The Fundamentals of Business Pricing

Pricing in most businesses is not a black art at all, but rather a haphazard collection of rushed decisions and best guesses.

In many companies, pricing is done on a “cost-plus” basis. The average cost of producing the product last year (say) is taken and a percentage mark-up is added. It is important to stress that this is a very bad method. The cost-plus price is never the profit maximising price: it bears no relation to the needs and wants of customers, or of what the competition is doing. Often cost-plus pricing leads to a complex and chaotic structure of discounts and other inducements depending on the bargaining power of the customer.

That is not a profit-maximising strategy. The profit maximising price is the one which maximises customer value; and customer value bears no relation to production cost. Value is determined by the customer; and the benefits that your products and services deliver to the customer at a particular time, determines their value to that customer.

So “value” is subjective, different for each individual customer, and changes over time as needs and perceived benefits change. However, customer value is not too difficult to measure (though it is a little subjective). It simply requires a good understanding of your customers and markets.

Customer Value is made up of a product or service’s reference value (the price of alternatives), plus its differentiation value – the premium that our differentiated product or service commands through superior features and benefits.

Differentiation value comprises four elements:

Company Profile

We are process improvement specialists with over 20 year’s experience, providing training and consultancy in lean service, process analysis and improvement, and lean finance.

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1. Cost drivers. The ways in which your product or service offers the buyer cost savings over and above the reference product or service. Demonstrated performance, savings, reliability, faster servicing, and so on, are all cost drivers;

2. Revenue drivers. The ways in which your product or services can help the buyer increase revenues, for example through superior technology, customer support or brand strength;

3. Psychological drivers. The intangible elements of your product or service which add value for the buyer. Psychological drivers include brand image and reputation, and also the risk that a buyer takes in purchasing from you;

4. Negative drivers. Where your product or service performs less well than the reference product or service in any areas, this will decrease the differentiated value of your offering.

In each market segment you serve, there will only be three or four key drivers of differentiation value. The key to measuring Customer Value is to identify those few drivers of value, and to compare your organisation's performance against them with that of your competitors. This comparison will allow you to make a judgement of where in the range of prices in the market place your product or service should lie. This comparison will also help identify ways in which you can best improve the Customer Value of your products and services.

Contact us for more information.

Ideas into Action

Understanding, Involving, Improving