PRICING STRATEGIES FOR SMALL BUSINESS

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WHY IS PRICING IMPORTANT?

The purpose of this book is to help small businesses with a neglected and vexing business problem: how to get prices right. They should be high enough so that the business makes a profit and yet low enough to keep customers coming through the door.

This is a neglected issue since most publications on this topic are for scholarly consumption, but judging by the current flurry of articles and books, pricing is becoming the next big business topic. Most of the books and articles I read for my research on pricing methods are struggling to find a framework for a new pricing “system.”

This is also a neglected topic since most publications are directed at big businesses and draw most of their examples from huge corporations. There may be similarities in pricing logic between General Electric and the corner shop selling used clothing, but the similarities do not immediately rush out and take you by the hand.

Pricing is a vexing subject. Have you ever had customers respond badly to your pricing structure? Having a customer walk out or outright declare that your price is a “rip-off” is a horribly discouraging
experience typically accompanied by a sick feeling in the pit of your stomach.

How do you get the pricing right, while in most markets there is competition from big-box giants like Wal-Mart or from chains bringing in Chinese-made goods, reducing your most profitable lines to a commodity that is bought and sold on the world stage based on price and nothing else?

“All too frequently, executives will complain about price problems and price pressures, but are these are rarely mere pricing problems. They usually deal with communication, branding, image, product, distribution, service excellence, segmentation, and other ill-conceived, ignored or poorly executed functions of a marketing strategy that isn’t focused on value.”¹

When you are finished reading this book, you will have a working knowledge of many different pricing mechanisms. Moreover, you will have the tools to examine your own business to enable you to measure the impact of a new pricing scheme. But best of all, you will have many pricing options to choose from, options that will help you to set prices so that your business will clobber the competition.

When I began preparing this book for publication, I began with my consulting experience for small companies that had not yet got the basics right. For the most part my clients didn’t grasp their real costs. Bidding on a job was something that happened on some distant planet in their imaginations, and bore no resemblance to the real world of their shop floors. A lot of my book is focused on helping small business owners to understand their costs and learn how to measure them.

As I have done my research for this book, I have dramatically expanded the value-added portion of pricing theory. In the past decade, pricing theory has reappeared in academic journals. The thrust of the research is no longer concerned with costs but with adding perceived value. The assumption is that the company knows its costs and as long as it covers its costs, it can proceed to add value by raising prices. I have used this information greedily.

If you read this book completely, you will discover that price is not purely a numbers game. In fact, it is difficult to get away from the notion that price reflects how a business delivers value to its customers. High prices ought to reflect high value. Low prices should

Why is pricing important?  

reflect commodities with little or nothing injected to add value. Therefore a large portion of this book encourages you, the reader, to review your business as a potential customer would; what value do you offer, how much is that value worth compared to your competition’s offers, and is this transaction a fair trade?

Journeying down the path of price discovery entails looking into many dark and perhaps underperforming corners of the business. Therefore, this book touches on but does not exhaustively examine sales training, merchandising, estimating, motivation and marketing. In each area I have tried to keep the focus of the impact of pricing strategy on areas such as staff motivation, for example, and in reverse the impact of staff motivation on pricing structure.

As a business owner you only have to work half a day, and, better yet, you get to choose which twelve hours. I remember being a small business owner and how true this joke was for me. With that in mind, I have tried to recognize that the average business owner will get maybe five minutes of uninterrupted time to dip into this book and grab a useful idea, or perhaps the inspiration to read a whole chapter at night after business shuts down and everyone has gone to bed.
I argue throughout this book that a business owner must see his or her business as a struggle of perception. Customers strive to reduce everything to the most easily comparable state — apples to apples — and that means dollars per unit. A business must strive, on the other hand, to stop this from happening by presenting itself as pomegranates. If successful, then the customer cannot reasonably make a comparison on price only. Create a perception in the customer’s mind that the business, product or service is different, and long-term business success can be yours. Create differences that actually have value in the mind of the customer. Throughout this book there are examples of perceived value and how it can be converted into better prices and better profits.

