

# Entrepreneurship

Prepared by Dr. Thana Ahmed

## Lecture 8

جامعة الجميع الذكية

تسعى لتكون الكيان الأول الذي يتبنى مبدأ المجتمع التعليمي  
التعاوني ويقدم العلم مقابل العمل لتنمية وبناء المجتمعات.

## Pricing and Credit Strategies

# Learning Objectives

1

Discuss the relationships among pricing, image, competition, and value.

2

Describe effective pricing techniques for introducing new products or services and for existing ones.

3

Explain the pricing methods and strategies for retailers, manufacturers, and service firms.

4

Describe the impact of credit on pricing.

# Introduction

## Pricing:

- – Price is the monetary value of a product or service in the marketplace;
- – It is a measure of what the customer must give up to obtain various goods and services.
- – It requires balancing a multitude of complex forces.
- – Pricing influences every aspect of a small company.
- – Is an important signal of value to customers.
- – Involves both math and psychology.
- – Has a greater impact on profits than corresponding increases in unit volume or reductions in costs.

# Pricing: introduction



Setting prices is not only one of the toughest decisions small business owners face but also one of the most important.



Setting prices too high drives customers away and destroys a company's sales.



Establishing prices that are too low, a common tendency among first-time entrepreneurs, robs a business of its ability to generate a profit, creates the impression among customers that the company's products and services are of inferior quality, and threatens its long-term success.

## Chapter 08

### What is the relationships among pricing, image, competition, and value?

A company's pricing strategy is a major determinant of its image in the marketplace, is influenced by the pricing strategies of its competitors, and is an important element in the value that customers perceive its products or services provide.



- Research by the University of Pennsylvania's Wharton School shows that companies that take a strategic approach to pricing and monitor its results can raise their sales revenue between 1 and 8 percent.
- *After analyzing its existing pricing techniques using price management software, New York City drugstore chain Duane Reade discovered that parents of newborns are less price sensitive than are parents of toddlers. Managers decided to make diaper pricing a function of the child's age, cutting prices to meet those of competitors on toddlers' diapers and raising them on diapers for newborns. A year later, the company's new pricing strategy had produced a 27 % increase in its baby care revenue.*

# Price Conveys Image

- Price sends important signals to customers: quality, position in the market, prestige, uniqueness, etc.
- Because most people have difficulty judging the quality of many products and services, they typically associate high prices with quality, prestige, and exclusivity
- Common small business mistake: charging prices that are too low and failing to recognize extra value, service, convenience, quality, and other benefits they offer.
- The key is to understand the target market and identify how much customers are willing to pay rather than how much to charge.



- A study of businesses in multiple industries by Rafi Mohammed, author of *The Art of Pricing*, found that those companies that raised prices by 1% saw their profits increase 11%. Those that raised their prices by 10% realized profit increases of 100%!
- The study does not imply that businesses have free rein to raise prices to any level, but it does suggest that many companies can raise their prices enough to improve their financial results **significantly as long as they convince customers that their products or services offer superior value.**



# Price Conveys Image

- One expert explains the relationship between value and price with the following conceptual equation:

$$(S + P)/D > \$ + E$$

- S = Company's standards of doing business
  - P = Product or service quality and performance
  - D = Doubt in customers' minds that detract from the value of the company's standards and products or services
  - \$ = Product or service price
  - E = Customers' expectations of a company and its products and services
- According to this equation, the value customers gain from doing business with a company and buying its products or services (after being diminished by doubts they have about the company and its products or services) must exceed the price they pay and the expectations they have about the company and its products or services.

- A key ingredient to setting prices properly is to understand a company's target market: the customer groups at which the small company is aiming its goods or services. Rather than ask "How much should I charge for my product or service?" entrepreneurs should ask "How much are my target customers willing to pay?" Target market, business image, and pricing strategy are closely related.
- For many of the products upscale brands sell, their final prices are more a reflection of their desired image than the reality of their costs.



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Used

- Competitors' prices can have a dramatic impact on a small company's sales. Today, small companies face competition from local businesses as well as from global online businesses
- Companies must take into account competitors' prices, but it is not always necessary to match or beat them.
- Unless a small company can differentiate itself by creating a distinctive image in customers' minds or by offering superior service, quality, design, convenience, or speed, it must match its competitors' prices or risk losing sales.
- Before matching any competitor's prices, small business owners should consider a rival's motives. A competitor may establish its price structure on the basis of a unique set of criteria and a totally different strategy. Blindly matching competitors' prices can lead a company to financial ruin.
- The similarity of competitors' goods and services also influences a company's pricing policies. Entrepreneurs must monitor competitors' prices on products that are identical to or that are close substitutes for those they sell and strive to keep their prices in line with them and nonprice competition can be an effective strategy for a small business in the face of larger, more powerful companies because experimenting with price changes can be dangerous for small companies.

