Dealing with Pricing Challenges

A guide to help you broaden your understanding of key pricing challenges applicable for small business owners and managers

The approach to pricing that you adopt in your business can ultimately determine its success or failure – it's as serious as that. Unfortunately, for some operators, their 'pricing strategy' consists of copying those offered by their competitors, or is simply focused on under-cutting others. Both these approaches, if not based on a solid understanding of what prices should be charged to generate the necessary returns, can lead to severe financial problems for a small business ranging from poor margins on products sold, through to losses on specific products/services due to cost inflation and failure to re-price. At worst it could mean the difference between making a profit or a loss. This short guide will help you to avoid common pricing pitfalls.

How to Make Sound Financial Decisions:

Dealing with Pricing Challenges

This short guide has been developed to help broaden your understanding of key pricing challenges applicable for small business owners and managers. The information here is designed to provide you with a general overview of this topic and further support can be found on the Business Tools web page.

1. The Importance of Pricing

The pricing of your products and services is one of the most important decisions you can take as a business person, and the price you set for your goods and services is a key determinant of the final profit (or loss) that your business will make. It is therefore in your best interests to ensure that you are fully aware of the impact of the factors which influence your pricing decisions and the opportunities that exist to enable you to maximise your sales income.

It is also useful to highlight from the outset that there are no firm rules to how you should define your prices, nor is there an ideal method for setting a price, but there are many indicators that can help you. Some of the factors that affect your pricing decisions include:

- **Your costs** – clearly your cost base will determine the prices you set.
- **Your business model/marketing strategy** – whether you are positioning yourself as a premium offering or a convenience product will determine the boundaries for your prices.
- **Market Conditions/Competition** – the level and nature of competition, the economic and market conditions and even certain pricing regulations can influence your pricing decisions.
- **Product types** – the perishability of your product will have a strong influence on the prices you charge.
- **Contribution and break-even requirements** – what contribution margins you need to sustain the business will also be a determinant.

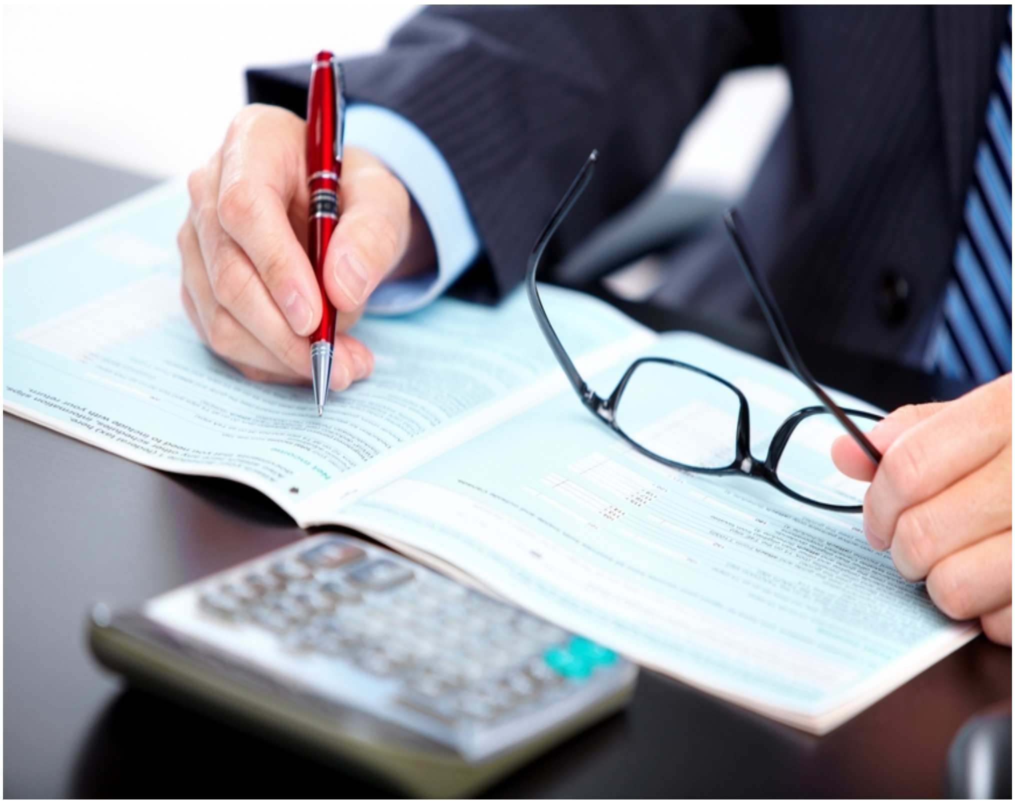
Whatever selling price you decide upon, your sales income should naturally exceed the costs associated with running your business. On each sale that you make, the excess of the income over the direct cost of providing the good or the service generates a contribution towards the fixed costs of your business. Only when you have covered the fixed costs of running the business (the "break-even point") will you begin to make a profit.

