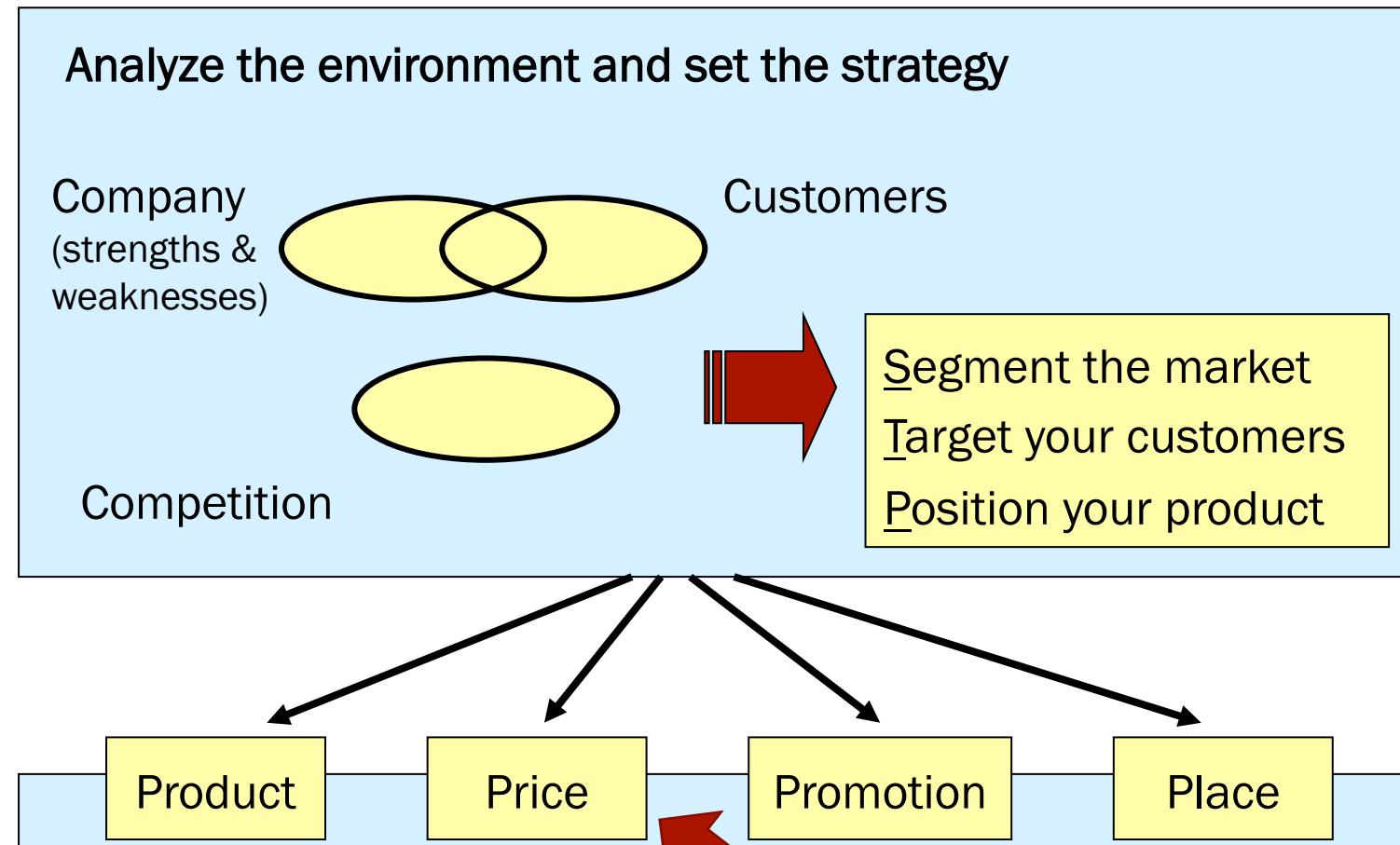


Chapter 13: Building the Price Foundation

Marketing Strategy Overview

– Basic Structure



Leveraging real tools to implement strategic objectives

Preview

- Price
- Value
- Elasticity of demand
- Break-even

Louis XVI – potato champ

Knowing that potatoes could be a key to feeding a nation in recession, Louis XVI took one of the best royal plots of land, planted it with potatoes and put out the most elite guard during the day.

