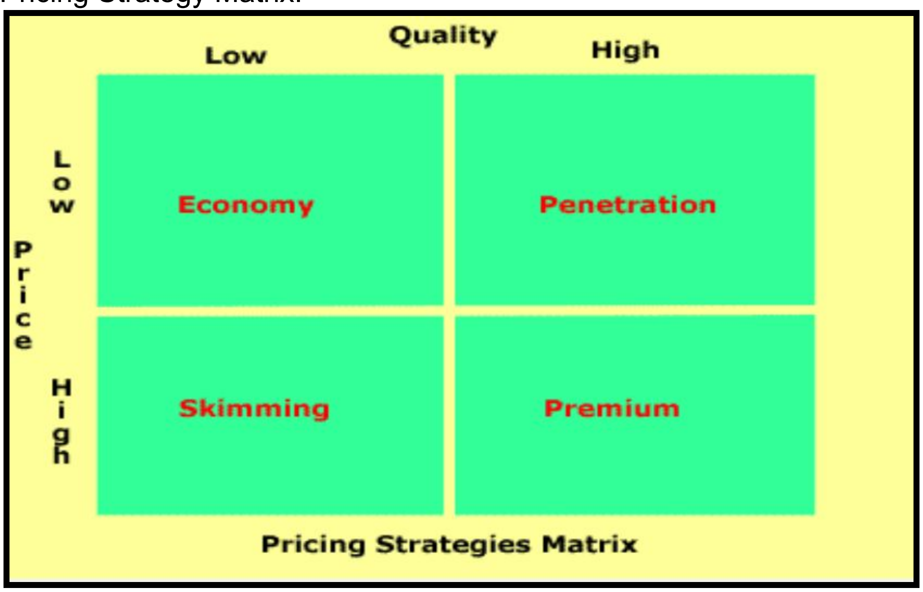
Lecture Notes:

- **Introduction to Pricing:**
- **Price** is:
  - What the business will charge in exchange for its product. (Revenue for the business.)
  - What a customer pays to acquire a product or service. (Cost for the customer.)
- **Note:** There is no such thing as "expensive". It's about price tag vs perceived value.
- Recall that a business has 2 purposes:
  1. Satisfy customers
  2. Make profits

  Because of this, there's no formula for setting price. Pricing depends on judgement and choice.
- **Costs:**
- There are 2 types of costs:
  1. **Variable Costs (VC):**
  - Increases with the volume of activity.
  - Cost of goods sold is variable cost.
  - E.g. Suppose making a pizza costs $5. The more pizzas you sell (and make), the higher the costs will be.
    If you make 1 pizza, it costs $5.
    If you make 2 pizzas, it costs $10.
  2. **Fixed/Operating Costs (FC):**
  - These costs do not increase with the volume of activity.
  - Examples include rent, salaries, insurance.
  - E.g. Suppose the rent on your pizza store is $2000 per month. The rent stays the same if you sell no pizzas or 1000 pizzas.
- **Value Based Pricing:**
- **Value-based pricing** is a strategy of setting prices primarily based on a consumer's perceived value of a product or service.
- Value pricing is customer-focused pricing, meaning companies base their pricing on how much the customer believes a product is worth.
- Value-based pricing is different than cost-based pricing, which factors the costs of production into the pricing calculation.
- Companies that offer unique or highly valuable features or services are better positioned to take advantage of the value pricing model than companies which chiefly sell commoditized items.
- **Cost Based Pricing:**
- **Cost-based pricing** is a strategy of setting prices primarily based on the company's costs and profit margins.
- The advantages of this method are that a business can be assured of always generating a profit, as long as the markup figure is sufficient and unit sales meet expectations, and that it is a simple way to develop prices. However, this approach routinely results in prices that diverge from the market rate, so that either the firm is selling at too high a price and is attracting too few customers, or it is selling at too low a price and so is losing profits that customers would otherwise have been happy to pay. An additional problem with cost-based pricing is that it does not force a business to keep its costs under control. Instead, costs are simply passed through to the customer.
- **Pricing Begins With the Costs:**
- Whatever the choice, a business must cover its costs.
- This means that in order to set a price, the business must first understand its costs.

