Chapter 11: Pricing strategies 2016-Oct-28

- *Pricing strategies*: pricing policies used by a business when deciding what to charge for its products
  - pricing strategies for *new products* (e.g., market skimming, penetration pricing)
  - pricing strategies for *existing products*
- Cost & pricing
  - pricing has to be such that *all costs are covered*: add a *mark-up* to unit cost (e.g., percentage of unit cost)
  - One method: *mark-up=percentage of cost*
    * method that is common with retailers
    * ignores *market conditions* (e.g., mark-up used by firm may be too high compared to prices of competitors → may result in low sales!)
    * difficulty of identifying all the costs associated with a particular product (e.g., multi-product business)
    * *see Worked example* and *Math tip*
  - Question 1 p.57
  - *Price skimming*: charge a high price on a new product for a limited time period
    * also known as *creaming*
    * *Goal* of this strategy:
      · generate high revenues *before competitors arrive on market*
      · exploit the popularity of product *while it is unique*
      · Example: Laptop in the early days (over 1000 pounds), phramaceuticals
    * prices are charged in a market where consumers are *ready to pay* higher amounts → helps maximise revenue
    * skimming can only be used when demand is *price inelastic*
    * skimming *might attract competitors* into the market
- *Penetration pricing*: setting a new price when launching a new product in order to get established in the market
  - Goal: get established in market
  - Customers will be *attracted* by low price and will then *stay with* this company
  - Example: offer products at lower rates for a *trial period*, offer the *first few items* at lower price (*introductory offer*)

- *Benefits* of penetration pricing
    * *low- or middle-income* consumers are responsive to these offers
    * sales will *grow quickly* during this period
    * fast growth in sales may allow business to *lower production costs* (economies of scale)
    * put *pressure* on rivals: they may be forced to lower prices as well or differentiate their product further
- Downside of this strategy
    * optimal length of this low prices period is difficult to determine
    * risk: customers may get used to low prices and they may leave when prices return to the pre-offer level
- Example of *industries* using penetration pricing: sports clubs, online gaming, satellite broadcasters, driving schools, ...

- *Predatory pricing* (or destroyer pricing): setting a low price forcing rivals out of business
    - Goal: Eliminate competitors from market
    - Charge a *very low price* until rivals leave the market
    - Selling a product below the *cost of production* in order to force out rivals is *illegal* in the UK and EU
    - Regulation: risk that in the long run it can lead to *lack of competition*
    - Low-price strategies are allowed if low-cost business can *endure* low profit for an *extended period*
    - Example of predatory pricing: Esso and Shell in 2013
    - Regulator in UK: *Office of Fair Trading*
- *Competitive pricing*: pricing strategies based on the prices charged by rivals
    - Usually done in *very competitive markets*
    - Advantage: avoids *price wars* (therefore a safe pricing strategy)
    - Market leader *sets* the price and all other *follow*: *price leadership*
    - *Price leaders* are usually the dominant firms in the market (e.g., low-cost operators, firms with strong brands)
- *Psychological pricing*: setting the price slightly below a round figure
    - Consumers are *tricked* into thinking that 99.99 is cheaper than 100

  - targets customers who are looking for *bargains*
  - this is strategy is not used for *up-market* products

- *Factors* that determine the choice of *pricing startegy*
  - Differentiation and USP: sufficinetly differentiated products can be charged higher prices (e.g., restaurant with innovative dishes)
  - Price elasticity of demand: price *inelastic* products may see a price increase
  - Amount of competition: low competition for a product in a given market may see a price increase (e.g., grocery shop in isolated location)
  - Strength of the brand: strong brands can charge higher prices
  - Stage in the *product life cycle*: low price (early stages) → increase price (when sales start to grow) → reduce prices a little (when product matures)
  - Costs and the need to make a profit

- Changes in pricing to reflect *social trends*
  - Online sales
    * dynamic pricing: different customers pay different prices depending on time and place
    * auction sites: find the customer who want to pay the most
    * personalised pricing: identify specificities/habits of online shopper
    * subscription pricing: sites that compare prices of goods and services from different suppliers
  - Price comparison sites

- Review questions (pick the right answer and **explain in detail**!):
  - Business Link offers owners of new, small businesses practical advice on its website. Business Link states each of the following about cost-plus pricing, **except**
    - ☐ it guarantees that a profit is made
    - ☐ it is usually expressed as a percentage of the cost which is added to the cost
    - ☐ it can ignore the image of a business and its market position
    - ☐ it can sometimes ignore hidden costs
  - Neil's Nuts, a newly established market trader of dried fruit and nuts in Walthamstow, London, successfully entered the market in January 2011.

- ☐ margin of safety
- ☐ pricing strategy
- ☐ sales volume
- ☐ potential profit

– **Cebu Home** (*Essay question*): Maria Rogers has worked hard to establish her business, Cebu Home, 'to bring original, beautiful and unique furniture to homes in Islington, London'. Cebu Home is in Arlington Way with a number of luxury independent boutiques and, importantly, the Sadlers Wells Theatre. Visitors to the Theatre form a significant core of Maria's customers and help to explain the business' unusual opening times of 3pm to 7pm, Monday to Friday.

  Cebu Home is named after a stunning island in the Philippines, renowned for its idyllic beaches and chilly mountains. Cebu is a place of impeccable craftsmanship and innovative design. The production of mahogany furniture is the focus of industry on the island, which exports worldwide. Maria imports this high quality designer furniture at affordable prices.

  Cebu Home's furniture collection contains both classic and contemporary pieces made with local materials and fabrics from Philippine markets. The furniture and homewares are unlike those often found in the UK, due to both innovative design and the use of traditional materials such as walnut, mahogany and pearl.

  Maria's business also has utmost respect for the environment, recycling where possible and only providing packaging by customer request. Furniture is hand-made with mahogany from sustainable forests in the Philippines. Cebu Home abides by the CITES (Convention on International Trade in Endangered Species) agreement which ensures that the survival of wild plants and animals is not threatened by trade.

  Maria's business thrives because of her natural entrepreneurial characteristics and motivation to succeed. Family and social values are central to all design, manufacture and supply processes. Furthermore, Cebu Home ensures that its products are manufactured without child labour and that fair wages are paid to workers.

  - ☐ Maria prices her products using a cost-plus pricing approach, applying an average mark-up of 300%.
    Evaluate the possible consequences to Cebu Home of Maria using this approach to pricing her products.