearth opportunities to increase your profits that have never occurred to you. If you charge for the value created rather than on the basis of your costs, you're going to greatly expand your profit opportunities. Doing this often uncovers generous amounts of previously hidden profits you can and should be harvesting for your business.

Different customers have different valuations for the same product all the time. Savvy businesses are aware of that, and develop methodologies by which those premiums can be secured. For example, Carribean resorts know vacationers from snow-covered Boston will value their hotel rooms more highly in January than do vacationers from sunny Florida. Therefore, they advertise their rooms for $350 a day in Boston newspapers if you ring up and use the promotional code "Boston". But if you were to use the code "Florida" instead, you might get the same rooms for $250 a day – the price quoted in Florida advertisements.

Three keys to better pricing 3 ▶ Different perspectives

The value customers place on products and services varies widely for an obvious reason: value is highly subjective and intensely personal. In simple terms, that means different people are always willing to pay markedly different prices for the same product or service. Value is truly in the eye of the beholder rather than set by any external metrics.

If this were not true, there would be no such thing as auctions. If everyone agreed on what the price of an item should be, no bids would be entered. Instead, when the price is low, there will be a flurry of bidders. As the price goes up, people will stop participating until finally there is just one person left who is willing to pay more than anyone else in the room for that item.

There are some great lessons to be learned from auctions from a pricing perspective:

- For every product in the world, customers will have different valuations. If you set just one price for whatever you offer, you're failing to take advantage of this fact.
- Price carries an enormous amount of clout with customers. It has the power to make or break a sale, irrespective of any other factor. For this reason, prices should be set carefully and deliberately rather than as a casual afterthought or as a flow-on consequence of your cost structure.
- High prices will always temper demand but not eliminate it altogether. Similarly, low prices will always stimulate demand and entice people to consider purchasing products they weren't even shopping for.
- Changes in price can be alluring for customers. Offering a 50% discount can change someone from "Not interested" into "I'll take it" in the blink of an eye. And on the other side of the coin, if you double your prices, there will still be people interested in buying. These new buyers may be smaller in number, but they will exist as long as you can justify the added value created by your higher prices.

To see this principle in action and to appreciate the flow-on effects of pricing decisions, consider a couple of case studies:

Case Study #1 – *A new restaurant*

A chef was opening a new gourmet restaurant, and he was trying to decide how to price his signature dish, a prime strip steak with mushrooms. He thought about setting the price at $18 so his restaurant would always be full, or at $31 so he would serve less people but make more. He also thought about going with a compromise $24.50 and hope for the best of both worlds.

Taking on board the idea that pricing should be a set of strategies to serve customers with different product valuations and correspondingly different profit margins, he decided on a multi-price approach which has been highly successful:

- A regular menu price.
- A breakfast menu version of the dish which was offered as an early bird special.
- Senior citizen discounts which could be applied to any items on the menu.
- $200 annual charter memberships which provided a 25% discount on all meals for a year.
- A discounted three-course meal bundle.
- A low-priced bar menu.
- Chef's table seating offering premium cuts and extra service.

Case Study #2 – *Ford Motor Company*

When Lloyd Hansen was appointed controller of the Ford and Lincoln Mercury Divisions, he began searching for the next big thing which would boost Ford's profits thereby boosting his own career prospects. He analyzed Ford's pricing practices, and found if he could generate an additional 1% of net profit margin, this would have the effect of boosting Ford's net income by 33% and its cash flow by an incredible 45%. He also realized this would, in turn, increase Ford's market valuation by 45% since market value is closely linked to the company's cash flow.