Example

The Liffey Restaurant sells lunch at €5, plus VAT. The cost of the food used in producing the meal is €3. The additional direct costs (e.g. payroll) associated with the provision of each meal is €1. The Gross Profit on each meal is €2 (sales price of €5 net of VAT less the cost of sales of €3) and the contribution to the fixed costs of the business is €1 (sales price less total direct costs of €4). The contribution margin percentage is the percentage of each €1 of sales income that is available to cover the fixed costs of the business. In this example, the contribution margin percentage is 20% (e.g. €5 less €4 divided by €5).

As the restaurant has fixed costs (insurance, rates etc.) of €200,000 per annum, it must sell 200,000 meals to break-even (e.g. €1m of sales). Every meal in excess of 200,000 provides a profit of €1. If the restaurant increases its prices, the contribution per meal sold will increase and the number of meals it must sell to cover its fixed costs will be reduced. However, should the restaurant sell meals below the direct cost of providing those meals, it will fail to make a profit, fail to cover its fixed costs and its losses will increase with each meal sold.

In considering your pricing strategy, good practice determines that you should calculate your sales income on the basis of your planned pricing structure and calculate the resulting contribution margin percentage. This will enable you to establish whether, or not, your pricing strategy is sufficient to enable you to attain a break-even trading position, or to make a profit. If your estimated sales income and profit margin is insufficient to enable you to reach a break-even level of trading, you need to increase your prices and/or, reduce the costs of operating your business. If you have any doubts as to the ability of your business to reach, and exceed, a break-even trading position, you should consult with your accountant immediately.



Pricing Challenges and Considerations

Are you charging enough to make a sustainable profit? That includes sufficient margin to pay yourself a living wage or salary, plus have extra funds for developing your business and replacing outworn equipment or furnishings. Here are four pricing challenges to avoid:

Underselling. You can't price your product or service properly until you identify **all** your costs. Run your expense figures past your accountant to ensure you have included everything, including a reasonable wage or salary for yourself. Don't forget to include your overheads such as utilities and rent. Then get help from your accountant to check that your pricing is adequate.

Following the competition. Basing your pricing on your competitors' prices is dangerous, as who's to say they know what they are doing. They may be operating at a loss. Or have very different cost structures to you. However, it makes sense to look at what your competitors are charging. Are you close or wildly out of line? If you're lower, then you have room to raise your prices. If you're higher, you may need to look at your cost structures. Perhaps you should start exploring alternative suppliers (offering a similar quality) to see if you can lower your costs.

Competing on price. Avoid discounting if you can because it can seriously impact on your profits and no one wins from a price war. The impact of a discount is always much higher than the discount. A 10% discount doesn't simply flow down the line as just 10%. For example, if your profit margin on a service (such as accommodation) is 30%, and you offer a 10% discount you'll need to sell 50% more of this service just to keep up. It makes more sense to avoid discounting and instead show customers you offer better value or more features and services.