# Competition & pricing

- An entrepreneur can create a low-cost advantage by:
  - choosing a low-cost location.
  - minimizing operating costs by maximizing efficiency.
  - exercising tight control over inventory and restricting product lines to those items that turn over quickly.
  - providing customers with no or limited service (e.g., self-service).
  - using low-cost, bootstrap marketing techniques
  - selling basic products but offering customers the option of purchasing additional product or service features that generate higher profit margins.
  - achieving high sales volume that allows the business to spread its fixed costs across a large number of units.





# Competition & pricing

- Price wars often eradicate companies' profits
- Best strategy: **Stay out of a price war!**



- The “right” price for a product or service depends on the value it provides for a customer.
- Two aspects of price:
  - – **Objective value**: which is the price customers would be willing to pay if they understood perfectly the benefits that a product or service delivers for them. Unfortunately, few if any customers can see a product’s or a service’s true objective value
  - – **Perceived value**: determines the price customers are willing to pay.
- People faced with pricing decisions often act irrationally: In one classic study, researchers asked shoppers whether they would travel an additional 20 minutes to save \$5 on a calculator that costs \$15; most said they would. When asked the same question about a \$125 jacket, most of the shoppers said no, even though they would be saving the exact same amount of money

- “Value” does not necessarily equate to low price,
- Businesses that underprice their products and services or constantly run special discount price promotions may be short-circuiting the value proposition they are trying to build and communicate to their customers.
- once customers grow accustomed to buying products and services during special promotions, the habit can be difficult to break. They simply wait for the next sale. The results are extreme swings in sales and diminished value of the brand.



- Techniques that companies can use to increase customers' perception of value and, essentially lower their prices with less risk of diminishing their brands:
  - **Offering coupons and rebates**
  - **Limited-time-only discounts**
  - **launch a “fighter brand”**: a less expensive, no-frills version of a company's flagship product that is designed to confront lower- priced competitors head-on, satisfy the appetites of value-conscious customers, and preserve the image of the company's premium product.

