

Week 1: Pricing Fundamentals



Three Pricing Lenses

Three lenses of pricing

Economics



Three lenses of pricing

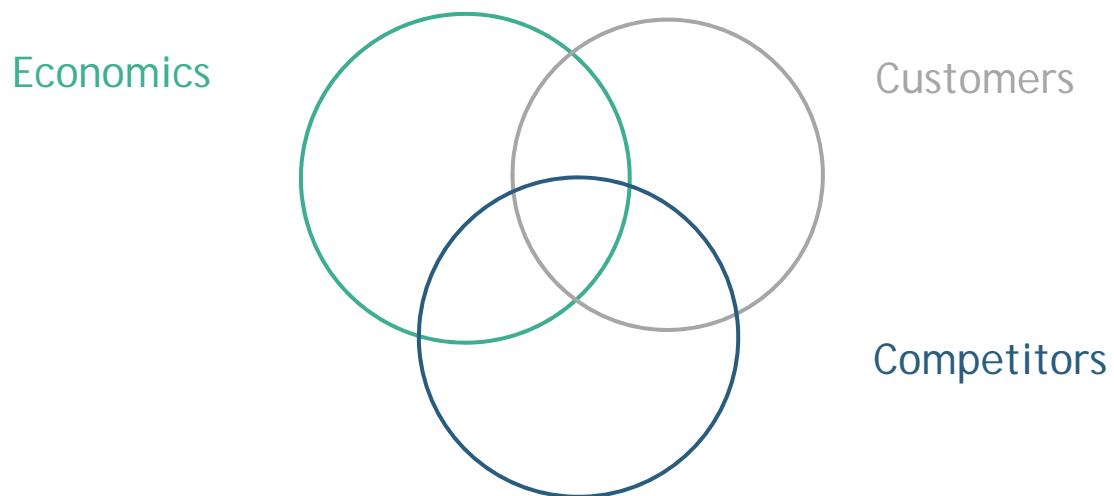
Customers



Three lenses of pricing

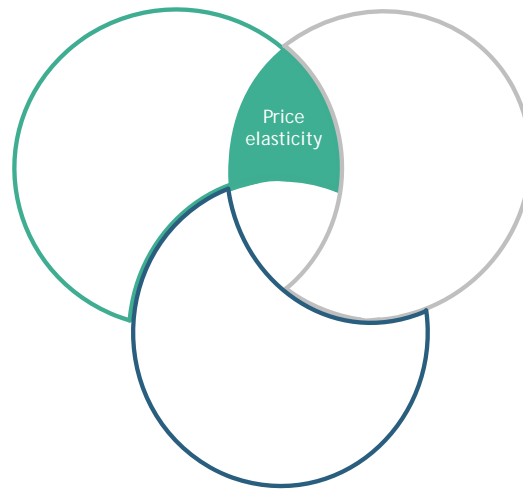


Three lenses of pricing



Three lenses of pricing

Economics

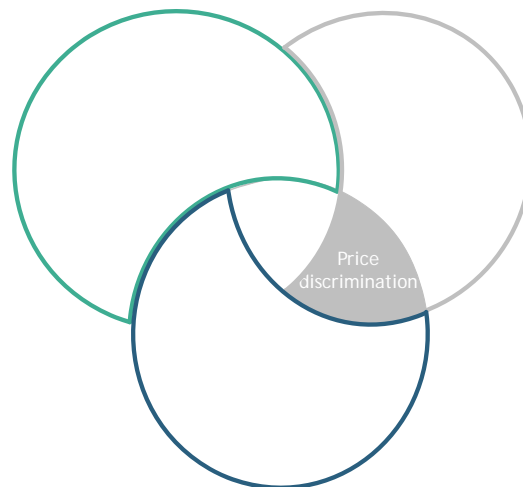


Customers

Competitors

Three lenses of pricing

Economics

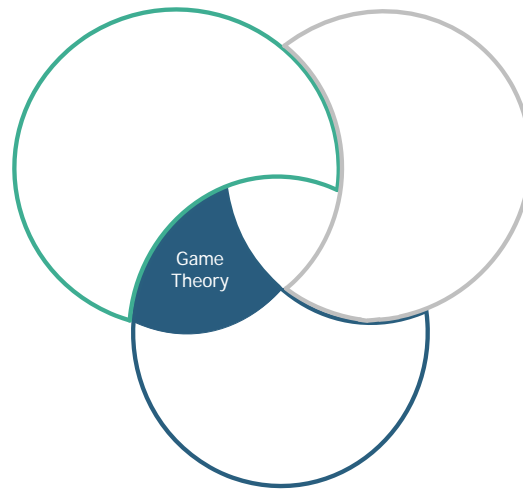


Customers

Competitors

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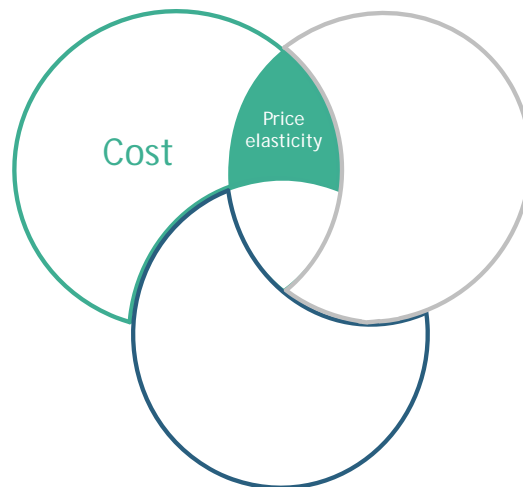


Customers

Competitors

Three lenses of pricing

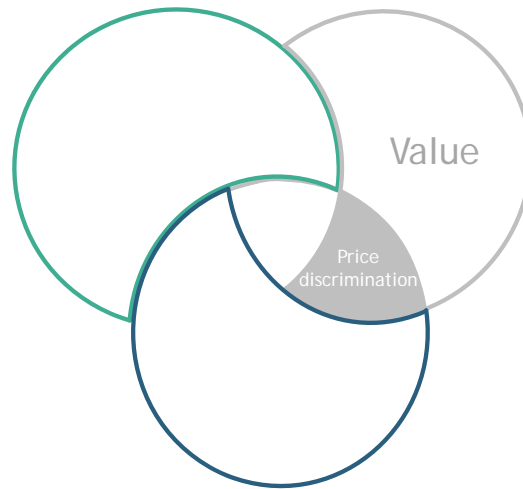
Economics
Course #1



Cost

Price
elasticity

Three lenses of pricing



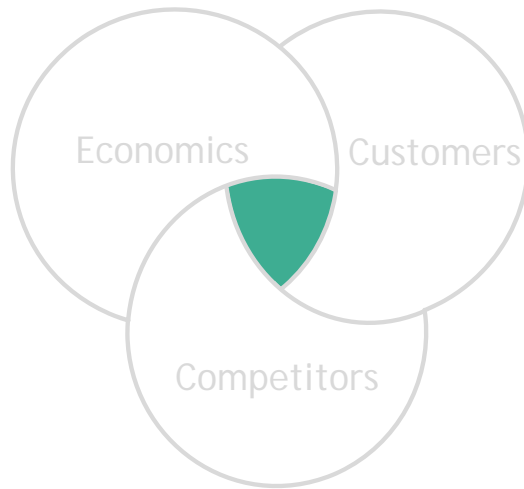
Customers
Course #2

Three lenses of pricing



Competitors
Course #3

Three lenses of pricing



Pricing strategy optimization

Course # 4 explains how these lenses intersect and work together to determine an optimal pricing strategy

Module Introduction

Pricing Fundamentals

- Margins
- Basic economic concepts
- Cost, cost variations, supply curves
- Basic pricing mechanisms
 - Fixed and types of discounting
 - Auctions: English, Dutch, Sealed Bid & B2B

By the end of this module
you'll be able to...

- Calculate mark-ups and margins
- Use basic economic concepts in pricing
- Recognize fixed price and auction type markets and the advantages/disadvantages of each

Calculating Margins and Markups

Margins Occur Across Distribution Channels

Manufacturer → Distributor → Wholesaler → Retailer → Customer



Calculating Margins

$$\text{Margin} = \text{Selling Price} - \text{Cost to Produce}$$

Expressed as a percentage...

$$\begin{array}{r} \text{Selling Price (100\%)} \\ - \text{Cost (\%)} \\ \hline = \text{Margin (\%)} \end{array}$$

Calculating Margins Example

Imagine your selling price is \$100.00 and your cost to produce is \$75.00. What's your margin?

