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TOPIC: PRICING METHODS
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Pricing Methods

The price the company charges will fall somewhere between one that is too low to produce a profit and one that is too high to produce any demand. Customer perceptions of the product's value set the ceiling for its price. If customers perceive that the product's price is greater than its value, they will not buy the product. Likewise, product costs set the floor for a product's price. If the company prices the product below its costs, the company's profits will suffer. In setting its price between these two extremes, the company must consider several external and internal factors, including competitors' strategies and prices, the overall marketing strategy and mix, and the nature of the market and demand.

1. Cost-based Pricing

a. Cost-plus pricing/Mark-up pricing

The simplest pricing method is **cost-plus pricing (or mark-up pricing)**—adding a standard mark-up to the cost of the product. Construction companies, for example, submit job bids by estimating the total project cost and adding a standard mark-up for profit. Lawyers, accountants, and other professionals typically price by adding a standard mark-up to their costs. Some sellers tell their customers they will charge cost plus a specified mark-up; for example, aerospace companies often price this way to the government.

Example 1:

Variable cost	shs 10
Fixed cost	shs 200,000
Expected unit sales	50,000

Then cost per unit;

$$\text{Unit cost} = \text{variable cost} + \frac{\text{fixed cost}}{\text{Unit sales}}$$

$$\text{Unit cost} = 10 + \frac{200,000}{50,000} = \text{shs } 14$$

Lets assume the firm wants a 20% mark up on sales.

The formula is given by;

Mark-up price = $\frac{\text{unit cost}}{(1-\text{desired return on sales})}$

mark-price = $\frac{14}{(1-20\%)}$

mark-price = $\frac{14}{(1-0.2)}$ = shs 17.5

Does using standard mark-ups to set prices make sense? Generally, no. Any pricing method that ignores demand and competitor prices is not likely to lead to the best price. Still, mark-up pricing remains popular for many reasons.

First, ***sellers are more certain about costs than about demand***. By tying the price to cost, sellers simplify pricing; they do not need to make frequent adjustments as demand changes.

Second, ***when all firms in the industry use this pricing method, prices tend to be similar***, so price competition is minimized.

Third, ***many people feel that cost-plus pricing is fairer to both buyers and sellers***.

Sellers earn a fair return on their investment but do not take advantage of buyers when buyers' demand becomes great.

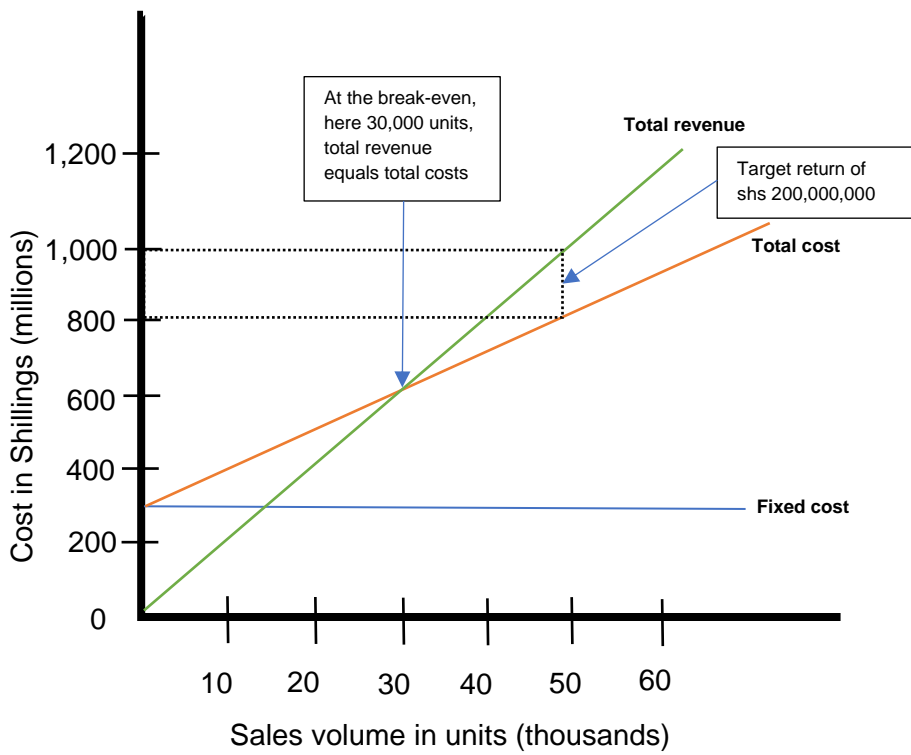
b. Break-Even analysis and Target Profit Pricing