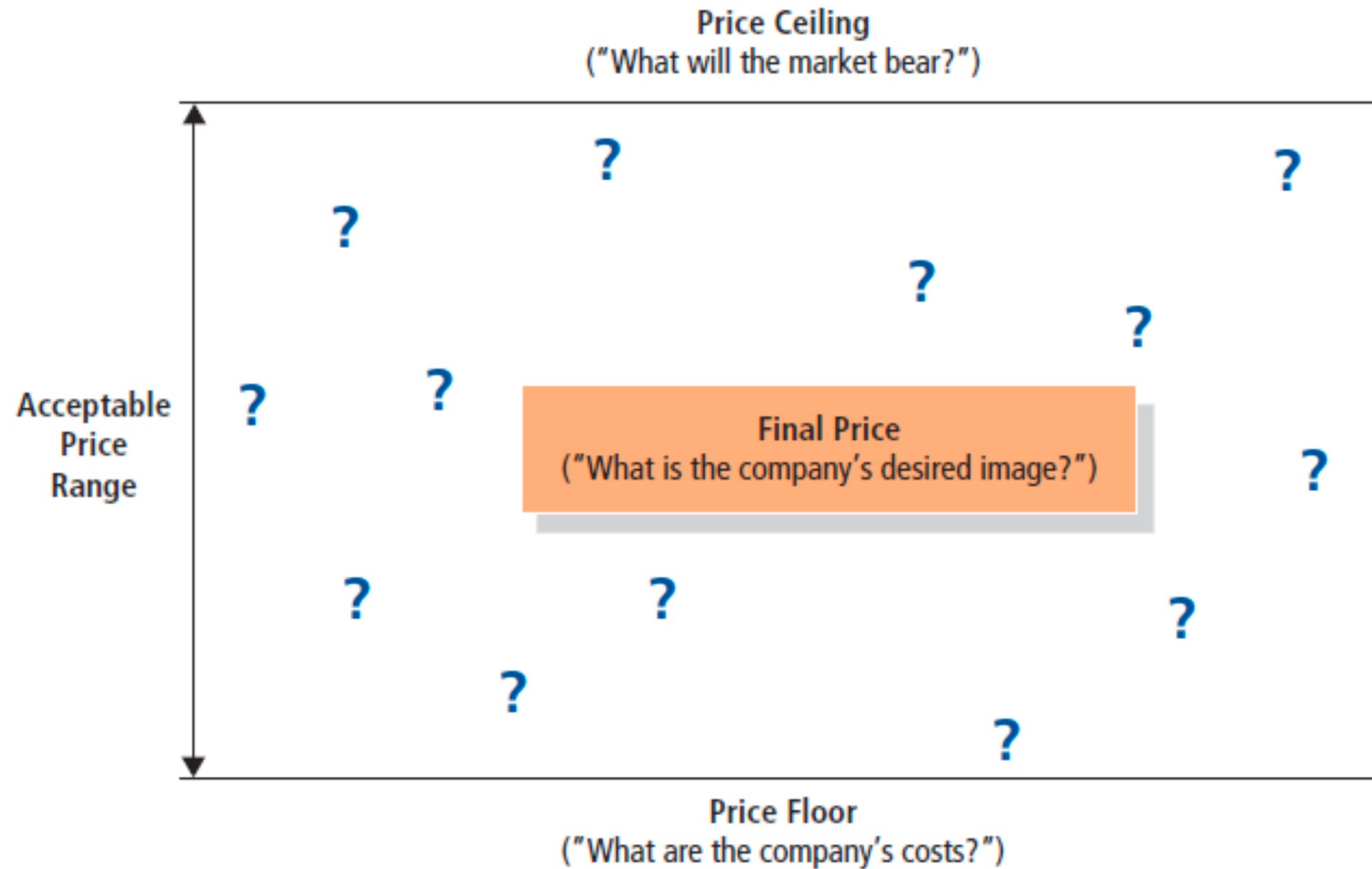
- One of the most important determinants of customers' response to a price is whether they perceive the price to be a **fair exchange** for the value they receive from the product or service.
- Companies can influence customers' perception of value.
- For most shoppers, three reference points define a fair price:
  - The price they have paid for the product or service in the past,
  - The prices competitors charge for the same or similar product or service,
  - The costs a company incurs to provide the product or service (often underestimated by customers)
- Customers are less likely to notice small, regular price increases that result from rising costs than a single, steep price increase that could send them running to competitors.

# Dealing with Rising Costs

- Businesses facing rapidly rising costs in their businesses should consider the following strategies:
  1. ***Communicate with customers.*** Let your customers know why you have to raise prices.
  2. ***Rather than raise the price of the good or service, include a surcharge.*** Price increases tend to be permanent, but if higher costs are the result of a particular event (e.g., a momentarily shortage of raw material), a company can include a temporary surcharge.
  3. ***Eliminate customer discounts, coupons, and promotions.*** Eliminating discounts, coupons, and other freebies is an invisible way of raising prices that can add significantly to a small company's profit margin.
  4. ***Offer products in smaller sizes or quantities.***
  5. ***Focus on improving efficiency everywhere in the company.***
  6. ***Emphasize the value your company provides to customers.***

- 7. Raise prices incrementally and consistently rather than rely on large periodic increases.*
- 8. Shift to less expensive raw materials if possible.*
- 9. Anticipate rising materials costs and try to lock in prices early.*
- 10. Consider absorbing cost increases.*
- 11. Modify the product or service to lower its cost*
- 12. Differentiate your company and its products and services from the competition.*

# What Determines Price?



## Three Goals for pricing new products:

### 1. Getting the product accepted

- **Revolutionary products:** products that are so new and unique that they transform existing markets. The acceptable price range for revolutionary products tends to be rather wide, but the businesses introducing them must be prepared to make an investment in educating customers about them.
- **Evolutionary products:** products that offer up-grades and enhancements to existing products. The acceptable price range for evolutionary products is not as wide as it is for revolutionary products. Companies that introduce evolutionary products with many new features at prices that are too low may initiate a price war.
- **Me-too products:** products that offer the same basic features as existing products on the market. The acceptable price range for these products is quite narrow, and many companies introducing them find themselves left with me-too pricing strategies that are the same or similar to those of their competitors.

### Three Goals for pricing new products:

#### 2. Maintaining market share as competition grows:

If a new product is successful, competitors will enter the market, and the small company must work to expand or at least maintain its market share. Continuously reappraising the product's price in conjunction with special advertising and promotion techniques helps to retain market share.