- **Markup** is what the business adds to the cost of making a product (the variable cost) to arrive at its price.
  I.e. Variable Cost + Markup = Price.
  E.g. Suppose it costs a company $5 to make a pizza. If they sell that pizza for $8, then the markup of that pizza is $8 - $5 or $3.
- Markup ensures that each pizza not sold at a loss and pays for the fixed costs.
- The **contribution margin** is markup expressed as a percentage of the selling price.
  I.e. Contribution margin % = $\frac{Markup}{Selling\ Price}$
  E.g. Suppose it costs a company $5 to make a pizza. If they sell that pizza for $8, then the markup of that pizza is $8 - $5 or $3. The contribution margin would be $3/$8 or 37.5%.
- **Pricing Strategies:**
- Pricing Strategy Matrix:



- No formula determines the price.
- The size of the markup is a choice left to the manager.
- There are 2 possible pricing strategies for new products:
  1. **Skimming:**
     - In the skimming strategy, there is a large markup, and subsequently, high prices.
     - Because of the high prices, there is a small market and low sales.
     - There doesn't need to be a lot of sales because each sale has a large contribution margin.
     - Some well-known successful businesses use skimming strategy are:
       1. Rolls-Royce cars
       2. Rolex watches
       3. Mont Blanc pens
  2. **Penetration:**
     - In the penetration strategy, there is a small markup, and subsequently, low prices.
     - Because of the low prices, there is a large market and high sales.
     - There needs to be a lot of sales because each sale has a small contribution margin.

- Some well-known successful businesses use skimming strategy are:
    1. Honda Civic cars
    2. Casio watches
    3. Bic pens
- **Break-even Analysis:**
- Helps managers understand relationship between costs, chosen selling price, and necessary volume of sales.
- Answers the question: “If I choose this price, how many units must I sell – to make a profit?”
- If you know your costs you can choose a price.
- **Break-even analysis** tells you the quantity you must sell in order to make a profit.
- **Break-even quantity** is the minimum number of units a business must sell in order to recover all costs and begin to make a profit.
- Formula:

$$\frac{\textit{fixed costs}}{\textit{selling price} - \textit{variable}} = \frac{\textit{fixed costs}}{\textit{profit from each sale}} = \textit{Number of units to break even}$$

- Examples:
    1. Suppose you own a pizzeria and you sell 3 types of pizza:
        a. Deluxe Gourmet Pizza - $15
        b. Mid-price Pizza - $10
        c. Low-price Pizza - $6

    Suppose each pizza costs $5 to make and the fixed costs are $100, 000/year.

    <u>The break-even for deluxe gourmet pizza follows:</u>
    Fixed Costs = $100, 000
    Variable Costs = $5
    Selling Price = $10

$$\frac{\textit{fixed costs}}{\textit{selling price} - \textit{variable}} = \frac{100,000}{10-5} = \frac{100,000}{5} = 20,\ 000$$

    Therefore, you need to sell 20, 000 deluxe gourmet pizzas to break even.

    <u>The break-even for mid-price pizza follows:</u>
    Fixed Costs = $100, 000
    Variable Costs = $5
    Selling Price = $15

$$\frac{\textit{fixed costs}}{\textit{selling price} - \textit{variable}} = \frac{100,000}{15-5} = \frac{100,000}{10} = 10,\ 000$$

    Therefore, you need to sell 10, 000 mid-price pizzas to break even.

    <u>The break-even for low-price pizza follows:</u>
    Fixed Costs = $100, 000
    Variable Costs = $5
    Selling Price = $6

$$\frac{\textit{fixed costs}}{\textit{selling price} - \textit{variable}} = \frac{100,000}{6-5} = \frac{100,000}{1} = 100,\ 000$$

    Therefore, you need to sell 100, 000 low-price pizzas to break even.