This is another cost-oriented pricing approach which is also called target return pricing. The firm sets a price at which it will break even or make that target return on costs of making and marketing a product.

The target return pricing concept uses the concept of a break-even analysis chart. This shows the total costs and revenue expected at different sales volumes levels.

The figure below shows a break-even chart for the candle manufacturer. The fixed costs are shs. 3,000,000 regardless of the sales volumes. Variable costs are added to the fixed costs to form total costs, which rise with volume. The total revenue curve starts at zero and rises with each unit sold. The slope of the total revenue curve reflects the price of shs. 200 per piece.

To make a target return of shs 2,000,000 the company must sell 50,000 units. The question is whether customers will buy those many units at the shs 200 price? The company should consider different prices and estimate break-even volumes and probable demand at each price.



The total revenue and total cost curves meet at 30,000 units. This is the break-even volume. At shs 70,000, the company must sell at least 30,000 units to break even, that is, for total revenue to cover total costs. Break-even volume can be calculated using the formula below:

$$\text{Break-even volume} = \frac{\text{fixed cost}}{\text{Price-variable cost}} = \frac{3,000,000}{200-100} = 30,000 \text{ units}$$

If the firm wants to make a profit, it must sell more than 30,000 units at shs 200. Suppose the firm invested shs 1 billion in the business and want to set a price to earn a 20% return or shs 200,000,000. In that case, it must sell 50,000 units at shs 200 each. If the company charges a higher price, it will not need to sell as many candles to achieve its target return. But the market may not buy even this lower volume at the higher price. Much depends on e price elasticity and competitors' prices.

The firm should consider different prices and estimate break-even volumes, probable demand, and profits for each. But as price increases, the demand for candles also decreases (column 3). At the shs 140 price, because the manufacturer clears only shs 40 per candle (shs140 less shs 100 in variable costs), it must sell a very high volume to break even. Even though the low price attracts many buyers, demand still falls below the high break-even point, and the manufacturer loses money. At the other extreme, with a shs 220 price, the manufacturer clears shs 120 per toaster and must sell only 25,000 units to break even. But at this high price, consumers buy too few toasters, and profits are negative.

The table shows that a price of shs 180 yields the highest profits. Note that none of the prices produce the manufacturer's target return of \$200,000. To achieve this return, the manufacturer will have to search for ways to lower the fixed or variable costs, thus lowering the break-even volume.

Break-Even Volume and Profits at Different Prices

Price (shs)	Unit demand needed to break even	Expted unit demand at given price	Total revenue (1)x(3)	Total costs *	Profit (4)-(5)
140	75,000	71,000	9,994,000	10,100,000	-160,000
160	50,000	67,000	10,720,000	9,700,000	1,020,000
180	37,500	60,000	10,800,000	9,000,000	1,800,000
200	30,000	42,000	8,400,000	7,200,000	1,200,000
220	25,000	23,000	5,060,000	5,300,000	-240,000

* Assumes fixed costs of shs 3,000,000 and constant unit variable cost of shs 100.

2. Customer Value-Based Pricing

This is a pricing method where the price is based on buyers' perceptions of value rather than on the seller's costs. This pricing method uses buyer perceptions as the key to pricing. Value-based pricing means that the marketer cannot design a product and marketing program and then set the price. Price is considered along with all other marketing mix variables before the marketing program is set.