#### 3. Earning a profit:

Entrepreneurs should not introduce a new product at a price below cost because it is much easier to lower a price than to increase it once the product is on the market.

Three basic pricing strategies:

1. Penetration
2. Skimming
3. Life cycle pricing





### 1. Penetration:

- Used when introducing a product into a highly competitive market in which a large number of **similar products** are competing for acceptance.
- Entrepreneurs introduce the product **at a low price**. They set the price just above total unit cost to develop a wedge in the market and quickly achieve a high volume of sales.
- A penetration pricing strategy is ideal for a market where no elite segment and **little opportunity for differentiation** exists.
- The introduction is usually accompanied by **heavy advertising and promotional techniques**, special sales, and discounts.
- **The objectives** of the penetration strategy are to **break into the market quickly**, generate a **high sales volume** as soon as possible, and **build market share**.
- **A danger of a penetration pricing strategy is that it attracts customers who know no brand loyalty.**
- Example: Amazon kindle (make money when people *use* Amazon devices rather than when they *buy* them)



## 2. Skimming:

- A skimming pricing strategy (setting high prices) often is used when a company introduces a new product into a market **with little or no competition** or to establish the company and its products or services as **unique and superior to those of its competitors** or When introducing a product into a competitive market that contains an **elite group** that is able to pay a higher price.
- The idea is to set a price well above the total unit cost and to promote the product heavily to appeal to the segment of the market that is not sensitive to price. Successful skimming strategies require a company to differentiate its products or services from those of the competition.
- Companies that use a skimming strategy often achieve success by emphasizing the intangible benefits of their higher-priced goods and services
- An advantage of this technique is that entrepreneurs can correct pricing mistakes quickly and easily



### 3. Life cycle pricing

- A variation of the skimming price strategy is called life cycle pricing.
- Using this technique, a small company introduces a product at a high price. Then technological advances enable the firm to lower its costs quickly and to reduce the product's price before its competition can.
- By beating other businesses in a price decline, the small company discourages competitors and gradually, over time, becomes a high-volume producer (High-definition television sets)
- Life cycle pricing is a strategy that assumes competition will emerge over time.
- Even if no competition arises companies almost always lower the product's price to attract a larger segment of the market.

### 1. Odd pricing

- A pricing technique to set prices that end in odd numbers to create the psycho- logical impression of lower prices. (12,69 instead of 13)
- Omitting the “\$” symbol from prices may help, too. Researchers at Cornell University have discovered that restaurants that list menu prices without the “\$” symbol (e.g., “21”) achieved \$5.55 more in sales on average than those whose menu prices were written in script or included a “\$” symbol.



### 2. Price Lining

- A technique that greatly simplifies the pricing function by pricing different products in a product line at different price points, depending on their quality, features, and cost.
- Under this system, entrepreneurs sell products in several different price ranges, or price lines.
- Each category of merchandise contains items that are similar in appearance but that differ in quality, cost, performance, or other features.
- Many lined products appear in sets of at least three—good (basic), better (upgraded), and best (premium)—at prices designed to satisfy different market segment needs and incomes.



### 3. Dynamic (customized) pricing

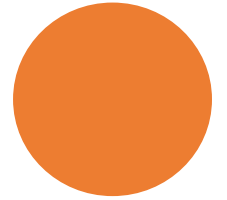
- A technique in which a company sets different prices for the same products and services for different customers using the information they have collected about their customers.
- Under this system, entrepreneurs sell products in several different price ranges, or price lines.
- For instance, a first-time customer making a purchase at an online store may pay a higher price for an item than a regular customer who shops there frequently pays for the same item.



# Pricing Established Goods and Services

## 4. Leader pricing

- Is a technique that involves marking down the normal price of a popular item in an attempt to attract more customers who make incidental purchases of other items at regular prices.
- The company earns a much smaller profit on each unit because the markup is lower, but purchases of other merchandise by customers seeking the leader item often boost sales and profits.





### 5. Geographic (zone) pricing

- A technique that involves setting different prices for customers located in different territories because of different transportation costs.
- Another variation of geographic pricing is **uniform delivered pricing**, a technique in which a firm charges all of its customers the same price regardless of their location, even though the cost of selling or transporting merchandise varies. A company calculates the proper freight charges for each region and combines them into a uniform fee. The result is that local customers subsidize the company's charges for shipping merchandise to distant customers.
- A final variation of geographic pricing is **F.O.B. factory**, in which a small company sells its merchandise to customers on the condition that they pay all shipping costs. In this way, the company can set a uniform price for its product and let each customer cover the freight costs.