At night, after the guards left, peasants would come steal the potatoes from the land—exactly as Louis XVI wanted.

What is Price?

- Price
 - The money or other considerations exchanged for ownership or use of a good or service
 - Barter – exchanging goods and services for other goods and services rather than for money



Price

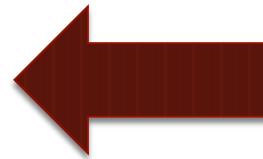
- Many factors increase or decrease price
 - Increases are caused by:
 - Extra fees
 - Extra Charges
 - Penalties
 - Decreases are caused by:
 - Discounts
 - Allowances
 - Rebates



Final Price = list Price – (incentives + allowances) + extra fees

Price Indicates Value

- Value = Perceived Benefits
 Price
- This is the ratio of benefits to price
 - Panera
- Price influences consumers' perception of quality and value to customers



What is the VALUE
of this t-shirt when I
tell you the price is
\$3.00 vs. \$300

Value

- How does this concept relate to the
“Have You Ever Tried to Sell a Diamond?” article?



When you're not sure...

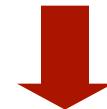


oftentimes, price serves as a proxy for quality

Pricing in Marketing Mix

Profit Equation:

Profit = Total Revenue – Total Cost



Total Revenue = (Unit Price x Quantity Sold)