Lowering price without changing service delivery. If you have to negotiate to win the business, make sure you get an appropriate concession in return. You might have to reduce a room rate, but maybe breakfast is then not included. A range of products and service (for example a room rate including breakfast and a rate without breakfast) will enable you to appease both cost and value-conscious customers.

> *“sufficient margin to pay yourself and develop your business”*

Your pricing policy must also take account of the following:

VAT

Your competitors' prices

The perishability of your goods and services.

VAT

Your goods and services will be subject to VAT. When deciding on your selling price, you must ensure that the amount that you will receive (net of VAT) will cover your direct costs and make a contribution to the fixed costs of your business.

Competitors' prices

As well as the points mentioned above regarding your competitors, think about whether your customers consider your products and services to be identical to those of your competitors? If so, and if it is relatively easy for your customers to purchase from your competitors, then your pricing decision requires careful consideration. Unless you can offer something different, or better, than the competition it is unlikely that you will be in a position to charge a higher price for your goods and services.

By and large, customers are willing to pay for high standards, excellent quality products and personal attention by staff whilst they are on the premises. It is important that you regularly check your competitors' prices. It is worth remembering that competing businesses may be based outside your immediate locality.

> *“stimulate demand”*

Perishability

'Perishable' goods and services cannot be stored for sale on another day and they are worthless if unsold. In particular, this applies to bedrooms, restaurant tables and food. If a guesthouse has 10 bedrooms and 2 rooms remain unsold on any given day those 2 bedroom sales are lost forever. They cannot be added to the stock of 10 bedrooms for resale the following day. In periods of low demand, you may be required to reduce the selling price to stimulate demand for your goods and services.

The 'yield management' concept is used by many tourism accommodation (and other) businesses, small and large, to maximise income during periods of peak demand and stimulate sales during periods of weak demand.

Other opportunities that you can utilise to limit the perishability of your goods and services include:

Establish good stock rotation practice which in turn reduces wastage.

If you serve food, consider advertising menus/daily specials on your website, on a display board in the foyer/bar or outside your premises, or on 'daily deal' websites.

If you are an accommodation provider, ensure that the services your premises can provide are visibly (and tastefully) displayed in bedrooms, corridors, and around public areas.

Ensure that every member of staff has the opportunity to sell your product. Training will ensure staff confidence and ability to become a member of the sales team.

2. The Pricing Decision

As stated, pricing is one of the most important decisions you will take in business life - get it wrong and you will likely find yourself in serious financial trouble. With an improved understanding of the cost structure of your goods and services, the sales volume required to break-even and the pricing policy of your competitors, you can make informed decisions regarding your own prices. There are a number of approaches that you can adopt in setting prices:

Mark-Up Pricing

Mark-up pricing is used frequently, particularly in the pricing of food and beverage menus, and is normally based on:

- The mark-up you must add to the cost of your products and services to achieve the desired profit.
- The mark-up used by your competitors.

The mark up, which is usually expressed as a percentage, is added to the cost of the product to achieve the selling price. Different businesses apply different mark-up rates on the basis of demand, competition, quality and perception. High quality products and services normally support a high mark-up.

Margin Based Pricing

Margin based pricing indicates the percentage of profit that a business makes on a sale, after applying the mark-up. It is expected that different products and services will have different profit margins. You should attempt to limit the number of low margin products and services that you offer and to maximise the number of high margin products and services that you offer.

Value Based Pricing

Value based pricing focuses on the price that customers are willing to pay. The perceived value of a product or a service to a customer may be driven by:

- **Convenience** - your accessibility to the market, or in certain cases, your opening hours.
- **Brand or image** – if your product is perceived to have a premium image or brand, customers will pay more for it.
- **Supply and demand** – if demand for your products and services is high, then you may be in a position to increase your prices.

A general point is worth remembering here. It is always easier to reduce the prices of your offering than it is to increase them; so, if you are unsure as to the prices you should set, opt for a higher price initially. Then, if your sales volumes do not materialise you should be prepared to reduce your price.

