Pricing PRIMER

by Richard Ensman

You want to get the maximum profit when you sell your goods and services. So you know instinctively that price is important.

But how do you set the right price? Though pricing can be a complex issue involving budgetary analysis, market research and testing, a few simple models are available to help you understand the basics. Here are four of them.

1. Cost Plus

The easiest way to set a price, of course, is to make it a function of your costs. Determine the direct cost of producing a unit of goods or services, add your overhead and then cap it with whatever you consider to be a fair profit percentage. This can range from a very small percentage (in the case of highly-competitive or high-volume businesses) to a percentage that's much higher (in the case of less-competitive businesses or businesses selling custom goods and services).

But simply adding a profit percentage to your costs doesn't take into account the competition you may face, so we move to another model.

2. Market Sensitivity

Using this model, you will make an attempt to discover what your competitors are charging for similar products—and price yours accordingly. You might sell at a slightly lower price than your competitors (if you're appealing to price-sensitive customers) or you might sell at a slightly higher price, particularly if you're adding value to your product line in some way. Or you might gear your prices toward new competitive markets you're trying to penetrate. Under this model, of course, you'll stay abreast of industry trends and competitor prices.

But competition alone doesn't give you the opportunity to reach for what you consider to be ideal profit projections, so we move to still another model.

3. Measured Results

Here, you'll set prices in order to achieve profits targeted against industry standards. For example, based on your expertise and your understanding of the industry, you might build your prices to stimulate a certain profit per unit sold. When you use this model, you're compelled to pay special attention to your internal budget. This model gives you precise profit targets which can, in turn, drive your marketing activities.

But we still haven't considered one important piece of the price equation: the customer. That brings us to a fourth model.

4. Demand Analysis

The law of supply and demand is a fundamental principle of economics, as is price elasticity. When supply is low and demand is high, you, the marketer, have an opportunity to establish higher prices and reach for higher profit margins. Conversely, low demand and high supply places a downward emphasis on prices and profits. The wise marketer sets prices strategically based on her understanding of the forces of supply and demand. For example, if you are trying to position your product as distinctive—and one or more market segments appear ready to embrace an exceptional product—you might increase your price, decrease your volume of sales, but ultimately increase your profit because of your higher margin. Or you might decrease your price in order to gain a greater share of the overall market and build profit through increased volume alone.

Each of these models, coupled with the advice of a good marketing staffer or business consultant, offers you clues to your ideal price. Understand the models and the dynamics of the marketplace around you, and you'll find yourself in a position to maximize whatever profit that ever-competitive marketplace offers you.❖

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