Hansen decided to broaden the way Ford set its prices by focusing on four initiatives:

1. *Empower the sales force* – by sharing with them information about which models were the most profitable for Ford. Hansen then provided incentives for the sales force to sell high-margin vehicles rather than the lower margin alternatives.
2. *Use promotional discounts* – to up-sell customers to more profitable models. Even after accounting for the discount, the sales transactions were still more profitable for Ford. In addition, the higher model purchasers also tended to buy more high margin options which enhanced the profitability of the transactions still further.
3. *Cross-sell financing* – by linking special promotions to customers who would finance their vehicle purchases through Ford Credit.
4. *Restructure fleet sales mixes* – so more sales were made to the higher margin commercial and government fleets while correspondingly lower sales were made to the low-margin daily rental car companies.

These four initiatives were tried as a one-year experiment in five of Ford's eighteen sales regions. These regions beat their profit targets by around $1 billion, while the thirteen other regions missed their targets by $300 million. This early success meant all eighteen regions adopted these four initiatives in 1999. As a result, Ford's annual net profits grew from $3 billion in 1995 to $8 billion in 2000. The net revenue per vehicle increased from $16,500 to $19,700. These stellar profits generated an enormous amount of positive publicity for Ford. Lloyd Hansen, meanwhile, has been promoted to vice president of revenue management at Ford.

"Prices need to be aligned with the value customers place on your product. Most companies have yet to adopt this fundamental pricing principle. Instead, they base their prices on how they've always done it, seat-of-the-pants analysis, or – most commonly – just marking up their costs. Think about your own purchases. You formulate the amount that you are willing to pay based on how you value a product, not on what it costs the manufacturer to make it. So if customers use value to determine the amount they are willing to pay, why should your company base its prices on costs? Seeing price as a reflection of value is essential to uncovering your product's hidden profits."

– Rafi Mohammed

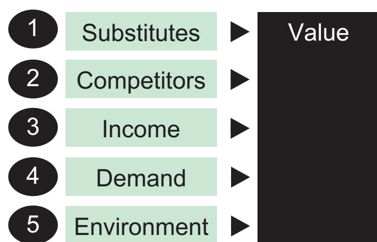
"Raising your average price by a penny or two per dollar can make the difference between a good year and a great year. A recent multi-industry analysis found that implementing strategies that increase average prices by only one percentage point can increase operating profits by 11%. It's surprising Wall Street has not picked up on this tremendous upside potential."

– Rafi Mohammed

2. Decoding the true value of your product or service

Before you can develop a worthwhile pricing structure, you have to understand how customers actually calculate the value of your product or service and what factors influence this valuation. Once you know this, you can then go to work on increasing your product's value and translating this information into the right market price or range of prices to be charging. Value is always changing and you need to know these fluctuations and allow for them if you're to have any chance of maximizing your profitability.

Value, in the mind of your customer, is always determined by five different factors:



1. The price and availability of potential substitute products. Customers will look to these substitutes for clues on what your product is worth. Even if you have a great product but competitors set their prices unrealistically low, customers will assume your product is worth less.
2. How your product measures up (in terms of attributes) by comparison with your competitors. Customers will look at brand, convenience, quality, service, style and other attributes to evaluate whether your product's value is lower or higher. This dictates whether you can charge a premium.
3. The income level of your product's buyers, and whether they have discretionary income or watch every penny. Obviously the higher their income, the more "wriggle room" you have to increase your margins. Increases in your customer's income will also impact their value perceptions.
4. Changes in the price for related products. For example, the price of gasoline influences the relative value of gas guzzlers. Increases or decreases in the prices of any products which are related to yours will impact noticeably on the perceived value of your product.
5. The overall market environment and whether your product's value is going to be affected by the arrival of a fad, new information, or other external events beyond your control.

By working through an analysis of these five factors, you can come up with a price recommendation for your own product or service. Note that only two of these factors are directly controlled by your company. The other three factors are determined by market forces you can't directly control. Your product's value will ebb and flow as these external factors change.

Note also these five factors are determined subjectively by each individual customer. Different people will always have differing personal judgements about the value of things. This is why the comparative value of the same product will differ markedly from one person to the next. If you set a single price point for your product or service, there will always be untapped profits you are failing to harvest.