### 6. Discount

- Many small businesses use discounts (markdowns)— reductions from normal list prices—to move stale, outdated, damaged, or slow-moving merchandise or to stimulate sales. A seasonal discount is a price reduction designed to encourage shoppers to purchase merchandise before an upcoming season. For instance, many retail clothiers offer special sales on winter coats in midsummer.
- As tempting as discounts are to businesses when sales are slow, they carry risks:
  - Discount often attract customers who are merely seeking bargains and who rarely turn into loyal customers
  - Excessive discounting also diminishes or eradicates altogether a company's profit margin.
  - Companies that frequently resort to discounts may ruin their reputation for superior quality and service, thereby diluting the value of their brand and image in the marketplace.

## 6. Discount

- **Earned discounts:** discounts customers earn by making repeat purchases at a business (Loyalty programs)
- **Limited time offers (LTOs):** are discounts that retailers run for a limited amount of time (“Regular price: \$150. Sale price \$120 for three days only.”) with the goal of creating a sense of urgency and excitement among customers.
- **Steadily decreasing discount (SDD):** a limited duration discount that declines over time. When one company used a hi-lo discount of 20 percent for three days before returning to the items to full price, sales increased by 75 percent. For the same items, a steadily decreasing discount of 30 percent the first day, 20 percent the second day, and 10 percent the third day (which yielded the same average discount of 20 percent), produced an increase in sales of 200 percent. The researchers conclude that the SDD is more effective because it creates a sense of urgency, especially among wary or indecisive customers.
- **Multiple unit pricing** is a promotional technique that offers customers discounts if they purchase in quantity.

- Grouping together several products or services or both into a package that offers customers extra value at a special price.
- Bundling is another way for companies to offer customers discounts without damaging their reputations.

