Strategic Management of Pricing

Samuel Engel

Class 1

1

2

3

Chick-Fil-A

$3.49

Popeyes

$3.99

4

4


Popeyes
@Popeyes
Chicken. Brioche. Pickles. New. Sandwich. Popeyes. Nationwide. So. Good. Forgot. How. Speak. In. Complete. Sandwiches. I mean, sentences.
POPEYES
7:32 PM · Aug 12, 2019
28.3K
1.3K
Share this Tweet

5

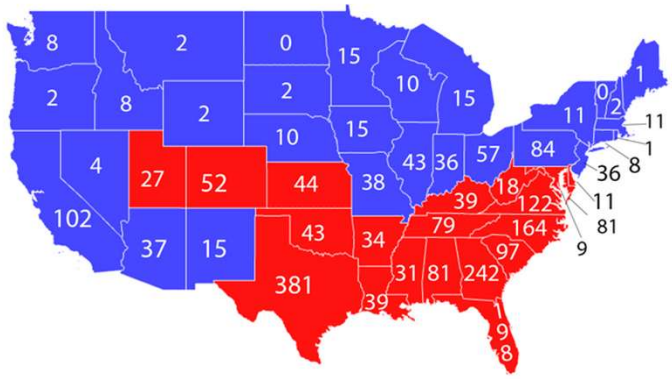
5


Chick-fil-A, Inc.
@ChickfilA
Bun + Chicken + Pickles = all the ❤ for the original.
Bun
Chicken
+ Pickles
Love

6

6

Chic-fil-A Locations (2017)



Red = More than 1 Chick-fil-A per 100,000 people

Source: https://thetab.com/us/2017/10/17/chick-fil-a-north-south-divide-72873

7

Popeyes Locations (2017)

Source: https://chainstoreguide.com/offthechain/2017/03/csg-snapshot-popeyes-louisiana-kitchen-inc/

8

BUSINESS

Burger King revives Chick-fil-A sandwich war with LGBTQ donation

By Ben Cost

June 8, 2021 | 2:21pm | Updated

Burger King … charging ahead in the sandwich wars: The burger monger **flame-broiled queer-rights critic Chick-fil-A in a Pride Month tweet in which they pledged to donate the proceeds from their new chicken sandwich to an LGBTQ charity**. …

The patty purveyor doubled down with a shot at Chick-fil-A, writing that the **deal is good "even on Sundays,"** when the devoutly Christian chicken chain shuts its doors.

https://nypost.com/2021/06/08/burger-king-flambes-chic-fil-a-online-donates-to-lgbtq-foundation/

9

9

Home / Restaurants / Burger King Is Allegedly Pulling These Recently Released Sandwiches Off the Menu

RESTAURANTS

Burger King Is Allegedly Pulling These Recently Released Sandwiches Off the Menu

The highly anticipated items seem to have been a flop.

By Mura Dominko / Published on August 8, 2022 | 9:39 AM

According to *Chew Boom*, Burger King is swapping its beloved Ch'King Sandwiches for a new line of BK Royal Crispy Chicken Sandwiches beginning this month. When reached for comment, Burger King declined to speak on its decision to nix the Ch'King Sandwiches. The new lineup, which was previously part of a limited test run in New York City and Virginia, includes four versions: Classic, Spicy, Bacon & Swiss Cheese, and Southern BBQ.

Carrols Restaurant Group, the 1,000-unit Burger King operator out of Syracuse, N.Y., is paying 13% more for wages and is paying premiums and overtime to meet customer demand.

https://www.thrillist.com/news/nation/burger-king-chking-replaced-new-chicken-sandwiches
https://www.restaurantbusinessonline.com/financing/labor-commodity-costs-hammer-big-burger-king-franchisee-carrols

