The Dark Art of Pricing

Deliberately Pricing for Profit

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Self-Counsel Press
(a division of)
International Self-Counsel Press Ltd.
Canada USA

Self-Counsel Press acknowledges the financial support of the Government of Canada for our publishing activities. Canada

Printed in Canada.

First edition: 2019

Library and Archives Canada Cataloguing in Publication

Title: The dark art of pricing : deliberately pricing for profit / Andrew Gregson.

Names: Gregson, Andrew, author.

Series: Self-Counsel business series.

Description: Series statement: Business series

Identifiers: Canadiana (print) 20190148942 | Canadiana (ebook) 20190148969 | ISBN 9781770403154 (softcover) | ISBN 9781770405028 (EPUB) | ISBN 9781770405035 (Kindle)

Subjects: LCSH: Pricing. | LCSH: Profit.

Classification: LCC HF5416.5 .G74 2019 | DDC 658.8/16—dc23

Self-Counsel Press
(a division of)
International Self-Counsel Press Ltd.

North Vancouver, BC
Canada

Bellingham, WA
USA

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Acknowledgments

I am dedicating this book to my father, Charles William Gregson, who passed away December 2, 2015, and to whom I owe a debt of gratitude for teaching me that an unbroken record of success is always a result of doing nothing. Most of the pricing errors I refer to in this book have been committed by me. We learn by doing and failing.

To my patient wife, Judith, who would prefer that we travel but has endured my passion for proselytizing that pricing is the final frontier of profit engineering.

I owe a debt of thanks to people who have read parts of the book and given back useful critiques: Richard Turley of Okanagan College, and Larry Widmer of Community Futures of the Okanagan.

I particularly owe thanks to all of the employees, clients, colleagues, and bosses who have listened to me over the years and offered their experience and further insight, all of which resulted in this more prescriptive book than my first.

Finally, I owe a big thanks to Self-Counsel Press and the encouragement they have always offered, and the chance they have taken with this work.

Preface

I have spent years consulting on profitability to small- and medium-sized businesses in North America. What I learned in doing this was that their experiences were not that different from my own, as I have started and owned five businesses, including two franchises. Many of these businesses struggled to generate enough wealth to make retirement for the owners a comfortable proposition. Far too many struggled just to pay the rent, payroll, or taxes. I know that they fought hard to try to be profitable, cutting fat and often slicing into corporate muscle to keep costs down.

Too often, the owners are the last ones to be paid.

Every business owner I worked with knew everything about the supply side of their business equation; they knew their sales processes and their costs. However, they could not grasp the other half of the transaction: the demand. In particular, how this applies to pricing and its role in profit and wealth generation.

I have called this book *The Dark Art of Pricing* because for many the process of determining price is akin to boiling eye of newt in a cauldron surrounded by wicked witches. Pricing is not magic, any more than selling is magic.

Finding the right pricing strategy is, like developing a sales program, work. It takes testing and tweaking. But the "how" and "why" are buried in corporate vaults and academic journals, almost inaccessible to the average business owner. My purpose in this book is to take those ideas and make them available to business owners so that they too can earn the profits they deserve.

This book builds upon the foundation I laid in my first book, *Pricing Strategies for Small Business* (Self-Counsel Press, 2008). After ten years of research and preaching that pricing is the last frontier of profit making, I needed to update my book with all that I have learned. Hence this book is more process driven and certainly grittier.

You will notice many references to my personal business experience in this book. When I lectured at Cape Breton University to MBA and BBA students, one of the attendees asked why I knew so intimately how pricing failed. My response was that I had made all the mistakes I talked about. Making mistakes is normal, but failing to learn from them is unfortunate.

What I wish for all business owners is that they find a way to charge what they are really worth, to drive larger profits, to build wealth, and to attract a buyer when the time comes to retire to a sandy beach. I hope this book helps them do just that.

Introduction: Why Is Pricing Important?

Pricing should be of the utmost importance to business owners because it is possible to use price strategies to engineer a deliberate profit.

You can drive sales and cut costs. Your accountant can tell you how to cut costs. Sales trainers can help you improve sales.

What is often mostly ignored is pricing, and pricing is, in my opinion, the final frontier of profit generation.

I tend to slam conventional pricing methods hard because it leads to mediocre results. Later on, I will offer some tried and tested pricing strategies used by companies such as Apple and DuPont. I will also explain the importance of knowing how to "sell your price," that being an immediate step to more sales and higher profits. My focus in this book is on value pricing because without value on the table, why would anyone pay your price? I will also offer two extended case studies about Return on Investment (ROI) pricing and price banding.

To make this book work for you, the reader and business owner, we must first establish that most pricing systems produce mediocre results and leave money on the table. Let's discuss some common myths.

1. Five Common Pricing Myths

At the bar and over the phone, business owners recycle old myths about their businesses and their industry in an attempt to simplify and understand their circumstances, but the myths do not bear much close scrutiny. Here are five deconstructed myths.

1.1 All my competitors buy better so they can sell more cheaply, and that explains my poor sales

It is unlikely that all of a business's competitors are able to buy better and sell more cheaply. Globalization of supply chains has made it simple for even owners of small stores to source well. The suppliers play games, of course, with volume discounts, rebates, and other sales devices to push up sales. But, to blame the supply chain for poor sales performance is just deflecting attention from other business problems.