Unit Price:
\$200

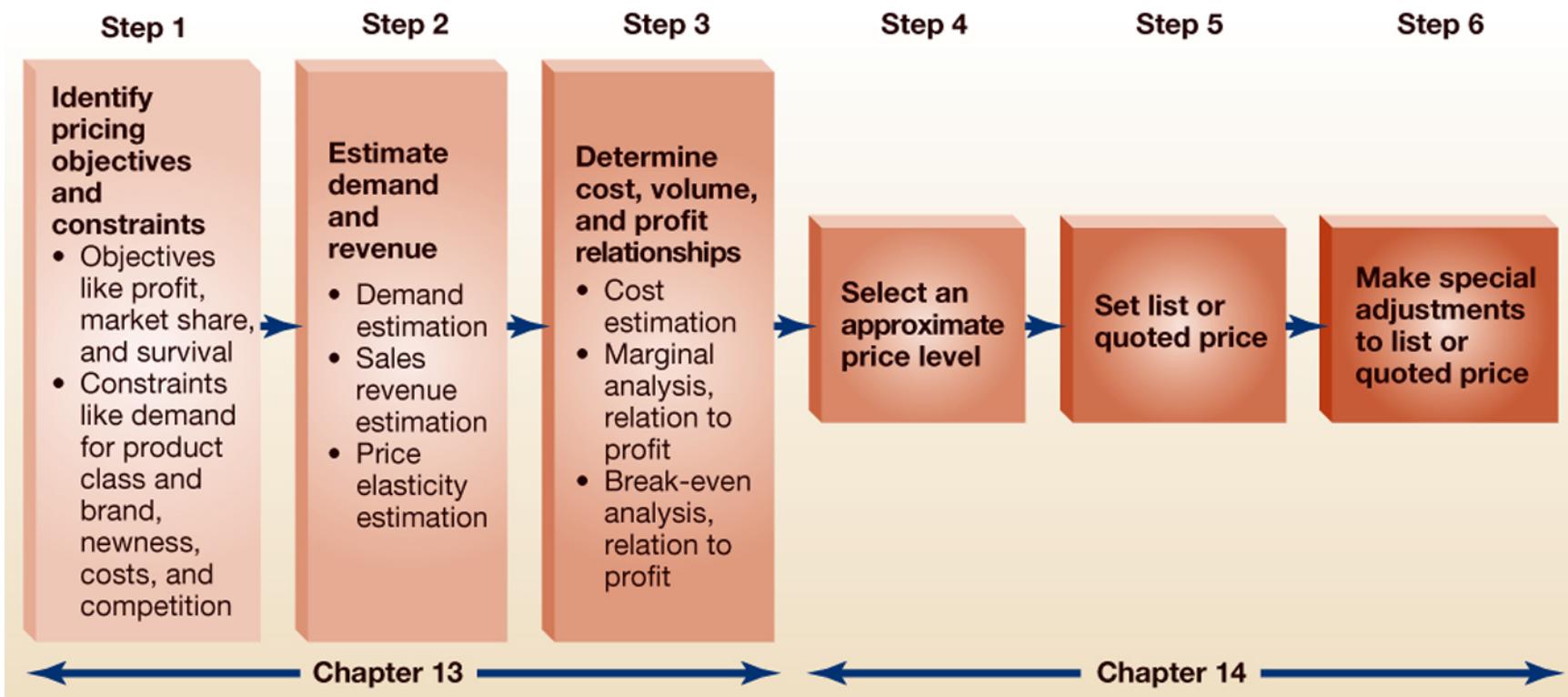
Cost: \$50/ club



TR:
 $\$200 \times 4 = \800

Profit:
 $\$800 - (4 \times \$50) = \$600$

6 Steps of Setting Price



Step 1: Identify Pricing Objectives & Constraints

- Specifying the role of price in orgs. marketing and strategic plans

Honda Civic



Lexus IS 250



How do each of these companies approach the price of their cars?

Profit

- 3 Objectives relate to a firm's **profit** which is measured as (ROI) or (ROA)
 - Return on Investment/Assets
 - 1. Managing for long-run profits
 - Give up immediate profit by developing high-end products to penetrate competitive markets → profits generated via market share

Michael Dell says that his company "is investing for its future" and that short-term losses might be a prerequisite to long-term gains. The buyout can thus been seen as Michael Dell's concession that additional short-term losses could be part of his long-term vision, and that investors focused on quarterly earnings would be an impossible hurdle.



Profit

- 3 Objectives relate to a firm's **profit** which is measured as (ROI) or (ROA)
 - Return on Investment/Assets
 - 2. Maximizing current profit
 - Setting a short term profit (quarter year or less)
 - 3. Target Return
 - Firm sets specific profit goal

Price Objectives

- A business set price to meet objectives like:
 - Generate a certain amount of sales
 - Market Share
 - maintain or increase firms sales as percentage of ttl. market
 - Unit Volume
 - Maintain or increase the number of products sold
 - Survival
 - Mere survival in a competitive market
 - Social Responsibility
 - Setting product price low enough to make product affordable to people that need it

Identifying Pricing Constraints

- Demand for the Product Class, Product and Brand
 - The # of potential buyers
 - More demand, higher price can be charged
 - Newness of Product:
 - Stage in product lifecycle → newer product can charge higher prices
 - Single Product vs. Product Line
 - Must be consistent with other products in the market based on features
- Cost of Producing and Marketing Product
 - Firm must cover cost of producing and marketing product
- Cost of Changing Prices and Time Period they Apply
 - If selling to multiple consumers, time and effort to change product prices
- Type of Competitive Markets
 - If market is highly competitive, harder to change prices
- Competitors' Prices
 - More difficult to change prices if competitors' prices were "standard"



Market Competition

- Pure Competition
 - Selling identical products
- Monopolistic Competition
 - competing producers sell products that are differentiated from one another as good but not perfect substitutes (such as from branding, quality, or location).
- Oligopoly
 - market or industry is dominated by a small number of sellers
- Pure Monopoly
 - a specific person or enterprise is the only supplier of a particular product

How Did Starbucks Deal with Constraints of This Product?



Imagine you want to increase the price of this

- What are your constraints?