To take a working example of this process, imagine you are the CEO of a startup company which is making a single-engine aircraft. Your board of directors wants to know how much you should charge for the aircraft. To decide this, you go through the following analysis:

1 Substitutes $300,000

The new airplane will be competing against Cessna's flagship C172 which has a list price of $300,000. This would be your logical starting price point.

2 Competitors $90,000

Your plane will have a faster cruising speed, a longer cruising range, a faster climb rate and a revolutionary new safety system. Your research suggests these attributes should be worth about $120,000 to purchasers. Your brand, however, is less well known meaning resale value will be affected. Detract $30,000 from the new airplane's value to allow for this.

3 Income $25,000

People who purchase your airplanes are able to claim a $25,000 tax break on their federal taxes because this plane features an enhanced safety system. Due to this, customers will be willing to pay $25,000 more for your airplane.

4 Demand .... - $20,000

To cover increased operational costs, airports have recently raised their landing fees. To compensate for that, most airplane manufacturers are lowering their list prices by $20,000. You decide you should do the same in order to maintain customer demand.

5 Environment $15,000

There have recently been some very positive news articles run in major newspapers talking about the benefits of private ownership of airplanes. It's currently considered to be the "in thing" to do. This should allow you to increase your prices by about $15,000.

Total $410,000

This exercise gives you a starting point that best reflects your product's value in the minds of potential buyers. This approach is structured and transparent, as opposed to the usual clouded thinking which tends to characterize most discussions on pricing matters. By breaking the overall value down into discrete sources of value, everyone is on the same page when discussing comparative value.

"A clearly articulated, data-backed value analysis is the key to pricing for profits and growth."
– Rafi Mohammed

"Every facet of every component of value is driven by every consumer's subjective judgement. Think about how diverse people are. It would be surprising to find two people who value the same product identically. The highly subjective nature of value is the reason product valuations vary so widely."
– Rafi Mohammed

3. Pricing strategies

The traditional search for the perfect price has to be replaced with a multi-price mindset if you're to capture missed profit opportunities. One price simply is not optimal. What is required is a series of strategies which will enable you to benefit from each customer's unique valuation of your product.

There are four primary strategies which can be used to create a workable multi-price mindset:

1. *Differential pricing* – where you sell your product at different prices to different customers.
2. *Versioning* – where you have a line of products which can be offered at different levels and corresponding prices.
3. *Segment-based pricing* – where you come up with strategies that activate otherwise dormant customers.
4. *Pricing to the market conditions* – where you run with high prices to create high expectations of value or low prices when it makes sense for strategic or fairness reasons.

Pricing strategies 1 ▶ Differential pricing

It's not at all unusual for two people sitting next to each other on the same flight to have paid markedly different prices for their tickets. This is an example of differential pricing in action. The essence is to determine how much each customer is willing to pay and then offer them your product at that specific price.

There are seven differential pricing techniques:

