Pricing Your Product

A lot of startups treat pricing as a math problem or, worse, an afterthought. Pricing is as much an art as it is a science, one that relies as much on marketing and psychology as it does on classical economics.

This Sequoia Guide covers strategies that can help you figure out the right price for your product—and end up with happier customers and more profit in the process.

The Sequoia Guide to Pricing

LinkedIn's decision to package some seldom-used features as high-margin "premium" accounts spawned a business line that now makes almost $250 million a year. At eBay, touting the benefits of a low-cost tool meant the difference between profitability and a loss.

Meanwhile, companies that didn't properly assess the value of their products and price them accordingly struggled or fizzled out.

Setting a price for a product is one of the most important decisions a company can make. But all too often it's treated as an afterthought. Startups in particular have a habit of setting their price low to attract customers and never raising it, or keeping a feature free long after it's clear people will pay.

"If you picked your price once and never changed it, it's probably wrong," says Phil Libin, chief executive of Evernote.

A more thoughtful approach to pricing can boost your company's profits, increase customer satisfaction and help you discover popular product variations that you hadn't considered.

Getting started

In theory, setting a price should be a rational economics problem. You have a set supply of a product and there's a certain level of demand for it in the marketplace. Since demand tends to increase as prices go down, you simply adjust your price until you've maximized profits.

Reality is more complicated. Technology companies usually don't have a finite supply of a product. And while you may spend a lot to develop software or a mobile service, over time the cost to produce additional units approaches zero.

Furthermore, many startups have a new product for which there aren't competitors for customers to benchmark against.

Under these circumstances “the traditional model starts to behave in weird ways,” say Michael Dearing, a professor at Stanford University’s design school, who ran pricing at eBay for many years.

In order to set a price, you'll need to form a hypothesis. You can A/B test it and use other analytics to refine it. But don't rely on data alone to inform your decisions. Also take into account input from your customers and employees, what the competition is doing and your intuition.

“Pricing is not a math problem,” says Dearing. “It’s a judgment problem.”

Increase perceived value

Usually, companies fixate on the gap between how much their products cost to make and how much they charge for them. But you should also focus on the gap between your price and how much value customers think it delivers, a concept known as perceived value.

Companies often assume that if sales are slow they need to cut prices. But more often, Dearing says, “If nobody’s buying my product, it’s because the gap between price and perceived value either doesn’t exist or it’s not large enough.”

Evernote is trying to measure that gap. The company’s Premium accounts currently cost $5 a month. Libin recently started testing Evernote’s price in some countries to find out whether that’s cheap or expensive relative to perceived value.

“It’s possible that in some countries, like India or China, $5 a month is too expensive,” Libin says. “For the U.S. or Japan it may be that $10 a month is still cheap.”

You can increase perceived value with better marketing. EBay, for instance, offered a feature from its inception that for 25 cents allowed people who sell products on the site to add a photo next to their listings. It wasn’t used much, Dearing says.

But it turned out that sellers who included the pictures had much higher click rates and tended to command a higher price for their goods. EBay started to market this data along with the feature.

With the benefit of the sales data, eBay's sellers saw that the pictures helped solve a problem and their perceived value skyrocketed.

Because it didn't cost eBay 25 cents to host a photograph, the feature, along with other optional upgrades, eventually generated hundreds of millions a year in pure profits, Dearing says.

Let your price tell a story

The price you set for a product also influences its perceived value. That's why people assume that a $50 bottle of wine is better than a $10 one.

In that sense, price can serve as a proxy for quality.

Natera recently brought to market a non-invasive pre-natal test that can detect Down syndrome and other conditions in a mother's blood. Previously, testing for these conditions required a risky procedure that extracted tissue from the fetus. Other non-invasive tests aren't as comprehensive.

Because Natera's test is better than its competitors' products, the company charges more.

"Premium pricing communicates a premium product," says Matthew Rabinowitz, the company's CEO.

Tip: Where in the shopping process you display your price can make a big difference. In some cases, such as a takeout menu, waiting until after a customer has already decided to buy your product may allow you to charge more. In others, like a hotel room, too much opaqueness can frustrate customers.

One way to expand your customer base is to offer multiple products at similar price points, catering to a range of tastes. This is known as horizontal assortment. The iPhone 5c, which comes in five colors, is a good example.

Another approach is vertical assortment, offering versions at multiple price points. While your most expensive model represents what your brand aspires to, customers will value features differently and some who don’t see the value in that high-end version might be willing to pay less for a stripped-down model.

Charging different prices for iPhones with different amounts of storage increases the addressable market for the product with minimal additional cost. Software bundles that come with a maximum number of users or different tiers of customer service accomplish the same thing.

No matter how much research you do, you’ll never know for sure what customers want. In addition to offering a variety of products levels, it's good to allow them to add features a la carte.

By letting customers create their own packages you get real-time feedback about price and product configurations.

Tip: Too much choice can be overwhelming. People would rather buy nothing than choose the wrong option. Similarly, variable pricing that slides upwards with more usage can scare potential customers. They'll often walk away if they can't easily figure out the right product to buy or if they're forced to make projections about future costs.

Know your pinch points

No two customers perceive the value of your product the same way. Some might think that it’s a pretty good deal given the price, while others might be willing to pay 10 times what you’re asking.

Understanding these different groups can help you identify "pinch points" where customers feel emotionally compelled to pay so that they can access key features. There’s some guesswork involved here, but it’s also a function of knowing how your customers use your product.

For instance, when LinkedIn in 2005 decided to charge for some of its services, the company started by identifying the features that about 90% of customers didn’t use regularly.