Step 2: Estimate Demand and Revenue

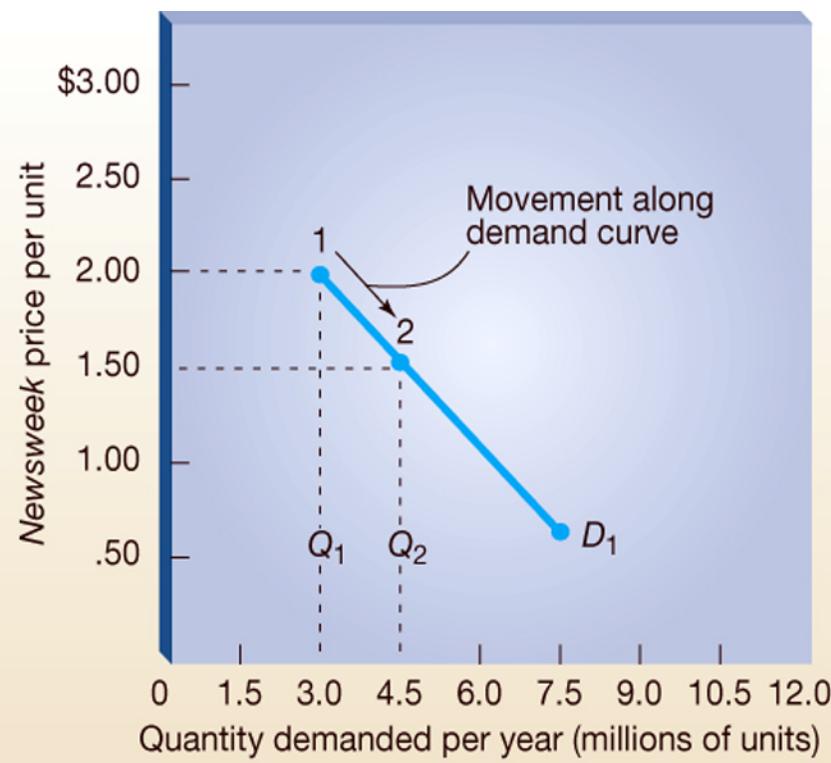
- Translate consumer demand into expected revenue
- Intuition: Lower price, Increase demand.
 - BUT, you have to offset less profit per product with volume

It's not possible to offset losses in profits with volume

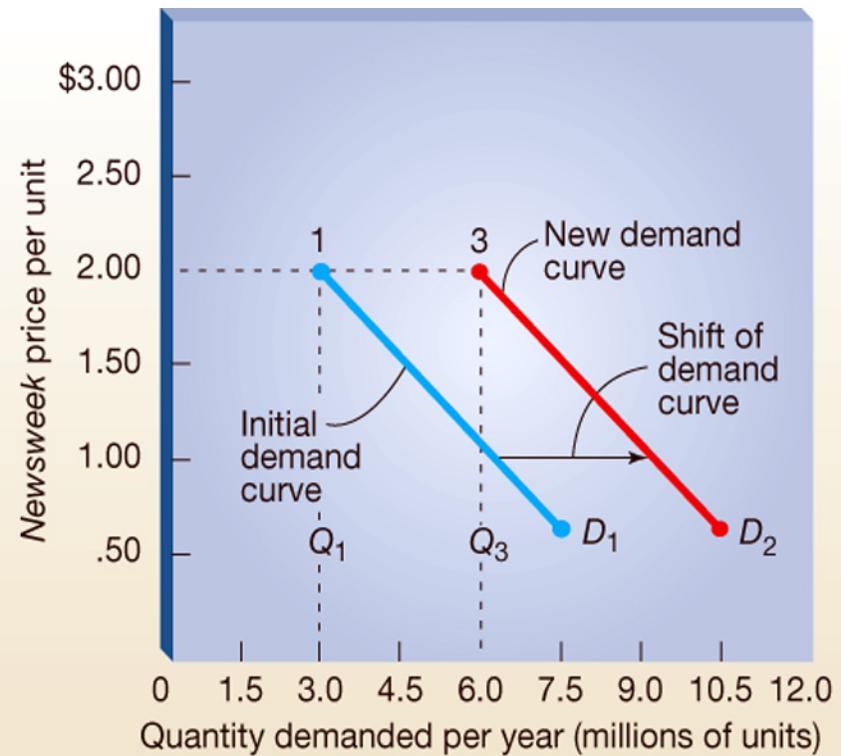


Demand Curve

- Graph relating the quantity sold and price



Demand curve under initial conditions



Shift in the demand curve with more favorable conditions

Fundamental revenue concepts

Total revenue (TR) is the total money received from the sale of product. If

TR = Total revenue

P = Unit price of the product

Q = Quantity of the product sold

Then

$$TR = P \times Q$$

Average revenue (AR) is the average amount of money received for selling one unit of a product, or simply the price of that unit. Average revenue is the total revenue divided by the quantity sold:

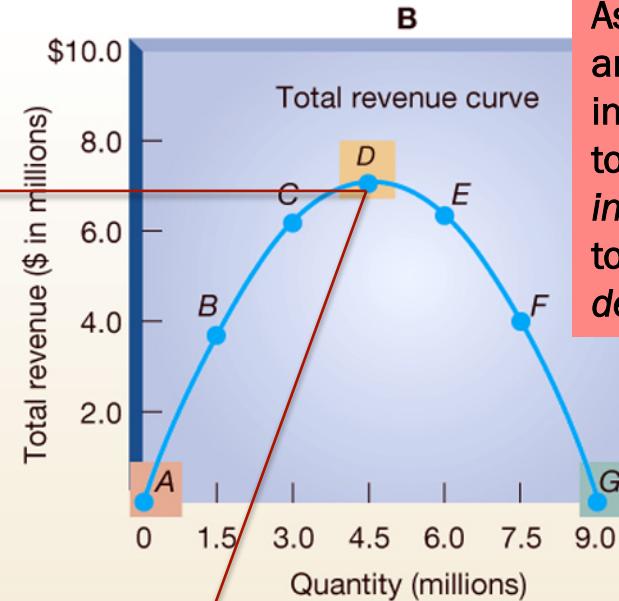
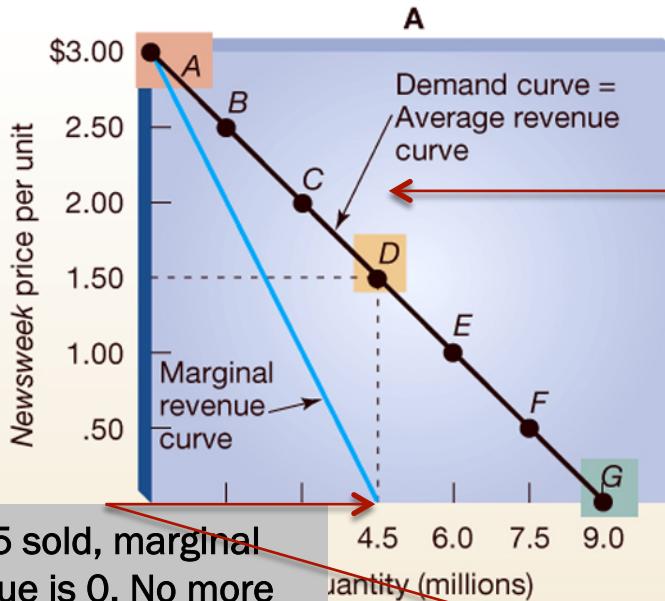
$$AR = \frac{TR}{Q} = P$$

Marginal revenue (MR) is the change in total revenue that results from producing and marketing one additional unit:

$$MR = \frac{\text{Change in TR}}{1 \text{ unit increase in } Q} = \frac{\Delta TR}{\Delta Q} = \text{slope of TR curve}$$

**In other words, MR is the additional revenue that will be generated or lost by increasing product sales by 1 unit.

How a demand curve affects total, average, and marginal revenue



As price decreases and demand increases from A – D, total revenue *increases*; D – G total revenue *decreases*

	QUANTITY SOLD (Q)	TOTAL REVENUE (P x Q)	AVERAGE REVENUE (TR/Q = P)	MARGINAL REVENUE ($\Delta TR/\Delta Q$)
A	\$ 3.00	0	\$ 0	\$ 3.00
B	2.50	1,500,000	3,750,000	2.50
C	2.00	3,000,000	6,000,000	2.00
D	1.50	4,500,000	6,750,000	1.50
E	1.00	6,000,000	6,000,000	-1.00*
F	.50	7,500,000	3,750,000	-2.00*
G	0	9,000,000	0	-3.00*

*Not shown in Figure 13–8A. (Note that the marginal revenue (MR) curve in Figure 13–8A is the slope of the total revenue curve in Figure 13–8B.)

Marginal Analysis and Profit Max

- Marginal Analysis
 - Incremental costs against incremental revenues
- **Big Idea:** as long as revenue received from the sale of an additional product (marginal revenue) is greater than the additional cost of producing and selling it (marginal cost), a firm will expand its output of product

Elasticity of Demand

- How sensitive are consumers to changes in price?