1. *Use customer characteristics* – to identify customers with different valuations and offer then correspondingly different prices. This is what Disneyland does when it offers lower prices to in-state residents. It realizes someone who has spent money on travel and accommodation values its attractions higher than someone who lives just down the street. Age, gender and affiliation to some organization are other characteristics commonly used to charge different prices to different customers for the same product.
2. *Use hurdles which require customers to take some action* – which will reveal who genuinely values a product higher or lower than others. If a person is willing to clip a coupon and present it, they are credibly budget-minded. Only those who genuinely require a discount to make the purchase will bother going to all that effort. Some shops offer early-bird discounts or memberships to identify those customers who are price sensitive and who need a discount to close the sale.
3. *Use delivery time differences* – to identify those who are willing to pay a premium price for immediate delivery as opposed to those who are willing to wait for lower prices. Some people live to be the first in their neighborhood to own something cool. By pricing products at a premium when first released and then lowering prices over time, profits can be maximized. This pricing strategy is commonly used with high-tech consumer electronics, in the fashion industry, in the hardcover and paperback publishing industries and in the entertainment industry. This strategy can also work in reverse. It is common for Broadway shows and live sports events to charge a premium for tickets bought on the day rather than in advance in order to capture some of the external value of last minute decisions.
4. *Offer quantity discounts* – where lower per unit prices are offered as an incentive for customers to purchase larger quantities of the product. This notion is deeply ingrained in the marketplace. A good variation is to offer huge servings of food products for an additional few cents in order to grab attention and sell the basic product. Volume discounts can also be used as ethical bribes to encourage customer loyalty. The only caveat is not to offer these discounts unless it will make a sale. Many customers won't require them and should not be offered them if you're to maximize your firm's profitability.
5. *Charge differently based on where customers are making the purchase* – which is the strategy many luxury brands use. They sell products at one price in their retail stores, a lower price at their factory outlets and then a different price again online from their Web site. Or they may differentiate prices geographically to reflect how the same product is valued in different regions.
6. *Use mixed bundling* – where products are sold in a bundle which is less than the sum of the prices of the individual components. This is an absolutely treasure trove of hidden profits for the astute seller. It enables people with widely varying valuations of the different components to purchase a bundle which makes them feel like they're getting a great deal. Bundling is widely used because it is so powerful and adaptable. Bundling offers customers incentives to buy more and appeals to a wider spectrum of customers.
7. *Negotiation* – let customers talk to you individually and reveal what it will take to get their business. This really isn't practical for low ticket items or for situations where one customer is fully aware of the discounted price another buyer has succeeded in negotiating with you. As a buyer, sometimes a little bit of staged theatrics in which you threaten to leave without buying can extract a decent discount, particularly if it has been a slow sales month.

The essence of differential pricing is purchasers with obvious motivation are identified and charged more than those with lower personal valuations of the same product. Movie cinemas and hotel chains have used this pricing strategy for many years and have become quite proficient at it. When you make personal purchases, you can use the existence of differential pricing options to your own advantage by always asking what you have to do to qualify for a lower price. You may be pleasantly surprised how many businesses will accommodate you simply for the asking.

"Every company should use differential pricing. Differential pricing allows you to understand the amount each customer is willing to pay and to charge them accordingly. As a consumer, you've undoubtedly experienced differential pricing. Chances are that you've been in a grocery-store checkout line when the person ahead of you used a coupon for an item that you were also buying. As a result, you paid more than the coupon-clipper did. Coupons allow companies to target and sell their products to customers with lower valuations. Customers who make the effort to redeem coupons are revealing their lower product valuation."

– Rafi Mohammed

"Aligning your price with value and adopting a multi-price mindset are the fundamentals of pricing for profits and growth. It is a low-risk/high-upside concept that enables you to collect the hidden profits that are rightfully yours."

– Rafi Mohammed

Pricing strategies 2 ▶ Versioning

Versioning means to sell similar products to different customers at different prices. This strategy requires that you have a range of products which you then offer as different options. Typically, these options are classified as good/better/best or something comparable. Customers can then purchase whichever option best fits their personal valuation and budget constraints.

Versioning works well because:

- It allows you to capitalize on the different valuations your customers have. Those with high valuations can find a high end version with all the bells-and-whistles while those at the low end can purchase a stripped-down and basic model. Everyone can be accommodated.
- Adding attributes to your basic product can attract entirely new customers and open up new markets. It can dramatically increase the size of your target market.
- Versioning is cost-effective. You've made your major investment in your core product and then the additional costs in developing different versions will usually be only small. It's a comparatively cheap way to broaden your customer base.

The main fear most companies have is that a low-priced version of their product will cannibalize sales of their preferred model. In practice, this situation is less likely to arise simply because there is so much variation in customer valuations. You should also keep in mind the marketplace determines sales winners and not arbitrary forces like your own preferences. Your objective should be to make money with all versions of your product so it doesn't matter which sells the best.