Variations on the Cost/Price Relationship

- $\text{Margin \%} = (\text{Selling Price} - \text{Cost}) / \text{Selling Price}$
- $\text{Selling Price} = \text{Cost} / (1 - \% \text{ Margin})$

Markups vs. Margins

- When expressed in currency, they are exactly the same.
- If percentages or decimals are used, a 20% markup (on cost) is different than a 20% margin (on price).

Calculating Markups

- Markup % = (Selling Price - Cost) / Cost
- Selling Price = Cost * (1 + Markup %)

Calculating Markups vs. Margins Example

Basic Metrics of Pricing: Margins and Markups

Basic Pricing Mechanisms: Auctions

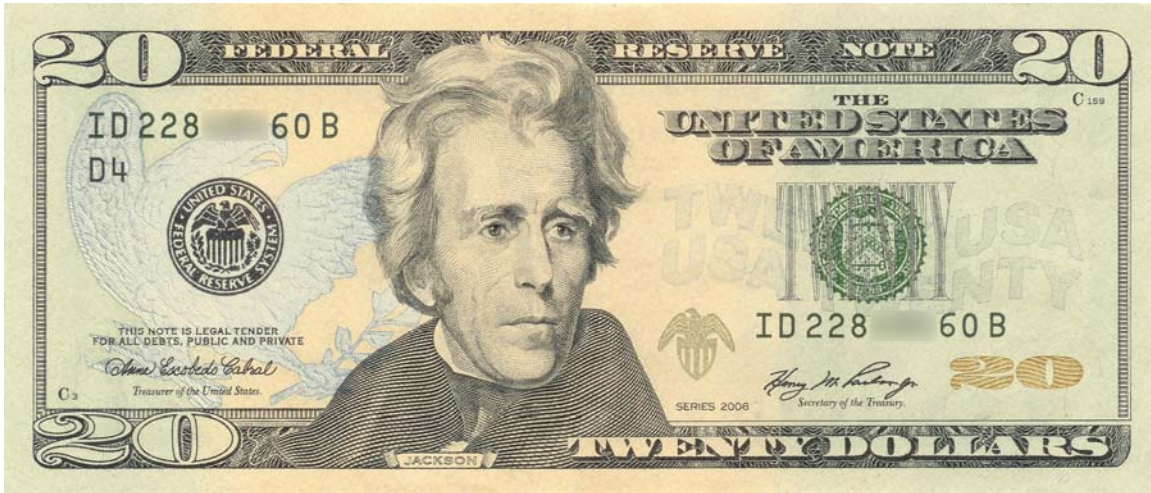
Auctions and Bidding: A Primer

- Explore the origins and key characteristics of the five major auction types
- Look at when and how auctions are used in many different business settings.

Let's Start By Thinking about \$20



One More Time!



English Auctions

English Auctions

- In English auctions (open auctions), bidders publicly announce their successive higher bids until no higher bid is forthcoming
 - Minimum bid: The price at which an auction begins
 - Reserve price: Minimum acceptable price

English Auctions: Advantages

- For sellers
 - Buyers become emotionally caught up in the moment and make really high bids!!
- For buyers
 - If the above does not occur the winning bidder pays less than their private valuation.

English Auctions: Disadvantages

- For sellers
 - Winning bidders tend not to bid their full private valuations
- For buyers
 - The risk of getting caught up emotionally in the excitement of competitive bidding

The Winner's Curse

- The “winner” most likely overvalued the item.
 - No one else would buy at that price.
 - Applicable to prospecting, buying companies, signing free agents, investing in artwork, etc.
- Emotions are extremely important!

Dutch Auctions

Dutch Auctions

- AKA descending-price auctions
- Bidding starts at a high price and drops until a bidder accepts the price
- Often better for the seller if buyers are risk averse to losing
- Fast!