1.2 Every customer who says we are too expensive is right

There are customers for whom free would be too expensive. Remember too, that sticker shock can be a buyer's strategy to get you to lower your price. There are some customers who buy on price alone but they need to be gently pointed in the direction of a competitor. These customers are no respecters of the value you offer. In general, enough customers will buy what they value.

1.3 If sales drop, then it is the fault of my high prices

Depending on how many items you're selling, it is unlikely that all your prices are poorly positioned. Most regular buyers of a particular product or service can recall ten prices only. That appears to be the maximum number of prices we can remember and then only through constant reinforcement. So, in a store selling a 1,000 items, as many as 990 things have no reference price in the mind of the buyer. Of course this applies to retail or distributors and wholesalers, but could also apply in the narrower range of the contracting world. Elaborating your offering with value propositions and add-ons for concrete work, say, helps you use that power of ten.

1.4 My invoice costs are the only factors that determine prices

Profits are determined by a whole host of factors. Among them are programs such as those involving volume discounts, 30 days to pay, free delivery, free installation, free support, and free add-ons. These factors and programs drive up costs but all too typically are not accounted for when building a price. These off-invoice costs are part of the price waterfall that erodes profits. See the Castle Battery case study in Chapter 13.

1.5 The price is the only factor that influences a sale

Price is not the only factor that influences a sale. With items of fashion or taste, higher prices are associated with better quality or social standing. There are cheaper sneakers than the ones demanded by teenagers so that they are seen as cool in their social circles. A Hyundai will get you to work just as easily as a Mercedes. Diamond rings would not be the symbol of undying love if they sold for $4.95, would they?

2. What This Book Is About

This book is the culmination of research and experience first incorporated into my book *Pricing Strategies for Small Business* (Self-Counsel Press, 2008), and then augmented by a subsequent decade of talking to business owners, students, and colleagues as they try to apply my ideas.

The purpose of this book is to present pricing as a tool to increase profits. Yes, big companies have pricing strategies that they nurture, protect, and aggressively use. But gaining an insight into what they are doing is almost impossible. Pricing is a tool underresearched, little understood, and underused by small businesses. If you want to cry into your martini and blame someone else for your business problems, go ahead. If you want to succeed, developing an innovative pricing strategy is the most powerful way to improve profit and build your customer base.

Pricing is part of marketing and not accounting and therefore a strategy should be born out of an individual business's marketing principles.

If you are a business owner, you already know your costs, but what you may not know is the upper limit of your price and profit band. I am not writing about gouging or ripping off customers. What I want you, the business owner, to understand is that people are willing to pay for quality, convenience, and service — but only if they are clearly articulated.

This book is not about increasing your prices but finding that sweet spot where you become the price leader because you are the best in your industry or area, and the go-to company because of the value you offer.

If you are in a hurry, you may wish to look first at Chapter 1, The Quick Fix, for an immediate boost in your ability to command the right price. Of course, if you follow my advice you should get a prompt return on your investment in this book!

Chapter 1

The Quick Fix

If your company is facing profitability problems today, this is a quick fix.

How quickly could you double your profits through extra sales alone? For most of us, doubling profits means doubling sales. Could you do that instantly or at least quickly?

How quickly could you double your profits from cost cutting alone? Just the thought of trying to do that should make you shiver.

But, you could change your prices tonight!

I am not an advocate of simply raising your prices without some justification. Typically reasonable justifications would be a rise in the cost of living, inflation, or simply that costs have risen for the industry. Most businesses could manage to raise prices by a mere 5 percent without losing or even alarming customers.

Rather, I would expect that businesses raise their prices after finding a solid competitive edge that demonstrates beyond the shadow of a doubt that they have put value on the table for the customer to see, taste, or touch.

Occasionally, however, there is a case to be made for a simple price hike. Businesses in serious trouble and in danger of collapse may be helped by this short chapter.

In my years of research, I learned that once, a sample of customers had to choose between fictitious, outwardly identical floor polish products, the only difference being the price. Fifty-seven percent of people chose the more expensive product.

Most small businesses in North America have a bottom line, before tax, of 5 to 10 percent. That means that the costs of goods and services provided plus the cost of administering the company come to a princely 90 to 95 percent. In Figure 1 this is illustrated for an imaginary million-dollar company.

BEFORE		
Revenue	$1,000,000	100%
Direct and Admin Costs	$950,000	95%
Profit	$50,000	5%

Figure 1: Typical $1 Million Business's Bottom Line

Let us suppose however, that you were to increase prices and do nothing else. Most companies could raise prices by 5 percent without customers leaving.

Let's look at the impact of merely making that one change in Figure 2. Make no other changes, no increases in costs or administration, and you can see that the 5 percent extra drops promptly to the bottom line. Just 5 percent more in price effectively doubles the bottom line in this example.

AFTER		
Revenue	$1,000,000	100%
Price Increase	$50,000	5%
Direct and Admin Costs	$950,000	
Profit	$100,000	10%

Figure 2: Typical 5 Percent Price Increase to $1 Million Business's Bottom Line

No other recommendation I could ever make to you and your company could double your profits so quickly.