There are seven techniques or approaches by which you can offer versions of your product:

1. *Go a la carte* – offer customers a menu of options and allow them to build the product or service bundle which best matches their valuation. This strategy works well because you can earn significant additional profits from all the add-ons and tangential products you offer. You can bank some healthy additional profits from your high-value customers by offering a range of options like delivery, quick turnaround repair service, gift wrapping, consultation services, storage solutions, etc.
2. *Have a more-is-better mindset* – meaning you take your existing product as the entry-level model and build some higher-end models which have numerous enhanced features incorporated. If you have high profit margins on the add-on features, your higher-end models can be vastly more profitable. The key to making more-is-better work is to offer options that will meet the actual needs of new customers.
3. *Offer stripped-down versions of your current products or services* – so you can appeal to the people who don't need all the functionality of your usual products. If you can carry this strategy to its logical conclusion, you can then become a wholesaler and allow others to sell your product under their own brand names and with their own tweaks and modifications. This allows you to reach customers you ordinarily would not serve because they are obviously wedded to purchasing from your competitors. Wholesaling also allows you to enter new markets in association with brands which are well known entities within the target market. Not everyone can do this, but if it is feasible, wholesaling a basic version of your product makes a lot of sense.
4. *Horizontal versioning* – which means you add attributes and features which will attract entirely new types of customers and motivate them to purchase. The new version of the product is not necessarily "better" than the original – it just has a different bundle of features. Automakers have used this approach for years with the roll-outs of various limited-edition models, usually in association with someone well known in another industry altogether. Another good example is electronics retailers. They will offer one version of a product which requires that customers bring the device to the store for servicing and another version where technicians will go to the home and get everything sorted out. These options mean both sophisticated and technically-challenged customers can be catered to.
5. *Expedited service* – which capitalizes on the fact some customers are willing to pay more for rush service. FedEx has two different overnight delivery rates depending on whether delivery is by 3:30 P.M. the next day or by 8:30 A.M. Their difference in costs are probably only minor, but the premium people are willing to pay for priority service can generate sizable revenue for the company. Not every company can offer rush service but for those who are able to reconfigure operations to do this it can be highly profitable.
6. *Offer a VIP option which avoids the wait* – allowing customers to pay more for smaller delays. Many amusement parks offer a regular admission price and a VIP pass at a premium which allows visitors to enter rides through separate entrances. Instead of having to wait in line with everyone else, the VIP pass holders can get on rides quicker. Or have reservations rather than being on a first-come-first-served basis like everyone else. Some consumers are willing to pay double the normal prices or more for the time savings created by the VIP version.
7. *Offer product versions which reduce risk and uncertainty for customers* – because people are often willing to pay more for peace of mind. For example, in many industries, buyers would prefer to have the certainty of a steady supply of inputs at a fixed price than to have their costs fluctuate wildly from one month to the next. Sellers value the ability to make last minute purchase decisions because their future needs cannot always be known in advance. Manufacturers want to know their new products will be accepted by the marketplace. If you offer versions of your products which incorporate insurance to mitigate these risks, many customers will be willing to pay a premium which actually exceeds the cost of that insurance. The same applies to contractual arrangements which remove price volatility. Versioning can remove risks for sellers as well. Some utility companies enter into contracts with their large-volume customers under which those customers agree to lower their energy consumption during periods of high demand in exchange for lower prices the rest of the time. This is far more cost effective for the utility companies than having to build costly generating capacity which is used only infrequently. Television networks do something similar. At the beginning of the season, they pre-sell 75% to 80% of their yearly advertising time slots for a set rate. The remaining 20% to 25% of the time is reserved for spot market sales which can be sold at a premium if demand is strong, or used to promote the network's shows if demand does not materialize. By being flexible, the networks reduce their risk with their guaranteed sales while at the same time positioning themselves to secure a premium if possible.

Pricing strategies ③ ▶ Segment-based

Segment-based pricing is another multi-pricing strategy. It suggests sometimes, a new pricing strategy can grow your customer base. It capitalizes on the interest that currently exists for your product or service by offering options on the way the transaction is structured. Segment-based pricing can convert interested parties into buyers and even reactivate your dormant customers when well thought out and executed.