Pricing Tactics

It is also worth highlighting the various price tactics employed in businesses of all kinds:

- **Odd Value** – instead of pricing a bedroom at €100 or a meal at €25, pricing them at €99.95 and €24.95 respectively creates a favourable impression.
- **Loss leaders** – selling a small number of products and services at cost will win new customers. However, reducing your profit margin on those products and services that are big sellers only makes sense if you can increase your total sales volume to the extent that the additional profit earned is more than the profit margin foregone by the introduction of your loss leader pricing policy.
- **Price War** – is the policy of deliberately undercutting rivals' prices to win market share. Such a strategy could backfire if your competitors respond similarly or if, having achieved market share, you are unable to increase prices and retain your customers.
- **Up Selling** – is the process of increasing your sales to your current customers by encouraging them to purchase more expensive goods or services than they intended. This is frequently achieved in restaurants, for example, where well trained staff may encourage diners to order an aperitif or an additional bottle of wine. Customers often respond positively to such suggestions
- **Value Added Offers** – offering customers additional perceived high value products or services at a competitive price, but which adds very little cost to your business.

3. Pricing and Profits

Whatever pricing policy you adopt, there are other matters that you should consider to assist you to improve your profitability.

Controlling variable costs - reducing your variable costs will enable you to increase your profit margin (or to reduce your prices and maintain your current profit margin). This may be particularly useful in a highly competitive environment.

Controlling fixed costs - what opportunities are available to you to reduce your fixed costs (e.g. can insurance premiums be reduced by sourcing quotes from a number of brokers)?

Maximising high margin sales - typically, accommodation sales are more profitable than food and beverage sales. In circumstances where accommodation sales are low relative to other sales, there may a significant opportunity to increase profits by concentrating on bedroom sales.

Finally, take a look at the following example for a fictitious Equestrian Centre to get a real understanding of how sensitive your profit is to variations is sales, prices and costs:

Fáilte Ireland Equestrian Centre's Profit Sensitivity Analysis for Month of July

	Budgeted P&L Account	10% reduction in sales volume	10% reduction in sales prices
Estimated number of lessons in period	500	450	5,000
Estimated average spend per lesson	€20	€20	€18
Sales	€ 10,000	€ 9,000	€ 9,000
Cost of Sales (variable)	€ 4,000	€ 3,600	€ 4,000
Gross margin	€ 6,000	€ 5,400	€ 5,000
Other costs (variable)	€ 1,500	€ 1,350	€ 1,500
Contribution margin	€ 4,500	€ 4,050	€ 3,500
Other costs (fixed)	€ 2,500	€ 2,500	€ 2,500
Profit	€ 2,000	€ 1,550	€ 1,000
Euro drop in profit		-€ 450	-€ 1,000
% drop in profit		-23%	-50%

What is the effect on your profit of a drop in treks/lessons, or in average guest spend, or in changes in your more significant costs? If sales drop by 10%, do profits also drop by 10%? The answer is – No! This example assumes a budgeted profit of €2,000. If there is a shortfall of 10% in expected lessons, sales value reduces by €1,000. Variable costs also reduce, of course, in proportion.

However, profit decreases by €450, i.e. by 23%, not 10%! The reason is that Fixed Costs remain constant and become a greater proportion of overall costs. To make up that fall in profit, prices (i.e. average spend) would have to increase by €1 per head, i.e. profit shortfall (€450) divided by the revised number of lessons (450).

Take another scenario. If lesson prices drop by 10% (i.e. average spend reduces from €20 to €18), sales value reduces by €1,000. Profit also falls by €1,000 – that is a 50% drop! The more severe drop in profit this time is because the price reduction has no effect on any costs, be they fixed or variable, and the gross margin (as well as the contribution margin) has now been squeezed.

Effective pricing requires a systematic approach, starting with a thorough analysis of the wide variety of factors that may affect your pricing decisions and results. It is only through having all the necessary information to hand that you can determine an overall pricing strategy, and then within those parameters, to calculate individual prices.

This guide has been provided to you as part of Fáilte Ireland's suite of guides and templates in the Business Tools resource.

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