Dutch Auctions: Origins



Dutch Auctions: Today



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Dutch Auctions: They Happen Everywhere



Dutch Auctions

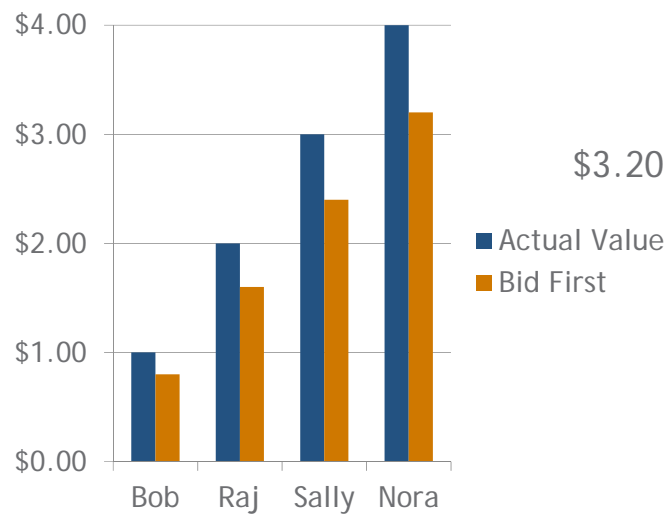
- Predictable over-time price discounts
 - Clothing
 - Cars
 - Consumer electronics

Sealed Bid Auctions

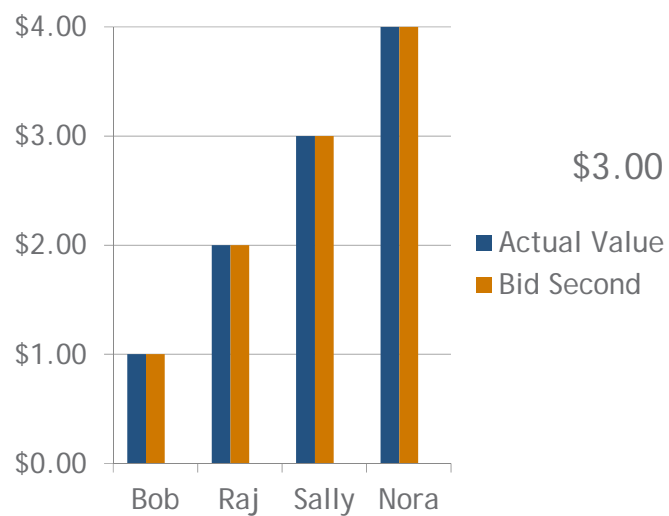
Sealed-bid Auctions

- Bidders submit their bids independently and are not privy to other bid values
- First-price sealed-bid auction
 - Highest bidder wins
- Second-price sealed-bid auction
 - AKA Vickrey auctions
 - Highest bidder wins at the price bid by the second-highest bidder