There are ten different segment-based pricing techniques:

1. *Interval ownership* – dividing your product into smaller, more affordable parts, each of which can be sold individually or as part of a package. This is the technique, widely known as time-sharing, which revitalized the resort industry. People who couldn't justify owning a condominium can purchase ownership for a week or two each year. The same thing is also happening in the private jet industry with fractional ownership generating solid growth.
2. *Bundling* – selling a number of products and services as a single package. The financial services and telecommunications industries are using these to great effect. Bundling can be used to get customers to purchase products they ordinarily would not buy or to sell any number of add-ons. People like bundles because of the convenience and the perception they offer a better deal.
3. *Leasing* – which is simply purchasing the use of a product for a fixed period of time. Leasing is great because it lets people afford to buy more expensive products than they would otherwise have been able to afford. It's also convenient as products are covered by a warranty which protects the customer from large maintenance bills. For corporations, leasing products is attractive because it means the internal purchasing bureaucracy can be side-stepped.
4. *Prepaid* – customers paying in advance for a service and drawing down on this credit with usage. This has been tremendously popular for cell phones because it avoids the user receiving a big bill at a later stage. Prepaid products offer flexibility because there is no need to establish an account. You can simply purchase a prepaid calling card, use it to make a set number of long-distance calls and then throw it away. Prepaid plans can also serve customers with poor credit who are unable to purchase regular products.
5. *Rental* – paying to use a product for a short period of time. This is the cornerstone of the rental car industry, but it can also be used elsewhere to good effect. For example, some airport booksellers rent business bestsellers. This appeals to frequent fliers who want to read a book while on the plane and then discard it at the other end. Some car rental companies now rent by the hour, serving city-dwellers who don't own cars but need one occasionally to run some errands.
6. *Two-part pricing* – the practice of charging a fixed up-front fee and a variable fee based on usage. A number of companies now charge an annual membership fee and lower activity fees instead of trying to make money from higher per-use fees alone. Costco is the ideal example of this strategy. Some rental car companies are doing something similar by charging a flat rate $9.99 per day to rent a car and twenty-five cents per mile. That is much lower than the $30 per day rate charged by their rivals who offer unlimited mileage. This attracts a different type of customer who needs a car for more local usage.
7. *Hurdles* – which often uses time to identify and serve new customer segments. Some amusement parks offer low-priced admission after 4 P.M. to attract locals interested in visiting the park after school or after work. Parking garages do something similar when they offer specials like "In by nine A.M., Out by six P.M. for $15".
8. *Payment plans* – the opportunity to spread out payments over a set period. This is the difference between paying $1,648 for a new laptop computer or making five monthly payments of $329.60 each. The option to spread payments attracts customers because it converts a large payment into a series of smaller, more manageable payments.
9. *Customized pricing* – developing pricing which is tailored to the way each customer values your product. You use a formula to input customer-specific information and come up with a price both you and they will find attractive. Auto insurance companies use this approach to determine a premium rate for customers they ordinarily wouldn't cover, or who really don't need all the features of standard coverage. Customized pricing allows these companies to serve customers they would ordinarily classify as "nonstandard" by setting appropriate rates.
10. *All-you-can-eat pricing* – paying one price for the unlimited use of a product or service. While on the one hand, this approach does draw in the gluttons who are attracted by the word "unlimited", it also attracts profitable customers who value the convenience and peace-of-mind of not having to make a financial judgement call for every purchase. This concept is popular with a wide variety of industries ranging from internet service providers to vacationers who often purchase all inclusive meal plans and unlimited alcoholic drinks plans. Naturally, care is required with this approach and setting the right price can be difficult, as some restaurants have discovered the hard way when their all-you-can-eat promotions have turned into financial disasters.