Before we can pursue that topic, however, we need to know if pricing is an issue in your business. In this chapter, I have highlighted a number of ways to see if your prices are too low. In the appendices, I have added sections on the math calculations to confirm this judgment and to help you measure the impact that pricing your product or service too low can have on your business.
Is Price Just a Number?
Price is the amount of money charged for a product or service for the benefit of receiving a product or service. The word “benefit” is emphasized because small business owners frequently lose sight of the relationship between benefits and the simple transaction of buying and selling.

An example is that of eating in restaurants. Most people eat in restaurants to celebrate an occasion, for “date night,” or merely to take a break. The experience of eating out is the benefit, and the price tag cannot fairly be compared to the money spent if the same meal was cooked at home instead.

What Makes Pricing Successful?
Pricing is successful if:

- The company has a decent profit
- The owner is paid a reasonable wage
- The company and the owner pay their taxes
- The company has no difficulty finding the cash to pay the bills
- The company attracts the best quality customers who are willing to pay for the value added by the company
- The company generates a reasonable return on investment
- Bids on jobs are planned to leave no money on the table

What is a decent profit?
According to Statistics Canada, the average small company in Canada generates a profit before taxes of 5 to 10 percent of sales. This is not the only indicator of the health of a company but it is a good first step. With healthy profits, cash will be relatively easy to manage; Accounts Payable will be smaller than Accounts Receivable, the bills can be paid without having to hound customers who are just a few days late to cut you a check. If you miss a few weeks looking at the cash flow, it just doesn’t matter too much.
I don’t like averages; so what should the numbers be for my company?

Would you like to know what the median numbers are for your type of company? Wouldn’t it be great to know if your percentage of profit or sales costs or even rent is “normal?” There are some ways to get that information. Quite often there are industry organizations that conduct “cost of doing business” surveys annually. By joining a trade association, you could get a survey and compare your own financial statements. Sometimes the previous year’s survey is available at a small cost to give you a taste of the benefits of joining a trade association.

Paying the owner

Most importantly, a business exists to create profits after the owner is paid. Small business owners often lose sight of this objective in the sound and fury of everyday business, but a paycheck was clearly important when they began or bought the business. Getting the price right is the most important element in reaching the distant goal of financial security — either through profit generation or in getting a good price when selling the company.

What is a reasonable wage for the owner?

The simple test is an honest answer to the question: “Could I be earning more working for someone else?” If that answer is no, then the business pays you what you are worth in the open market. If the answer is yes, then your business needs work.

Or, suppose that you were planning retirement or became disabled. You could hire a manager in order to step back from the business and pay that person your wages. Would your pay be enough to attract and keep that person? If the answer is yes, then you are paying yourself a market value wage.

If you calculate the total hours you spend working and your wages are less than the wages of person who sweeps the floor, then you are not paying yourself enough.

Consider this scenario: You have a potential buyer across the desk from you. Of course, the price for the company is the topic. He
or she wants to know how much he or she will earn and how much will be left over in the company. Is there a bottom line after his or her reasonable wage?

The company and the owner pay their taxes
Why is this important apart from not having CRA or the IRS chasing you? Recently I spoke with a business owner who wished to buy a house. His credit score was excellent and he had cash in the bank to manage the down payment. But because he had deliberately understated his personal and business income to reduce his taxes, his provable income was too low for the bank to consider loaning him the mortgage money.

In another instance, the owner of a company was trying to convince a potential buyer that the company was worth a great deal more than was shown on the books because the owner pocketed so much cash. But because the owner could not prove the cash flow either in his books or in his personal tax returns, the valuation of the company remained very low and no deal could be struck.

It is standard practice when preparing a company for sale to declare all revenues and take the tax hit during the last couple of years before the anticipated sale date. This bumps the revenue and the sale price. The new owner can employ whatever tax scheme he or she wishes after the cash has changed hands.

The business has no difficulty finding the cash to pay its bills
This would appear to be a “no-brainer” until you consider the colossal number of business owners who struggle to make payroll or find the money to pay for goods ordered to restock the shelves. Every time the price is too low, any minor expense that takes cash from the bank account — a sudden increase in Worker’s Compensation rates, for example, or a fire, or a vehicle that is damaged by an employee — means there is a mad scramble for cash. If you have ever read any financial self-help books, you will remember that paying yourself first, or “saving for a rainy day,” is the key to being able to sleep at night.
The business attracts the best quality customers who are willing to pay for the value added by the company

This is really the crux of the pricing issue. Good quality customers recognize the value in what your business offers and willingly write the checks. To get to that position, the business owner has to clearly articulate to the potential customer why his or her price has value for the customer’s money.