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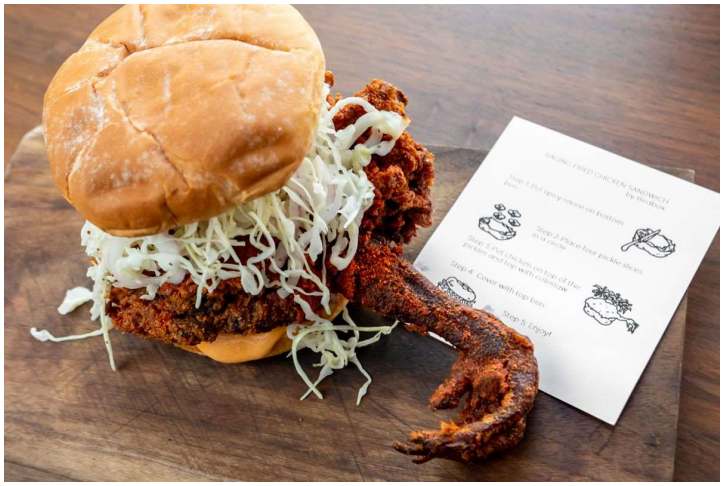
10

Birdsong SF: Claude the Claw — $20

Free-range, organic, sourced locally — of course!



https://sf.eater.com/2022/7/12/23205378/birdsong-fried-chicken-sandwich-claude-claw-birdbox

11

11

Pricing Matters

12

12

Course Objectives

Strategy

Economics

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Management

13

13

Organization of the Course

1. **Costs and Contribution**
   - Costs – *2*
   - Price-volume trade-off (Breakeven Sales Change) – *3*
   - Value estimation (Economic Value Estimation) – *4*

2. **Customers**
   - Price sensitivity, psychology and framing – *6 and 12*
   - Communicating value – *5 and 7*
   - Customer segmentation and price structure – *8 and 12*
   - Designing price structure for customer value – *11 and 12*

3. **Competitors**
   - Assessing competitive moves (Game Theory) – *9*
   - Managing for competitive response – *10*
   - Antitrust law – *13*

14

14

Course Objectives

Tactics

Decision-Making Tools

15

15

Tools You Get

1. **Costs and Financial Analysis**
   - Activity-based costing (ABC)
   - Breakeven sales change tools for price change decisions
   - Economic Value Estimation

2. **Customers**
   - Demand assessment tools
   - Value communication tools – associative and analytic
   - Price desensitization tools and framing strategies
   - Customer segmentation and fencing tools

3. **Competition**
   - Competitive moves analysis
   - Competitive response tools
   - Legal guidelines

16

16

Why We Do The Assignments – MKTG864

Assignment	Skills Applied	
Swing vs. Steady	Breakeven sales change formulas and contribution analysis	10%
Atlantic Computer	Recommend prices and communication strategy based on analysis of Economic Value, Cost-Based and Competitor-Based approaches	20%
Federated Industries	Competitive analysis, managing price war, determine industry pricing roles and behaviors, recommend pricing strategy for market stability and long-term profit	25%
Universal Rental Car	Make pricing decisions that address multiple different customer segments simultaneously and respond to real-time "market" feedback	25%
Class Preparation and Participation	Practice with costing, Economic Value Estimation, price sensitivity and competitive moves analysis; actively engage with the material, learn from one another	20%
		100%