Overall, segment-based pricing strategies allow you to broaden your pool of potential buyers for your product or service. They remove the purchase barriers for those people for whom a single purchase transaction doesn't work for one reason or another. This strategy capitalizes on the interest which already exists for your product and service more than anything else.

"Segment-based pricing is my personal favorite multi-price mindset pricing strategy. This strategy activates dormant customers by offering new pricing options for purchasing your product. It capitalizes on the fact there may be segments of customers who are interested in your product but simply aren't purchasing because your pricing strategy doesn't fit their needs. New pricing options can activate these consumers."

– Rafi Mohammed

"For most businesses, pricing is a profit-leaking paradox. Managers put a great deal of effort into making and marketing their products to create value, but where many fall short is in transforming the value they create into profits. After enduring the challenges of bringing a product to market, all too often I see critical pricing decisions being made in hastily called 'pricing meetings'. What results is a price which has very little connection to the amount that consumers were willing to pay – a classic case of a product with hidden profits. Pricing is more than a number; it's a series of integrated strategies."

– Rafi Mohammed

Pricing strategies ④ ▶ Market conditions

The final step in pricing is to refine your prices based on your goals for your business and your knowledge of your customers. In practical terms, this means raising or lowering your prices for strategic and fairness reasons to better align with the purchasing reflexes of your customers.

Before you set a price, keep in mind there are four reasons why you may want to lower your prices a little:

1. Low prices can create invaluable publicity and generate long term awareness of your product.
2. Low prices can ensure the right people get your product and not just those who are interested for social reasons.
3. Low prices promote repeat business and almost every company in existence lives by the creed “Repeat customers are the key to our success”.
4. Lower prices can fit the perceptions customers associate with certain price levels by positioning your product where it will have the broadest appeal. Once some psychological thresholds are crossed, all sorts of problems can arise. You may want to price low to avoid these altogether.

Certainly you should set a price that reflects the value of your product or service, but there will be occasions when, for fairness reasons, you should exercise some restraint in how you price your products or services. This may be necessary:

- When giving a discount is a competitive necessity because everyone else is doing it.
- When you serve customers who aren’t very sophisticated and who won’t really be able to appreciate the greater value you offer for a higher price.
- When you have established a long-term relationship with your customers and they view your actions as being personal rather than business-based.
- When you have offered lower prices to other customers and you need to be completely transparent and even-handed in the way you deal with all your customers.
- When you’re selling an essential product with few substitutes. Companies selling lifesaving drugs have a particular dilemma here. On the one hand, pharmaceutical companies are perfectly entitled to make a profit from their research. On the other hand, having people die because they cannot afford the drugs which are available is also highly undesirable. To address this, several pharmaceuticals have banded together to launch a discount card which will enable bona fide patients without health care to obtain their prescription drugs at steep discounts from the prices they ordinarily charge. (A perfect example of a multi-price pricing strategy).
- When you could be accused of taking unfair advantage of customers in a dire situation. For example, when some 7-11 stores started raising their prices for water and other food staples after hurricanes and other natural disasters, this created a huge public relations nightmare for the parent company. It makes the company look like it is benefitting from the misery of others, which is not at all a good look.

The final step in pricing is to make your pricing practices sparkle by tapping into the ways people think. Specifically:

1. *Use the nine and zero effect* – end your price with a nine to make it appear lower ($7.99 instead of $8.00) or a zero to make it look more luxurious ($320 rather than $316.74).
2. *Use a payment plan to enhance satisfaction* – because customer satisfaction is closely correlated to usage. If people pay one annual subscription rate, they will be less satisfied than those who are paying month by month and therefore forced to regularly evaluate their satisfaction levels.
3. *Set your prices high for prestige products* – because customers still equate high prices with quality products. Use your price to signal how people should perceive your product by comparison with its peers.
4. *Anchor your products appropriately* – meaning set prices which are not too low when compared to the more established products. Don’t make people wonder what you’ve left out in terms of quality to achieve your price point when everyone else is so much higher.
5. *Price to suggest a good quantity to purchase* – perhaps sell ten packages for $1 rather than selling them at ten cents apiece. How you phrase the purchase offer can have a direct impact on how much you sell.
6. *Pose your pricing offer as a series of small investments rather than one sizable transaction* – since most customers will relate better to eight payments of $27.86 than they will to one payment of $222.88.
7. *Cram your product bundles with oodles of extras which convey the impression of value* – because the more you fit in, the better. If you’re lucky, people may even be so impressed by all the sweeteners they consider your product to be a no-cost add-on, which is great.
8. *Offer people a bargain* – because everyone loves buying products that are heavily discounted. The bigger the discount you offer customers, the greater the perception is customers have got a great deal. Push this idea to the max.