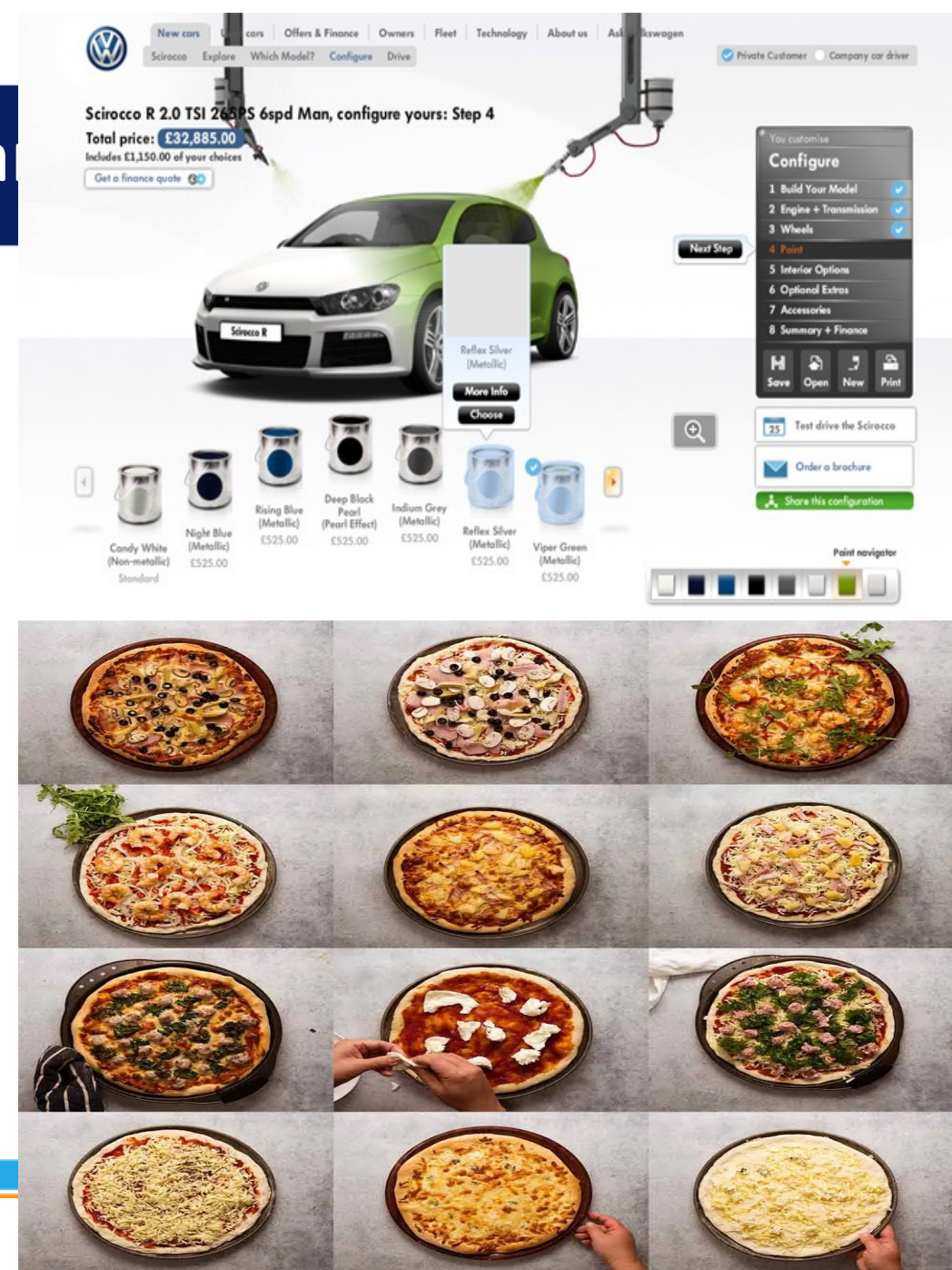


# Chapter 08

## Pricing Established Goods and Services

### 8. Optional-product pricing

A technique that involves selling the base product for one price but selling the options or accessories for it at a much higher markup.



### 9. Captive-product pricing

- Is a pricing strategy in which the base product is not functional without the appropriate accessory.
- Manufacturers of electronic games also rely on captive-product pricing, earning lower margins on the game consoles and substantially higher margins on the game cartridges they sell.



### 10. By-product pricing

- Is a technique in which a company uses the revenues from the sale of by-products to be more competitive in pricing the main product



## 11. Suggested retail pricing

- Many manufacturers print suggested retail prices on their products or include them on invoices or in wholesale catalogs. Small business owners frequently follow these suggested retail prices because doing so eliminates the need to make a pricing decision.
- Nonetheless, following prices established by a distant manufacturer may create problems for a small company. For example, a men's clothing store may try to create a high-quality, exclusive image through a prestige pricing policy, but manufacturers may suggest prices that are incompatible with the company's image.
- Another danger of accepting the manufacturer's suggested price is that it does not take into consideration a small company's cost structure or competitive situation.

### 12. Follow-the-leader pricing

- Many manufacturers print suggested retail prices on their products or include them on some small companies make no effort to be price leaders in their immediate geographic areas and simply follow the prices that their competitors establish.
- maintaining a follow-the-leader pricing policy may not be healthy for a small business because it robs the company of the opportunity to create a distinctive image in its customers' eyes.

- **MARKUP**

- The difference between the cost of a product or service and its selling price is called markup.
- **Dollar Markup = Retail price - Cost of the merchandise**
- **Percentage (of retail price) markup = Dollar markup / Retail price**
- **Percentage (of cost) markup = Dollar markup / Cost of unit**
- **EXAMPLE:** if a shirt costs \$14, and a retailer plans to sell it for \$30, the markup would be:
  - Dollar Markup = \$30 - \$14 = \$16
  - Percentage (of retail price) markup =  $(16 / 30) \times 100 = 53.3\%$
  - Percentage (of cost) markup =  $(16 / 14) \times 100 = 114.3\%$

### • MARKUP

- Once entrepreneurs create a financial plan, including sales estimates and anticipated expenses, they can compute their companies' initial markup. The initial markup is the *average* markup required on all merchandise to cover the cost of the items, all incidental expenses, and a reasonable profit:
- **Initial dollar markup = (Operating expenses + Reductions + Profit) / (Net sales + Reductions)**
- where operating expenses include the cost of doing business, such as rent, utilities, and depreciation, and reductions include employee and customer discounts, markdowns, special sales, and the cost of stock-outs. Entrepreneurs must be aware of the impact that discounts have on their markup percentages.

- **MARKUP**

- Suppose that a small retailer forecasts sales of \$980,000, operating expenses of \$544,000, and \$24,000 in reductions. If the retailer establishes a target profit of \$58,000, the initial markup (of retail price) percentage is calculated as follows:
- Initial markup percentage =  $(544,000 + 24,000 + 58,000) / (980,000 + 24,000) = 62\%$
- Any item in the store that carries a markup (of retail price) of at least 62 percent covers costs and meets the owner's profit objective. Any item that has a markup of less than 62 percent reduces the company's net income.