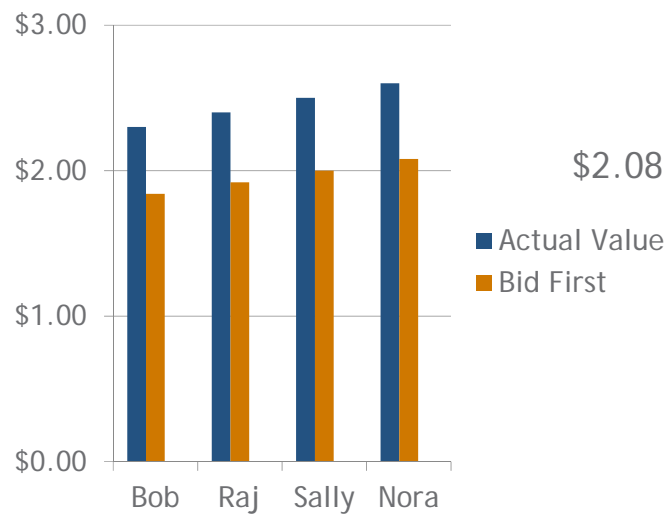
First Price Sealed Bid



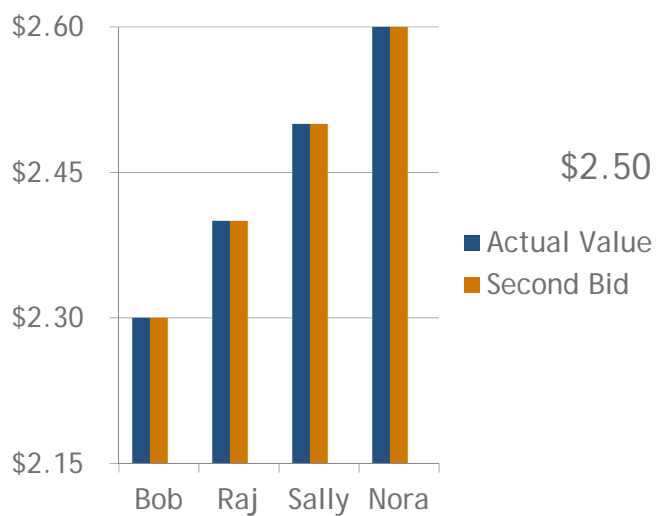
Second Price Sealed Bid



First Price Sealed Bid



Second Price Sealed Bid



First Price Versus Second Price

- First price
 - Works well when there is a lot of variance in private values
- Second price
 - Gets buyers to bid their actual valuation, instead of shading their bid downward
 - Works well when there is less variance

Second Price Auction is Optimal!



Business-to-Business Auctions

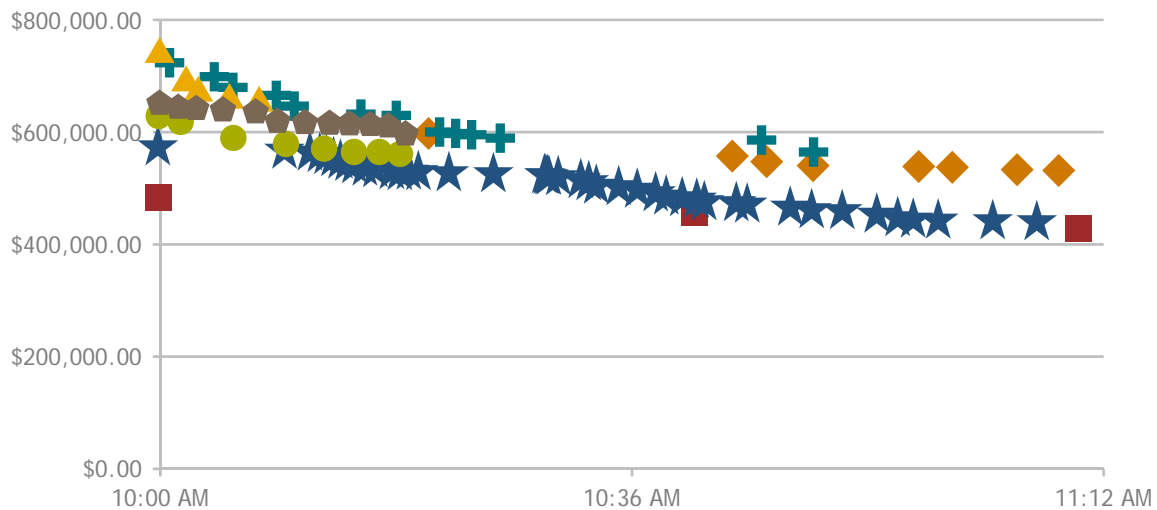
B2B Reverse Auctions

- Used by many businesses and governmental organizations
 - Reduces costs for the supply a particular product (i.e. stamped metal)
 - Requires careful specification of a supply contract and suppliers who are willing to bid for that contract
 - Used for items that are more-or-less commodities—or that have easily specified engineering characteristics

B2B Reverse Auctions



B2B Reverse Auctions



CUSTOMER:	Clinical Center	CUSTOMER:	Food & Drug Administration
COMMODITY:	Paper Towels & Toilet Tissue	COMMODITY:	Copier Paper
DATE:	December 14	DATE:	September 2
GOVERNMENT COST EST:	\$1,980,399.00	GOVERNMENT COST EST:	\$1,297,302.00
COST SAVING% ACHIEVED:	25%	COST SAVING% ACHIEVED:	16.70%
DECREMENT USED:	\$500.00	DECREMENT USED:	\$500.00
ACTUAL COST SAVINGS:	\$495,099.75	ACTUAL COST SAVINGS:	\$216,649.43
ENABLER COST:	\$2,500.00	ENABLER COST:	\$10,000.00
ENABLER:	CIS Global	ENABLER:	CIS Global

Disadvantages of B2B Reverse Auctions

- Focus on price can destroy trust in the supply relationship
- Supplier customer service may be sacrificed to achieve cost savings
- Can drive suppliers margins so low that it threatens future supply

Module Takeaways

Pricing Fundamentals

Key Points

- Margins
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