Following are two examples of how perception can create “value for money.”

EXAMPLE 1

Many years ago at a presentation in Chicago, we were shown two pictures. One showed an unshaven man with a bulging abdomen, wearing a dirty, torn t-shirt with a cigarette pack twisted up under the shirt’s left arm. He wore dark glasses, had a cigarette hanging from his lower lip and was ignoring the camera.

The second picture showed a clean shaven man in a white lab coat looking right at the camera and clutching a clipboard.

The presenter asked the room full of business owners what these two individuals did for a living. We replied that the first one had to be a plumber and the second a doctor.

In fact, both pictures were of the same person, just presented in a way that made one look more valuable than the other. Although there are jokes about doctors being paid less than plumbers these days, the point of the slide show was to demonstrate the importance of presentation to gain price and market share.

EXAMPLE 2

Plumbers have a bad, perhaps unearned, reputation for being slovenly and unreliable. But in the middle 1990s in Richmond, British Columbia, I came across a fellow who helped me with a toilet problem that arose after a visit from small members of the family, and was ultimately caused by the unauthorized presence of a toothbrush stuck in the toilet.
I had a very narrow window of opportunity, so Bob the plumber had to arrive at my house at 7:00 a.m. I would be away and my wife would have to let this stranger into our house at that early hour.

At precisely 7:00 a.m., Bob arrived and rang the doorbell. Bob was dressed in clean, pressed white overalls and presented his business card to my wife as she opened the door. When he finished fixing the toilet, he used his wet-dry vacuum to clean up the inevitable water spill and left a bill for me to pay.

Bob’s Plumbing got a great review from my wife who proceeded to tell others about his services. How else could he stand out from the crowd? Wearing white overalls! Presenting a business card! Cleaning up all the water spills! Bob added value to his service, which in turn earned him valuable word-of-mouth promotion and the opportunity to further his business.

The business generates a reasonable return on investment

It is a good return if the $200,000 you have invested in your business gives you better returns than the bank would after taxes and your salary are paid. What this means is that if the cash you have invested in your business could be taken out and plunked into a bank account, would it earn more money than where it is currently in use?

**EXAMPLE 3**

If $200,000 in a nice, safe bank account generates 15 percent in interest revenue per year, it will give you a tidy $30,000 a year income before taxes.

If the business has $200,000 of your money invested in it — your cash — and the annual profit before tax is less than $30,000, then you have a poor investment. It would be smarter to have that cash in a nice, safe bank account.

In comparing these two situations, of course, the owner would be drawing a wage and some benefits out of the company cash flow. We can safely assume here that with $200,000 stuffed into a bank account, the owner would still be working. We are only talking about the return on cash invested.
In fact this comparison can be used to decide the value of a business being sold or bought. Essentially, if you would earn more money just by having the cash in the bank and earning interest on it than you would by investing the same sum in the business, why would you invest in the business?

**Bids on jobs are planned to leave no money on the table**

Lots of companies bid on many jobs but plan for a predetermined profit, leaving no money on the table.

What this means is that the company plans to lose some bids deliberately and uses the ratio of bid-to-job to test prices every day. If prices are too high, then the ratio of lost bids climbs. If the company gets too many jobs, then it is time to raise prices.

Of course, knowing what the costs are in this scenario is critically important. If prices are generally sliding, then being able to cut
costs quickly is important. So too is having flexible communications with the sales team so that cost-added features can be trimmed to bring prices into alignment.

If the company gets 100 percent of its bids, the price is likely too low and money is being left on the table. The services of the company are being sold as a commodity because the sales process has not found a way to find value and to make the company different from the competition. If you and the competition are identical then the only thing left to differentiate you is price.

**How Do You Know That Your Pricing Is Not Right?**

**The Hamster Cage Syndrome**

A company in the United States fabricated large metal tanks for several major industrial manufacturers. With two of its three major customers, it made a profit on the tanks. On the third contract, the largest of the three customers, the company lost money. The result was the company struggled to pay its bills but looked “sexy” because it had large revenue volumes. When a company is really busy but the dollars just flow through the bank account leaving nothing at the end of the year, the prices may be too low. Here the owner of the business runs and runs all day on the “wheel” like a hamster and goes nowhere.