“The best way to start uncovering your hidden profits is to tap into your employees’ insights and experiences (especially those of your sales force). They are on the front line every day, interacting with your clients. They know what customers value, who will pay more for your product, and which prospects can be converted into buyers by a discount. Your employees are a treasure trove of pricing information. The challenge is in organizing their insights in a constructive manner that enables you to price for profits and growth.”

– Rafi Mohammed

“Companies may not have a choice. If rivals are better at pricing, companies risk losing customers and eventually end up competing against firms that are better capitalized because they price for profits and growth. For example, after years of watching Lloyd Hansen’s pricing success at Ford, both General Motors and DaimlerChrysler made similar efforts to better manage their pricing. Mastering the strategy of pricing is essential to prospering in our increasingly competitive business environment.”

– Rafi Mohammed

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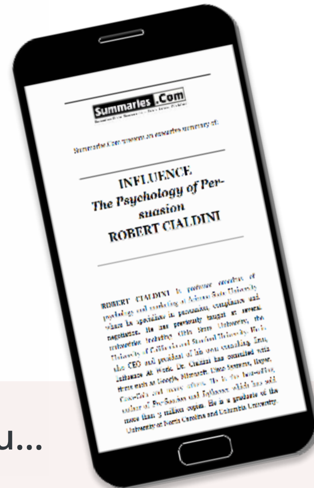

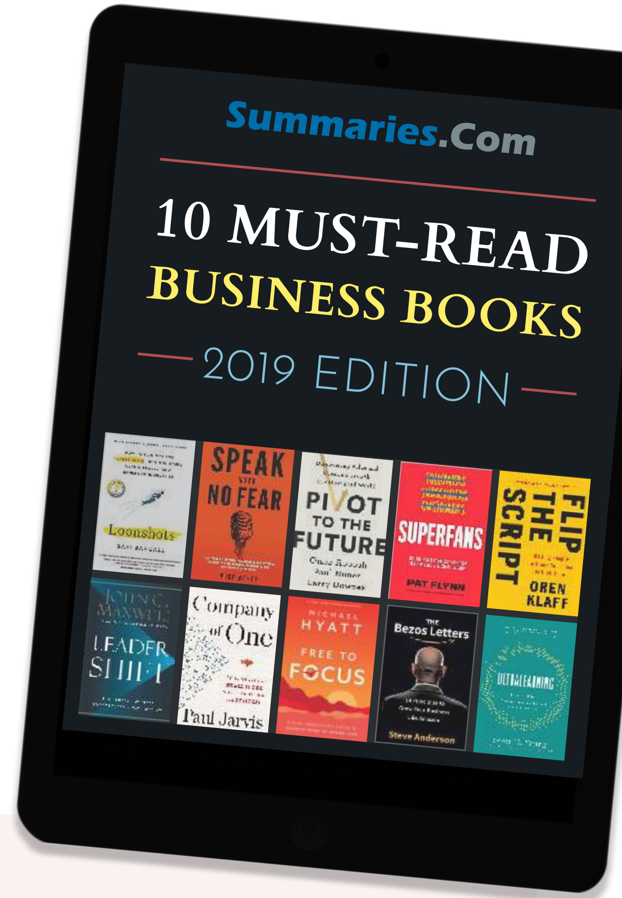

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