Big Company Pricing Experts Give Small Business Pricing ‘How-To’ Advice

Lisa Pierce sets her company’s prices using a technique best described as advanced back-of-the-envelope. The founder of eight-employee Alpha & Omega Delivery, a courier service in Springfield, Ill., simply adds up her costs and estimates how much she needs to charge to cover that amount. But her $500,000 company has seen the edge of bankruptcy in five of its eight years, and Pierce’s pricing strategy — or lack thereof — isn’t helping. “That’s going to change,” she says.

Any of this sound familiar? The “charge based on what the other guys are charging and hope to squeeze out a profit” method of pricing, otherwise known as “cost and competition,” is used by plenty of companies, both large and small. It’s intuitive and can be relatively easy to work out. But it often leaves a lot of money on the table.

As Thomas Nagle, a partner at Monitor Group in Cambridge, Mass., puts it, sticking to the cost-and-competition paradigm “is an almost certain way to lose.” That’s because the cost-and-competition method has little to do with how your customers value your products or services. For all you know, your pricing may be steering people away from your company.
Pierce knows she needs to find a new approach. It may be time for you to do the same.

While both cost and competition are important, they shouldn’t be your focus. Consultants agree that there is a correct price for everything — often a band of prices for different combinations of products and different customers.

That price brings satisfactory returns, sure, but it also helps strengthen sales and accurately reflects the value you’re delivering to customers. Not surprisingly, that ideal price isn’t going to be found by just looking at the cost of doing business or what your competitors are charging.

Developing a pricing strategy begins with determining the true value of your offerings to customers. If you doubt that different people place different values on the exact same product or service, just go to an auction, where a single item can bring wildly varying bids.

For entrepreneurs, the key is to segment customers and charge a corresponding range of prices. That will take some research.

Say, for example, you charge a flat fee for telephone technical support. To determine demand and how much you should charge, you’ll need to track the number of calls that come in and how long they last.

You may find that you can charge a variety of prices, with customers who stay on the line longer paying more than those with simple questions that need only fast answers.

Cultural Shift Needed
Changing a company’s prices often demands a shift in a company’s culture, says Nagle. Salespeople will need to shake the habit of selling at the lowest price to close a deal, and any employee who works directly with customers must be able to explain the value of your product.

“How getting the price 100% correct is obviously a great goal,” says Rafi Mohammed, a Batten Fellow at the University of Virginia’s Darden Graduate School of Business. “Few firms do it, but there’s a lot of room to be better in pricing today than you were yesterday.”

Don’t Sell Yourself Short
It may be counterintuitive, but the lowest price will not always reel in the most customers. Eric Mitchell, Founder and President of the Professional Pricing Society in Marietta, Ga., suggests plotting a simple graph that shows your actual historical sales by volume and price, or by volume and discount, or volume and profit. You may find that lower prices really do not drive volume.

If the graph looks as scattered as a shotgun blast, you’re pricing haphazardly and probably giving discounts that aren’t driving sales. Sometimes that’s the result of bidding low to win a job, then being stuck with that number.

People pay for what they value, and that translates into a willingness to pay a premium for higher-quality, greater expertise or faster service.

There often is a gap between what customers will pay and what a business charges. The first step toward closing it, Mohammed suggests, is for entrepreneurs to ask, “How much do my customers value me, and what’s their next-best option?”

If you have the budget, you can try the big-company tactic of employing researchers to perform so-called discrete choice analysis. In this scenario, customers view different products with different features and are asked to judge the varying prices researchers attach to them. Those findings help a company settle on an attractive mix of features and price them accordingly.

Perform Price-Acceptance Research
As you may suspect, there’s also a simpler, cheaper way to get good pricing information: Just ask the right questions of employees and customers.

“Your people on the front line have a really good idea about what customers want and need, and you should tap them for insight,” says Mohammed. “Your sales force knows a lot about what people think about value, but they don’t have an avenue to get it out.”

Then there are your customers. “You don’t have to do big research,” says Mitchell. “If you have five or 10 people who are 50% of your sales, just ask them, ‘Where do I fit into your system?’ If your customer says he is saving $100,000 a year because you cut his turnaround time, or because your service is so fast, that’s a hint to charge more for faster delivery.”

Keep conversations friendly, and ask customers what they would substitute for your product if it did not exist. That will tell you if they have other options and how good those options are, which reveals the true value of your product or service.

Alpha & Omega’s Pierce discovered she had a number of customers who didn’t
have a viable alternative to her courier service.

She charges $50 to pick up and deliver legal documents, such as traffic-court decisions, to attorneys who can then get a client’s driver’s license restored in a matter of days rather than weeks.

She thinks the lawyers might pay twice as much and is thinking about how she could speed things up further and charge even more.

Pierce also charges a flat fee for pharmaceutical deliveries, even though shipments that include narcotics have to be accompanied by a special tracking form that means more time and responsibility for her drivers. The narcotics deliveries should be commanding a premium over other drug deliveries.

Selling versions of the same product at different prices to different customers often means listing separate rates for students, senior citizens, educational institutions, corporations or other groups of customers. A subtle change in what a product is or how it is packaged can mean a significant leap in value.

Think of it as offering good, better and best choices. Restaurants often exploit this technique by offering early-bird discounts, normal dinner-hour prices and a chef’s table, where special attention is lavished on patrons for a premium price.

While there is no magic formula, Mohammed says two or three price levels usually are sufficient. “You don’t want to make it too complex,” he says.

A Case Study
President Erika Mangrum and Chief Financial Officer David Mangrum of the 63-employee, $2.2 million Latria Spa & Health Center in Raleigh, N.C., offer patrons a variety of spa packages with different mixes of services and themes.

Erika Mangrum says the three-hour “Teen Queen” for $175 is more “educational,” and includes a deep cleansing facial and cosmetics makeover, while “Tranquil Destinations,” a three-hour package that includes massages and body wraps, is geared to groups of women or couples and costs $304 per person.

The spa has four locations, and the Mangrums add 5% to 10% for services at the downtown spa.

“A couple of people, in the beginning, said, ‘Why does it cost more at your downtown location?’ because they wanted the pricing to be the same everywhere. We just can’t. It has to be more in the downtown area,” she says, noting that leasing space in a city’s center is more expensive than in the suburbs.

The different prices do create minor hassles: If a customer receives a gift certificate bought at a suburban location and redeems it at the downtown spa, she will have to pay the difference.

Nagle says even businesses that initially argue they can’t add options can usually find a way. Often, the key is to unbundle services currently sold together.

“You see this at bike stores where you can buy a bike unassembled or assembled, and you can buy additional parts and put them on yourself or have the store do it for an additional price,” says Nagle.

Sell It To The Salespeople
A new pricing strategy won’t pay off if customers don’t understand the logic behind it. But before your customers can understand it, your employees have to.

Erika Mangrum says because her prices are slightly higher than most other spas in the area, her employees know how to discuss the services so that potential customers understand the difference. When a customer calls and asks for the price of a massage, the receptionist is sure to outline the amenities included.

If your salespeople are compensated solely on volume, says Mohammed, they have no incentive to maximize profits. Ideally, reconsidering your pricing will force you to think more about your customers’ needs and wants. And that’s priceless.