Establishing your correct price:

Having the lowest price is not important to everyone!

Pricing strategies vary considerably, depending on market conditions, your product or service offering and the prevailing economic conditions.

- 10-15% of the population buy the cheapest goods on offer.
- 80% buy value.
- 5% buy expensive because they can afford 'the best' and, to them, a high price represents high value.

So unless you operate in a 'perfect market', where the laws of supply and demand affect the price of a commodity, there is always room to appeal to those customers who value what you are selling, and value it enough to pay a little bit more for it because you are differentiated from the competition .

This is where you need to understand a little bit more about marketing and how the positioning of your business in the market is so important.

The great thing about business is that there is no such thing as a 'perfect market'. The whole point about markets is that they are all made up of buyers and sellers all looking for an 'edge' and, at any time; someone has more of an edge than the others. In these circumstances deals take place!

This where your pricing strategy is mot important

There is one golden rule to establishing the right price for anything and that is that the customer will only ever pay what they think it is worth for them.

You must very carefully consider you pricing structure (particularly in a start-up business), because whatever the price that you come up with, you are normally stuck with this for a least 12 months.

Therefore, if you get this wrong or you just do what everyone else does, your profits may well be just 'walking out the back door'' for some of your products even before you start. That is to say you have not taken into consideration your overhead requirement and/or your point of difference or competitive advantage that can achieve for you a much higher (perceived value) pricing structure.

Flexing or changing prices

Small businesses are so often cautious about flexing prices, for apparently good reasons:

1. We are intimidated by the big extremes between the pleasures of high prices and the pain of low prices.
2. We fear that we may lose more customers than we can afford.
3. We don't really understand what motivates our customers.
4. We have calculated price according to what things cost, or what the market go rates are, rather than what they are worth (perceived value pricing).
5. We don't understand how to do 'the numbers' or how we can make them work in our favour.

The effect of price changes on profit

One thing that many businesses fail to understand is that when you discount your prices you also discount your profit (both gross and net profit). This (unless checked) can spell disaster and usually indicates that the business has not done enough market research and gone into business in a price sensitive market with insufficient product depth. In other words all they have are 'me too' products with no clear differentiation and all they can do is follow what the market is doing!

Let's look at a scenario where we are selling 'good old' widgets

- Our widget cost price is $30.00
- Our widget sell price is $50.00
- Our gross profit on our sales of widgets is therefore $20.00
- So 40% gross margins, not too bad so far!

We sell currently 5,000 widgets per month.

See below the profit and loss snapshot of the business, calculated from the information above.

Current Pricing

1	Sales	$250,000	100%
2	Cost of Goods Sold	$150,000	60%
3	Gross Profit	$100,000	40%
4	Expenses (Overheads)	$45,000	18%
5	Net Profit	$55,000	22%

Pricing Increased to $55.00 per Widget

1	Sales	$275,000	100%
2	Cost of Goods Sold	$150,000	55%
3	Gross Profit	$125,000	45%
4	Expenses (Overheads)	$45,000	16%
5	Net Profit	$80,000	29%

As you can see (above) a simple $5.00 price increase has increased our net profit by $25,000 dollars to $80,000, that's HUGE! Remember this when you increase your prices (and your product costs remain the same of course) that price increase drops straight to the bottom line!

You should plan to increase your prices at least annually, your prices to operate are going up (fuel costs, labor costs etc.) customers will expect you to increase your prices.

Pricing Decreased to $45.00 per Widget

1	Sales	$225,000	100%
2	Cost of Goods Sold	$150,000	67%
3	Gross Profit	$75,000	33%
4	Expenses (Overheads)	$45,000	20%
5	Net Profit	$30,000	13%

In the snapshot above, the reverse has happened with a $5.00 price discount everything has gone south! Our cost of goods sold % to sales is up to 67% which reduces gross profit. This $5.00 price discount has wiped $25,000 off our net profit (bottom line). So now what happens?

If the competitors decrease their prices further what do we do? Follow suit? Only the strong can survive here, the one with the most profit or assets than can be quickly turned into cash!

The message here is to make sure you are diversified have many products in many market segments, have plans always in place to produce more products and/or services to add to your offering. Do not put all your eggs in one basket; look to get into other areas of different markets, also have you considered exporting your products?

Run rates are a great way to understand whether your sales and margins are on track with budget and to indicate the variances by week, month or whatever period you choose. Also this is a great tool to keep on top of these critical areas of your business, providing a snapshot view this method is a quick and easy way of analysing your business. Check out our Sales Run Rates Business Tool.

For more tips, ideas, informations and resources join our mailing list.