- Using break-even analysis, managers must ask:
    1. Can we sell this many pizzas?
    2. Should we raise price, sell fewer, but make more profit on each?
    3. Should we cut price, sell more, but make less profit on each?
- **Psychological Pricing Tactics:**
- There are 2 types of psychological pricing tactics:
    1. **Odd-Even Pricing:**
        - Setting a price just below the next whole number.
        - E.g. $9.99 or $9.95 instead of $10.00.
    2. **Bundle Pricing:**
        - Adding another item to the purchase.
        - E.g. Buy 2 sandwiches and 2 cans of pop for $15.

<u>Textbook Notes (Chapter 4):</u>

- **What Determines a Product's Price:**
- Businesses exist to satisfy customer needs and to make a profit. Because of this, there is no precise formula to tell managers exactly what the price of each product should be. Setting a price involves tradeoffs between the business' two purposes.
- Two things that determine the business' ability to set its prices are:
    1. The degree of competition
    2. The business' costs
- **How Competition Affects Price:**
- <u>Pricing in a perfectly competitive market:</u>
    - A perfectly competitive market is characterized by a large number of small sellers, offering more or less the same product.
    - In a perfectly competitive market, buyers enjoy a great deal of choice. Buyers can walk away from any seller and look for a better deal because there are so many sellers.
    - This means that sellers have little control over the product's price and must charge what everyone else is charging. This is called the **market price**.
    - With little or no control to influence a product's price, businesses that choose to sell perfectly competitive products can increase their profits by minimizing their costs.
- <u>Pricing in oligopoly market:</u>
    - In an oligoply, a small number of competitors watch each other closely.
    - If one supplier raises or lowers prices, then others will soon follow.
    - Oliogopoly businesses tend to compete on the basis of differentiation. That is, they try to convince potential customers that their product is different or better in some way. One method of doing this is branding. Oligopoly businesses want consumers to associate their products with colours, designs and logos that become symbols for the product's reliability. This requires companies to spend a lot of time and money on branding, advertising and other forms of promotion.
- <u>Pricing in a monopolistically competitive market:</u>
    - In a monopolistically competitive market, there are many small sellers with a small number of big sellers.
    - E.g. Coffee stores. Most coffee stores are small, but there a few large one like Tim Hortons or Starbucks.
    - The large sellers will differentiate their products so that they can charge more than others.
- <u>Pricing in monopoly market:</u>
    - In a monopoly, there is only 1 seller.
    - Consumers have to purchase the item on the seller's terms.

- **To Set a Price a Business Must Understand its Costs:**
- Before determining the price of a product, managers must first understand the cost of that product.
- A business has 2 types of cost:
    1. Cost into making the product.
    2. Cost of running the organisation to make the product.
- The cost that goes directly into making the product is called **cost of sales**.
- When a business is making a tangible good, the ingredients, parts and materials that go into it are often visible and obvious. So, these costs are even more frequently known as the **cost of goods sold**.
- Another term for the ingredients, parts and materials that go directly into making a product is **variable cost**. Variable cost is the cost of anything that increases in direct proportion to each addition unit of product that is made.
- E.g. If a pizza costs $5 to make, then if the pizzeria makes 2 pizzas, the cost would be $5*2 or $10.
- The first constraint for managers setting a price is they must charge at least the variable cost. If managers set a price lower than the variable costs, the business would make a loss for sure.
- E.g. If making a pizza costs $5 to make, and the pizzeria sells it for $4, then they will be losing $1 for each pizza sold.
- Knowing the variable costs give the managers a floor to set the price.
- The second type of cost that business incur is the cost of running the organization.
- E.g. In addition to the cost of making a pizza, a pizzeria will need to spend money on other expenses such as rent, utility, salaries, etc.
- The cost of operating a business organisation, as opposed to making a product, is known as **operating cost/operating expense**.
- Operating costs are known as **fixed costs**. **Fixed costs** are the costs of operating the business, which do not change as the volume of production increases.
- **Markup and Margin:**
- **Markup** is the amount that a business adds to the variable cost of making a product, in order to set its selling price.
- Variable Cost + Markup = Selling Price
- The markup ensures that with every unit the business sells, the business will generate funds towards the fixed cost of running the organization.
- **Contribution margin** is the markup expressed as a percentage of the selling price.
- Contribution Margin (%) = Markup / Selling Price
- The business' managers must now make a choice. They can either choose a high markup, which will deter many customers, but each unit of product sold generates a lot of revenue, or they can choose a low markup which will attract many customers but each unit of product sold won't generate a lot of revenue.
- **Skimming** is the strategy of charging a high price, expecting a small volume of sales, but making a large contribution from each.
- Examples of businesses that do skimming are:
    - Rolls-Royce cars
    - Rolex watches
    - Mont Blanc pens
- The advantage of skimming is that even though the target market is small, this segment is not **price sensitive**.
- **Price sensitivity** is the degree to which the price of a product affects consumers' willingness to buy.
- The disadvantage of skimming is that the target market is small.