LinkedIn concluded that its service was worth more to the heavy users than it was to casual ones and so the company hived off the 10% features. Power search and the ability to contact other members became the basis of premium accounts.

Sure enough, the heavy users were willing to pay more. Premium accounts produced $248 million in revenue for LinkedIn over the last four quarters.

Coming up with packages that appeal to different customers will be more profitable for you and allow customers to feel better about their relationship with your company. But beware: you'll need to support the different options going forward or explain to customers why they need to switch to a different plan.

Design for snap judgments

There's another reason why traditional economics aren't a good way to set price: people don't act rationally.

In fact, in many cases the decision to buy something is a split-second one people make before the parts of their brains that apply logic and reason kick in. To do this people take shortcuts, falling back on a judgment they've already made instead of making the effort to evaluate the value of something new.

Take a pair of loafers, for instance. It's hard to judge how much they're worth just from an online image. But someone who sees a picture of a teenager wearing the loafers along with cutoffs and a hoodie is likely to conclude they should cost less than someone who sees a picture of the same shoes worn by a briefcase-toting businessman.

Instead of trying to determine the value of the shoes—a difficult problem that would require the person to assess the material, the stitching and other factors—the customer substitutes a question that's easier to answer: How much would a high-school student or a businessman spend on shoes? That becomes the baseline for deciding whether the loafers are expensive or a bargain.

Tip: Figuring out what goes through a customer's mind when she first sees your product can help you set a price. Dearing suggests writing down all the things someone might associate with your product. Include things like whether it's cool or expensive, but also other products that someone who buys yours might already own.

This phenomenon played out at Weebly, which offers tools that make it easy to build websites. The company on its website emphasized that its service is free and easy.

That made sense early on when the product was relatively simple, says David Rusenko, Weebly's co-founder and CEO. But people associate free and easy with lightweight and cheap. Small-business owners, Weebly's target customer, didn't want to pay much for the websites, but they didn't want their sites to look cheap, either.

Weebly has evolved over time into a tool with a lot of features that's still a great value. To make this clear, the company revamped its image. Its new tagline, "create a site as unique as your are," conveys a special product and its website is now filled with high-quality images from customer websites that look like they cost a million dollars to build.

"We used to use words that made sense to us, but they weren't the ones that made sense to customers," Rusenko says.

That's also why Libin banned swag. He doesn't want customers to associate Evernote with stress balls and 30-cent mints. Companies like Nike and Apple don't put their logos on things that aren't products, he notes. So if

Evernote makes a T-shirt “it’s going to be a really great one that you’d be happy to pay for,” he says.

Similarly, he stopped promotions that let people get premium Evernote accounts at a discount, like a deal on MacHeist that sold a collection of software, including Evernote, for $29.

At the same time, Evernote extended its deal with Moleskine, which makes a $25 notebook that comes with a three-month premium subscription, because that product costs more than the subscription would on its own.

“If all you want is Evernote premium you can’t get a deal,” Libin says. “It’s a way to keep perceived value from falling.”

Tip: Logic kicks in eventually, so your price needs to stand up to scrutiny. If your product is priced too low, someone will try to figure out why. If something cheap is dressed up with expensive imagery people will figure that out, too. Big purchases like a million dollar enterprise-software deal are going to require some rigorous analysis no matter how good the messaging.

Decoy pricing

The Economist magazine once offered three subscription packages: an online one for $59; a print one for $125; and a combined print and online subscription also for $125.

The ad caught the eye of a professor, who asked 100 of his students which subscription they would choose. Eighty-four chose the combo and 16 chose the online only. No one chose the print only subscription.

But when the print-only option was eliminated and students were just given a choice between the $59 online subscription and the $125 combined one, 68 chose the cheaper option.

The print-only subscription doesn’t have a lot of value as a package. But it influences the way customers make snap judgments.

These “decoy” packages make other—often more expensive—ones look good by providing a clearly inferior choice. There’s no obvious way to determine whether the online subscription or print-and-online combination is a better value. But compared with the print-only one, the combo is clearly a better deal. The reference point makes people more inclined to pick it.

Similarly, a company may use a decoy to make an expensive product look affordable. A common tactic is enterprise software that costs, say, $500 a month for up to 10 users, $1,000 a month for up to 25 users but just $1,200 for unlimited users.

Tip: People tend to overvalue things they already have, a pattern known as the endowment effect. This is something that enterprise companies should be particularly aware of. It's going to take an extra effort to get a customer to rip out something they already have even if what you're selling is demonstrably better. That's one reason why it's easier to sell to a greenfield customer than to win one away from a competitor.

Developing your pricing hypothesis

The following worksheet can help you assess your product's perceived value and the accuracy of its price.

In field (1) write down the things that people will think about when they first encounter your product. Use the left side for things someone might use in place of your product and the right side for things they'd likely use along with it.

In field (2) write down the intuitive snap judgments someone will make about your product and what they'll conclude after a more rigorous analysis.

Field (3) visualizes your product's perceived value, which should be heavily influenced by substitutes and complements. If your product replaces something that costs $200 it's perceived value likely won't be any higher than that.

Field (4) will help you identify how broad of a market you are targeting.

As you proceed with your pricing strategy, routinely remind yourself that your customers are analytical, but prone to leaps of logic; that they want bargains, but often base them on arbitrary reference points. Above all, they don't want to feel like they're on the hook if they make the wrong choices.

If you can manage these desires while providing a product that customers are eager to pay for, you'll be on your way to building an enduring business.

Pricing Worksheet

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