- **COST-PLUS STRATEGIE**

- The most commonly used pricing technique for manufacturers is cost-plus pricing.
- A manufacturer establishes a price that covers the cost of direct materials, direct labor, factory overhead, selling and administrative costs, and a desired profit margin.

- Cost-Plus Pricing Components



- **COST-PLUS STRATEGIE**

- The main advantage of the cost-plus pricing method is its simplicity.
- In addition, because they add a profit onto the top of their companies' costs, manufacturers are likely to achieve their desired profit margins.
- This process, however, does not encourage the manufacturers to use their resources efficiently. Even if the company fails to employ its resources in the most effective manner, it still earns a profit, and thus there is no motivation to conserve resources in the manufacturing process.
- Finally, because manufacturers' cost structures vary so greatly, cost-plus pricing fails to consider the competition (and market forces) sufficiently.

- Break-Even Pricing

Break - even selling price =

$$\frac{\text{Profit} + (\text{Variable cost per unit} \times \text{Quantity produced}) + \text{Total fixed cost}}{\text{Quantity produced}}$$

### • Break-Even Pricing

To break even, the manufacturer assumes \$0 profit. Suppose that plans are to produce 50,000 units of the product and that fixed costs will be \$110,000. The break-even selling price is as follows:

$$\begin{aligned}\text{Break-even selling price} &= \frac{\$0 + (\$6.98 \times 50,000 \text{ units}) + \$110,000}{50,000 \text{ units}} \\ &= \frac{\$459,000}{50,000 \text{ units}} \\ &= \$9.18/\text{unit}\end{aligned}$$

Thus, \$2.20 (\$9.18/unit – \$6.98/unit) of the \$9.18 break-even price contributes to meeting fixed production costs. But suppose the manufacturer wants to earn a \$50,000 profit. Then the selling price is calculated as follows:

$$\begin{aligned}\text{Selling price} &= \frac{\$50,000 + (\$6.98/\text{unit} \times 50,000 \text{ units}) + \$110,000}{50,000 \text{ units}} \\ &= \frac{\$509,000}{50,000 \text{ units}} \\ &= \$10.18/\text{unit}\end{aligned}$$

**Any price above \$9.18 will generate some profit although less than that desired. In the short run, the manufacturer could sell the product for less than \$9.18 if competitive factors dictate but *not* below \$6.98 because a price below \$6.98 would not cover the variable cost of production.**



- Service businesses must establish their prices on the basis of the materials used to provide the service, the labor employed, an allowance for overhead, and profit.
- Most service firms base their prices on an hourly rate, usually the actual number of hours required to perform the service.
- Some companies, however, base their fees on a standard number of hours, determined by the average number of hours needed to perform the service.

$$\text{Price Total cost per hour} = \frac{\text{productive hour}}{(1 - \text{net profit as a \% of sales})}$$

- Ned estimates that he and his employees spent about 9,250 hours in the actual production of computer repair service. Therefore, total cost per productive hour for Ned's Computer Repair Shop comes to the following

$$\frac{\$104,000 + \$68,000}{9,250 \text{ hours}} = \$18.59/\text{hour}$$

- Now Ned must add in an amount for his desired profit. He expects a net operating profit of 18 percent on sales. To compute the final price, he uses:

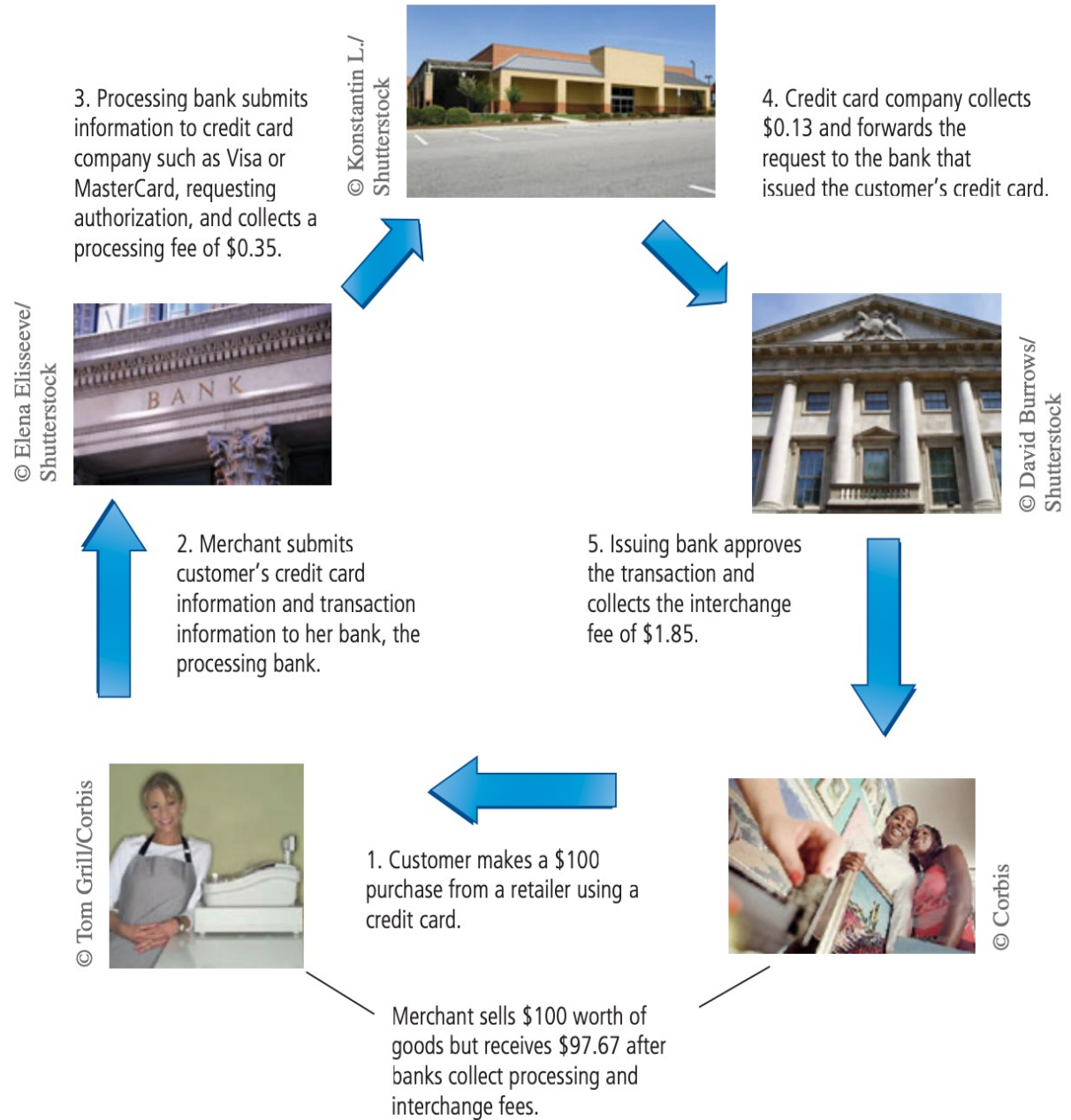
$$\begin{aligned}\text{Price Total cost per hour} &= \text{productive hour} \div (1 - \text{net profit target as \% of sales}) \\ &= \$18.59 \div (1 - .18) \\ &= \$22.68/\text{hour}\end{aligned}$$

- 58% of small business owners say that their customers expect them to accept credit cards. But companies incur an additional cost to offer this service.
- **Interchange fee** : the fee banks collect from retailers whenever customers use a credit or debit card to pay for a purchase.

- Three options for selling on credit:
  1. **Credit (and debit cards)**
  2. **Installment credit:** Small companies that sell consumer durables—such as major appliances, cars, and boats—frequently rely on installment credit to support their sales efforts. Because very few customers can purchase such items in a single lump-sum payment, small businesses finance them over an extended time.
  3. **Trade credit:** The typical small business bills its credit customers each month for small items. To speed collections, some offer cash discounts if customers pay their balances early; others impose penalties on late payers

# Chapter 08

## How a typical credit card transaction works



## Credit (and debit cards):

- To minimize credit card fraud:
  - – Use an address verification system
  - – Require a CVV2 number
  - – Check customers IP addresses
  - – Monitor Web site activity with analytics
  - – Verify large orders
  - – Post notices on Web site that your company uses anti-fraud technology
  - – Contact the credit card company or bank that issued the card

- Pricing techniques impact every aspect of a company including:
  - Image
  - Customers
  - Cash flow
  - Profits

thanks for  
listening!