17

17

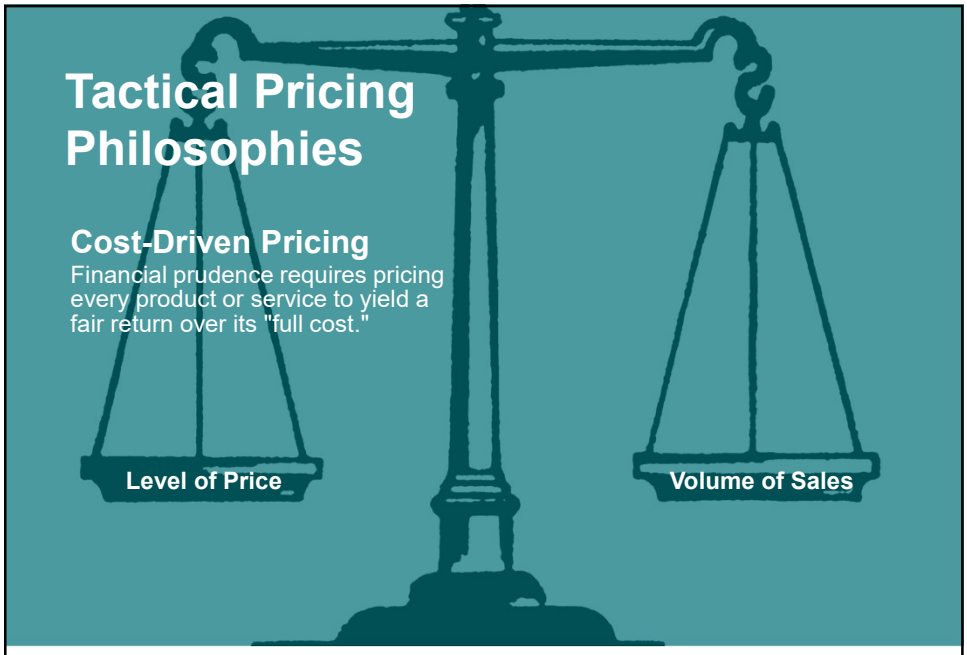
Class Preparation Exercises

Class Preparation Exercises	With one or two study-buddies: • Destin Brass: calculate and compare four different ways to look at costs (for Class 2) • Medi-Cult: calculate the economic value of IVM; assess the price sensitivity of demand for IVM in each country (for Class 5) • Mobile Price War of 2014: prepare a timeline of the competitive moves and reactions (offers, trade-ins, etc.) made by ATT, Sprint and Verizon (for Class 9) • Evernote: assess the effectiveness and wisdom of Evernote's freemium model as a segmentation and fencing strategy (for Class 12)	**Submit one page on Blackboard prior to class**	20%
In Class	• *Thoughtful* participation in class discussion		

As part of preparation for class, you will also submit four short exercises, which you are encouraged to do with one or two study-buddies. The purpose of these submissions is to ensure that you are fully prepared to engage in class for that day. They will be graded as check/check-plus or zero and will form a part of your class participation grade. If you work in teams, you may submit one copy for the team.

18

18



19

Tactical Pricing Example

Plan

Projected Costs and Revenues at Expected Sales = 1,000,000 units

	Total	Per Unit
Direct Variable Costs	$3,000,000	$3.00
Direct Fixed Costs	$3,000,000	$3.00
Administrative Overhead	$1,500,000	$1.50
Full Cost	$7,500,000	$7.50
Revenue	$9,000,000	$9.00
Profit	**$1,500,000**	**$1.50**

20

20

Tactical Pricing Example

Result

Actual Costs and Revenue at Actual Sales = 750,000 units

	Total	Per Unit
Direct Variable Costs	$2,250,000	$
Direct Fixed Costs	$3,000,000	$
Administrative Overhead	$1,500,000	$
Full Cost	$6,750,000	$
Revenue	$6,750,000	$
Profit	$0	

21

21

Tactical Pricing Example

Result

Actual Costs and Revenue at Actual Sales = 750,000 units

	Total	Per Unit
Direct Variable Costs	$2,250,000	$3.00
Direct Fixed Costs	$3,000,000	$4.00
Administrative Overhead	$1,500,000	$2.00
Full Cost	$6,750,000	$9.00
Revenue	$6,750,000	$9.00
Profit	$0	$0

22

22

Tactical Pricing Example

Are higher prices more profitable?

Projected Costs and Revenues with Price Increased to $10.50 Per Unit

	Current	5% Decline in Unit Sales
Price	$9.00	$10.50
Unit Sales	750,000	712,500
Variable Costs	$3.00	$3.00
Fixed Costs	$4.00	$4.21
Admin. Overhead	$2.00	$2.11
Unit Cost	$9.00	$9.32
Unit Profit	$0	+$1.18
Total Profit	$0	$843,750

23

Tactical Pricing Example

Are higher prices more profitable?

Projected Costs and Revenues with Price Increased to $10.50 Per Unit

	Current	5% Decline in Unit Sales	33% Decline in Unit Sales
Price	$9.00	$10.50	$10.50
Unit Sales	750,000	712,500	500,000
Variable Costs	$3.00	$3.00	$3.00
Fixed Costs	$4.00	$4.21	$6.00
Admin. Overhead	$2.00	$2.11	$3.00
Unit Cost	$9.00	$9.32	$12.00
Unit Profit	$0	+$1.18	-$1.50
Total Profit	$0	$843,750	-$750,000

24

Tactical Pricing Example

Are lower prices less profitable?