Value-based pricing reverses the process where you first look at production costs and then use marketing to convince customers of the product's value that justifies the price. The company first assesses customer needs and value perceptions. It then sets the target price based on customer perceptions of value.

The targeted value and price drive decisions about what costs can be incurred and the resulting product design. As a result, pricing begins with analyzing consumer needs and value perceptions, and the price is set to match perceived value.



Good value is not the same as low price. Some customers may consider certain items a bargain even at eye popping prices. Some one purchasing an item at 1,000,000 or even 10,000,000 may not consider it expensive. This is because of the perceived value. Some times it is difficult to measure values customer attach to its products. Value is subjective; it varies both for different consumers and different situations. Companies should continuously asses customer value so that they are able to assess prices charged.

Sometimes, companies ask consumers how much they would pay for a basic product and for each benefit added to the offer. Or a company might conduct experiments to test the perceived value of different product offers. According to an old Russian proverb, there are two fools in every market—one who asks too much and one who asks too little. If the seller charges more

than the buyers' perceived value, the company's sales will suffer. If the seller charges less, its products will sell very well, but they will produce less revenue than they would if they were priced at the level of perceived value.

We now examine two types of value-based pricing: good-value pricing and value-added pricing.

Good-value pricing

Good-value pricing means offering the right combination of quality and good service at a fair price. This follows an aspect of charging prices based on the prevailing economic conditions and consumer price perceptions. In many cases, this has involved introducing less-expensive versions of established brand name products or new lower-price lines. For example, Walmart launched an extreme-value store brand called Price First. Priced even lower than the retailer's already-low-priced Great Value brand, Price First offers thrift-conscious customers rock-bottom prices on grocery staples. Good-value prices are a relative thing—even premium brands can launch value versions.

In other cases, good-value pricing involves redesigning existing brands to offer more quality for a given price or the same quality for less. Some companies even succeed by offering less value but at very low prices. For example, Spirit Airlines gives customers "Bare Fare" pricing, by which they get less but don't pay for what they don't get.

An important type of good-value pricing at the retail level is called **everyday low pricing (EDLP)**. EDLP involves charging a constant, everyday low price with few or no temporary price discounts. The ALDI supermarket chain practices EDLP, with a good-value pricing value proposition that gives customers "more 'mmm' for the dollar" every minute of every day. Perhaps the king of EDLP is Walmart, which practically defined the concept. Except for a few sale items every month, Walmart promises everyday low prices on everything it sells. In contrast, high-low pricing involves charging higher prices on an everyday basis but running frequent promotions to lower prices temporarily on selected items. Department stores such as Kohl's and JCPenney practice high-low pricing by having frequent sale days, early-bird savings, and bonus earnings for store credit-card holders.

Value-Added Pricing

Value-added pricing doesn't mean simply charging what customers want to pay or setting low prices to meet competition. Instead, many companies adopt value-added pricing strategies. Rather than cutting prices to match competitors, they add quality, services, and value-added features to differentiate their offers and thus support their higher prices.

Value-added pricing: Value-added pricing Attaching value-added features and services to differentiate a company's offers and charging higher prices.

3. Competition-based pricing

Competition-based pricing involves setting prices based on competitors' strategies, costs, prices, and market offerings. Consumers will base their judgments of a product's value on the prices that competitors charge for similar products.

In assessing competitors' pricing strategies, a company should ask several questions. First, how does the company's market offering compare with competitors' offerings in terms of customer value? If consumers perceive that the company's product or service provides greater value, the company can charge a higher price. If consumers perceive less value relative to competing products, the company must either charge a lower price or change customer perceptions to justify a higher price.

Next, how strong are current competitors, and what are their current pricing strategies? If the company faces a host of smaller competitors charging high prices relative to the value they deliver, it might charge lower prices to drive weaker competitors from the market. If the market is dominated by larger, lower-price competitors, a company may decide to target unserved market niches by offering value-added products and services at higher prices.

Importantly, the goal is not to match or beat competitors' prices. Rather, the goal is to set prices according to the relative value created versus competitors. If a company creates greater value for customers, higher prices are justified.