**But shouldn’t you just cut costs and make a profit at lower prices?**

Never pass up an opportunity to keep costs down. After all, the purpose of a business is to profit on the difference between selling price and costs.

However, every $1 earned from a price increase is $1 added to the bottom line. If your company typically generates a 5 percent profit before tax, every $1 saved in costs generates 5 cents on the bottom line. Better to find a way to increase your prices.

Two studies, one performed by McKinsey & Company and the other by A.T. Kearny, both consulting firms, demonstrated that a one percent improvement in the following areas resulted in net income increasing as shown in Table 2.²

TABLE 2
PRICING FUNCTION AND THE NET INCOME EFFECT
MCKINSEY AND A.T. KEARNEY STUDIES

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<th>McKinsey Profit improvement</th>
<th>A.T. Kearney Profit improvement</th>
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<td>Reducing Fixed Costs by 1 percent</td>
<td>2.7 percent</td>
<td>1.5 percent</td>
</tr>
<tr>
<td>Increasing Volume by 1 percent</td>
<td>3.7 percent</td>
<td>2.5 percent</td>
</tr>
<tr>
<td>Reducing Variable Costs by 1 percent</td>
<td>7.3 percent</td>
<td>4.6 percent</td>
</tr>
<tr>
<td>Increasing Price by 1 percent</td>
<td>11 percent</td>
<td>7.1 percent</td>
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Table 2 shows that driving sales volume is not as powerful a path to profit as increasing prices or reducing variable costs.

However, not all hamster cages are created equal. There was a business model in Vancouver, British Columbia, whereby all the products sold at rock bottom prices. The markup from landed cost (invoice cost plus shipping and handling, duty and all other costs attached to get the product onto shelves) covered the overhead and staffing.

The company profit component entered the picture only when staff hit very high sales targets that triggered a sales bonus from the manufacturer. The management had focused their time on negotiating these large bonuses and on driving the large volumes. While from the outside it looked like the business merely spun its wheels, in fact the owners had found a unique path to profit.

You hate your customers
Where price has been the sole focus of the company, it will attract only the most cost-conscious customers. These are the customers who want a discount on every item and ask for a discount even when the product is free. These are the customers who drive you crazy because they want a Cadillac job but only want to pay Pinto prices. These are the customers you hate to see coming through the door.

This type of company attracts only the price-conscious customers who do not really care about the quality of the job or the value the owner places on training employees, longevity in the business, or value-added features. You, as the business owner may care deeply about these features, but these customers place zero value on them.
What would your company be like if there was never any squabbling over prices and every customer beamed at you as they handed over a check? How would your staff react to being treated with respect for a job well done? What would the impact be on your reputation in the community?

Your company has a reputation for high prices
If your company has generated a reputation for high prices but has not successfully communicated the value to the customer, who sees only the sticker price and none of the benefits, you could have a problem. Unfortunately, this customer complains to his or her mother-in-law who mentions you to someone else and the ripple effect begins. Then, too few customers consider buying from your company and the business starves. This is the terror that stalks most businesses.

Summary
Your prices are probably too low if:
• Your company does not generate a profit and a liveable wage for the owner
• You hate your customers because they beat you up on price every day
• You get every job on which you bid
• You just spin on the wheel like a hamster but don’t create profit

Your prices are probably alright if:
• The company has a decent profit
• The owner is paid a reasonable wage
• The company and the owner pay their taxes
• The company has no difficulty finding the cash to pay the bills
• The company attracts the best quality customers who are willing to pay for the value added by the company
• The company’s return on investment is better than that of a bank account
The bids on jobs are planned to leave no money on the table.

The company loses a pre-determined percentage of jobs to lower bids.

In the appendices you will find calculations to help you decide whether, in your business, the problem of low profits is the fault of low prices or some other factor.

The next chapter concerns itself with existing pricing methods, how they work, and their downfalls. After that, the balance of the book is concerned with ways to raise prices by showing real and demonstrable value in what your company offers.