- Other businesses do the opposite. They add a small markup to their costs and attract a large number of customers. This is known as **penetration pricing**.
- Some well-known successful businesses use skimming strategy are:
    1. Honda Civic cars
    2. Casio watches
    3. Bic pens
    4. Wal-Mart
- The disadvantage of penetration pricing is that the company must sell large number of units to make a profit.
- Since most people won't be able to afford expensive items, and people will think of cheap items as having poor quality, the most likely pricing policy for the majority of businesses is somewhere in the middle.
- **Break-even Analysis:**
- To understand the implications of choosing a slightly higher or lower price, businesses perform **break-even analysis**.
- **Break-even analysis** is a tool that helps managers understand the relationship between their costs, their chosen price, and the number of units that the business must sell in order to make a profit.
- **Break-even quantity** is the minimum number of units a business must sell in order to recover all costs and begin to make a profit.
- Break-even quantity = Fixed Costs / (Selling Price - Variable costs)
- **Consumers Aren't Necessarily Rational:**
- Marketers should remember that consumers, being human, make purchasing decisions based on emotions as well as logic/reason.
- There are a number of tactics that businesses can use to excite customers into making purchases. These tactics are collectively known as **psychological pricing**.
- Two tactics are:
    1. **Odd-Even Pricing:**
    - A strategy of setting the price of a product just below the whole dollar amount.
    - E.g. Using $4.99 or $4.95 instead of $5.
    - Buyers tend to associate the price with the first digit they see. Hence, if a business uses $4.99 or $4.95, customers will perceive the price to be closer to $4 than $5.
    - This also applies to larger numbers.
    - E.g. Using $399, 999 instead of $400, 000.
    2. **Bundle Pricing:**
    - Packaging several products together and offering the combined package at a single price that is less than the sum of parts.
    - "Combo" and "package" are commonly used words.
    - E.g. A combo package of a large popcorn and medium drink costs $5 while individually, a large popcorn costs $4 and a medium drink costs $3.

Textbook Definitions (Chapter 4):

- **Break-even analysis:** A tool that helps managers understand the relationship between their costs, their chosen price, and the number of units that the business must sell in order to make a profit.
- **Break-even quantity:** The minimum number of units a business must sell in order to recover all costs and begin to make a profit.
- **Bundle pricing:** Packaging several products together and offering the combined package at a single price that is less than the sum of parts.
- **Contribution margin:** The markup expressed as a percentage of the selling price.

- **Cost of sales/Cost of goods sold:** The cost of the ingredients, parts, and materials that go directly into making a product.
- **Fixed costs:** The costs of operating the business, which do not change as the volume of production increases.
- **Market price:** At any particular time, the prevailing price to which buyers and sellers agree.
- **Markup:** The amount that a business adds to the variable cost of making a product, in order to set its selling price.
- **Odd-even pricing:** A strategy of setting the price of a product just below the whole dollar amount.
- **Operating cost/Operating expense:** The cost of operating a business organisation.
- **Penetration pricing:** The strategy of charging a low price, and relying on a large volume of sales, making a small contribution from each.
- **Price sensitivity:** The degree to which the price of a product affects consumers' willingness to buy.
- **Psychological pricing:** A range of tactics designed to appeal to customers' emotions.
- **Skimming:** The strategy of charging a high price, expecting a small volume of sales, but making a large contribution from each.
- **Variable cost:** Costs that increase in direct proportion to every additional unit of product that is made.