Price Elasticity of Demand = % Δ in Quant. Demanded

% Δ in Price

○ Elastic Demand

- When 1% decrease in price produces *more* than 1% increase in quantity
 - actually *increases* sales revenue

○ Inelastic Demand

- When 1% decrease in price produces *less* than 1% increase in quantity
 - actually *decreases* sales revenue

○ Unitary Demand

- When % change in price is identical to % change in quantity demanded – sales revenue *remains same*

Price Elasticity of Demand

- Determined by Factors:
 - Substitutability
 - More subs → more price elastic
 - Necessity (or not)
 - If it *is* → more price inelastic
 - Price compared to wealth
 - If high priced (vs. wealth) → more elastic

Consumers are also more inelastic after being exposed to advertising!



Step 3: Determine Cost, Volume & Profit Relationships

- Costs or Expenses are the monies the firm pays out to its employees and suppliers

Total cost (TC) is the total expense incurred by a firm in producing and marketing a product. Total cost is the sum of fixed cost and variable cost.

Fixed cost (FC) is the sum of the expenses of the firm that are stable and do not change with the quantity of a product that is produced and sold. Examples of fixed costs are rent on the building, executive salaries, and insurance.

Variable cost (VC) is the sum of the expenses of the firm that vary directly with the quantity of a product that is produced and sold. For example, as the quantity sold doubles, the variable cost doubles. Examples are the direct labor and direct materials used in producing the product and the sales commissions that are tied directly to the quantity sold. As mentioned above:

$$TC = FC + VC$$

Variable cost expressed on a per unit basis is called **unit variable cost (UVC)**, or:

$$UVC = \frac{VC}{Q}$$

Marginal cost (MC) is the change in total cost that results from producing and marketing one additional unit of a product:

$$MC = \frac{\text{Change in TC}}{1 \text{ unit increase in } Q} = \frac{\Delta TC}{\Delta Q} = \text{slope of TC curve}$$

Break even analysis

- Break even point is the point either in volume or dollar terms where total cost = total revenues, i.e. no profits/losses
- Anything below the BEP would lead to losses and anything above the BEP would contribute to profits. Thus, the BEP is the minimum level of sales you must achieve in order to avoid a loss.
- Break even market share indicates how much of the market you need to capture to avoid losses.

Break-Even Analysis

- An technique that analyzes the relations between total revenue and total costs
 - used to determine profitability at different levels of output

Break-even point = Fixed Cost

 Unit Price – Unit Variable Cost

Calculating Break-Even Point

- Let's try one:

$$\text{Break-even point} = \frac{\text{Fixed Cost}}{\text{Unit Price} - \text{Unit Variable Cost}}$$

- Imagine:

You have a company that sells a product that costs \$.30/product to produce. Also, you have fixed costs of \$40,000 annually to cover. You charge \$2.00/product. What is your break-even point?

Activity

Please do the following calculations using the information provided:

- Total Revenue
- Average Revenue
- Total Cost
- Unit Variable Cost
- Profit
- Break-even point (assuming you DON'T know in advance that you will be selling some products on sale)

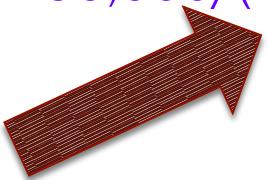
Activity

- You are a marketing manager with the following financial information:

You recently started a business selling widgets. You *made* and sold 230 widgets last year at \$4.50 each. However, you gave a 20% discount on 30 of the widgets. You know that you have fixed costs of \$50,000 and \$345 in variable costs each year .

Activity

Please do the following calculations using the information provided:

- Total Revenue = Price*Quantity = $(200 * \$4.50) + (30 * 3.60) = \1008
- Average Revenue = Tot. Rev/ Quantity = $1008 / 230 = \$4.38$
- Total Cost = Fixed Costs + Variable Costs = $\$50,000 + \$345 = \$50,345$
- Unit Variable Cost = VC/U = $\$345 / 230 = \1.50
- Profit = Total Rev – Total Costs = $\$1,008 - \$50,345 = -\$49,337$
- Break-even point = Fixed Costs/ Unit Price – UVC
 $50,000 / (4.50 - 1.50) = 50,000 / 3 = 16,667$ 

** Use \$4.50 as Unit Price because this is a projection tool
– you don't know how many you will sell on sale.

Review

- What are the six steps in setting price?
- How is the break-even point calculated?
- What is elasticity?