Financial Implications of a 10% Price Cut

	Current	5% Increase in Unit Sales
Price	$9.00	$8.10
Unit Sales	750,000	787,500
Variable Costs	$3.00	$3.00
Fixed Costs	$4.00	$3.81
Admin. Overhead	$2.00	$1.90
Unit Cost	$9.00	$8.71
Unit Profit	$0	-$0.61
Total Profit	$0	-$480,375

25

25

Tactical Pricing Example

Are lower prices less profitable?

Financial Implications of a 10% Price Cut

	Current	5% Increase in Unit Sales	33% Increase in Unit Sales
Price	$9.00	$8.10	$8.10
Unit Sales	750,000	787,500	1,000,000
Variable Costs	$3.00	$3.00	$3.00
Fixed Costs	$4.00	$3.81	$3.00
Admin. Overhead	$2.00	$1.90	$1.50
Unit Cost	$9.00	$8.71	$7.50
Unit Profit	$0	-$0.61	+$0.60
Total Profit	$0	-$480,375	$600,000

26

26

New World Order: Changing Cost Structure Matters

High Variable Costs, Low Fixed Costs

When variable costs are high, there is much greater profit leverage in a price increase than in a volume increase

High Fixed Costs, Low Variable Costs

When variable costs are low, both volume and price are effective levers.

However, when variable costs are low, sellers are tempted to discount.

27

27

Example of High-Variable Costs

	Base Case			
Unit Price	1.00			
Variable Cost per Unit	0.80			
Fixed Costs	10			
Units	100			
Revenue	100			
Variable Costs	80			
Contribution	20			
Fixed Cost	10			
Profit	10			
% Increase on base				

28

28

Example of High-Variable Costs

	Base Case		10% Unit Increase	
Unit Price	1.00		1.00	
Variable Cost per Unit	0.80		0.80	
Fixed Costs	10		10	
Units	100		110	
Revenue	100		110	
Variable Costs	80		88	
Contribution	20		22	
Fixed Cost	10		10	
Profit	10		12	
% Increase on base			+20%	

29

29

Example of High-Variable Costs

	Base Case		10% Unit Increase	10% Price Increase
Unit Price	1.00		1.00	1.10
Variable Cost per Unit	0.80		0.80	0.80
Fixed Costs	10		10	10
Units	100		110	100
Revenue	100		110	110
Variable Costs	80		88	80
Contribution	90		22	30
Fixed Cost	10		10	10
Profit	10		12	20
% Increase on base			+20%	+100%

30

30

Example of High-Fixed Costs

	Base Case
Unit Price	1.00
Variable Cost per Unit	0.10
Fixed Costs	80
Units	100
Revenue	100
Variable Costs	10
Contribution	90
Fixed Cost	80
Profit	10
% Increase on base	

31

31

Example of High-Fixed Costs

	Base Case	10% Unit Increase
Unit Price	1.00	1.00
Variable Cost per Unit	0.10	0.10
Fixed Costs	80	80
Units	100	110
Revenue	100	110
Variable Costs	10	11
Contribution	90	99
Fixed Cost	80	80
Profit	10	19
% Increase on base		90%

32

32

Example of High-Fixed Costs

	Base Case		10% Unit Increase	10% Price Increase
Unit Price	1.00		1.00	1.10
Variable Cost per Unit	0.10		0.10	0.10
Fixed Costs	80		80	80
Units	100		110	100
Revenue	100		110	110
Variable Costs	10		11	10
Contribution	90		99	100
Fixed Cost	80		80	80
Profit	10		19	20
% Increase on base			90%	100%

33

33

Somerset Corporation

The Solvents Division of the Somerset Corporation is one of many producers of a popular industrial solvent. During this past year they priced this product at $8/bottle. They arrived at this price by applying the directive from the corporate office that the Solvents Division should earn a net profit of at least $80,000 to their projection that 100,000 units would be sold during this past year. Their thinking can be summarized as follows:

Projected unit sales	**100,000**
Revenue*	**$ 800,000**
Variable costs**	**$ 300,000**
Fixed costs	**$ 420,000**
Net profit	**$ 80,000**

*($8/unit * 100,000 units)
**($3/unit * 100,000 units)

34

34

Somerset Corporation (continued)

The president of the Solvents Division is now making the pricing decision for the upcoming year. His current thinking can be summarized by the following quote: "This past year's problem was that we didn't do a good job of predicting sales. Now that we know that sales will be 80,000 units, we can price this product so we can make that $80,000 of net profit that the corporate office wants."

a) Compute the price per unit that is specified by the president's current thinking (you can assume that the past year's fixed costs and variable costs/unit are the same as those for the upcoming year).

b) Do you agree with the president's current thinking? Why, or why not? Is there a better way to go about setting the upcoming year's price?

35

35

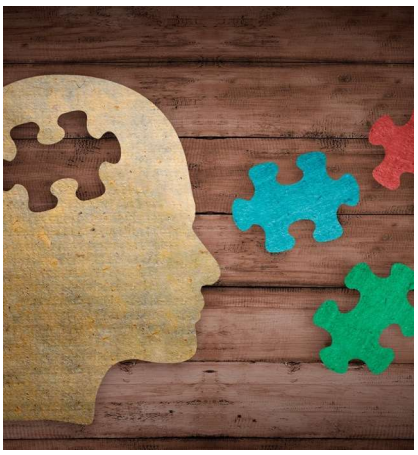
Somerset Corporation

The Solvents Division of the Somerset Corporation is one of many producers of a popular industrial solvent. During this past year they priced this product at $8/bottle. They arrived at this price by applying the directive from the corporate office that the Solvents Division should earn a net profit of at least $80,000 to their projection that 100,000 units would be sold during this past year. Their thinking can be summarized as follows:

Projected unit sales	**100,000**	**80,000**
Revenue*	**$ 800,000**	**$740,000**
Variable costs**	**$ 300,000**	**$240,000**
Fixed costs	**$ 420,000**	**$420,000**
Net profit	**$ 80,000**	**$80,000**

*($8/unit * 100,000 units)
**($3/unit * 100,000 units)

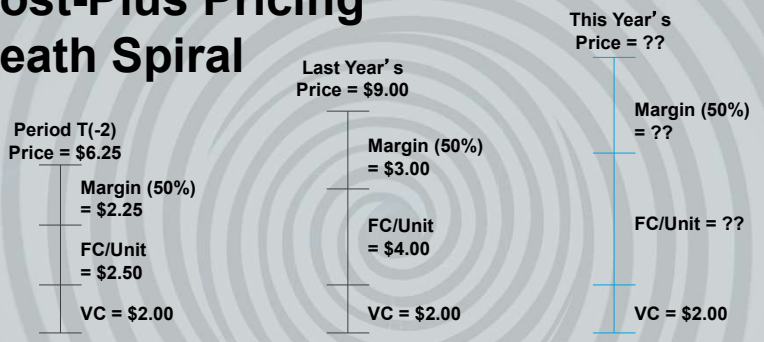
New Price = $9.25
$740,000 ÷ 80,000



36

36

Cost-Plus Pricing Death Spiral



Period T(-2) unit sales volume = 400,000

Last year's unit sales volume = 250,000

This year's unit sales volume = ??

Annual Fixed Costs $1 Million

Adapted from: Gerald Smith

37

37

Lessons From Tactical Pricing Failures

Reality 1

There is no direct relationship between levels of price and profit.

Reality 2

Cost-based target prices tend to become price caps.

Reality 3

Cost-driven pricing can end up penalizing strong selling products and subsidizing weak selling products.

38

38

Wrong vs Right (1)

The cost question in pricing is not:
How should we price to cover all our costs and achieve our profit objectives?

The cost questions in pricing are:

1. How much sales volume would we need to profit from a price cut?
2. How much sales volume could we afford to lose and still profit from a price increase?
3. What is the incremental cost to serve customers? How should we adjust price to reflect incremental cost?

39

39

Tactical Pricing Philosophies

Customer-Driven Pricing
The demands of the market require pricing every product to reflect the customer's "willingness-to-pay."

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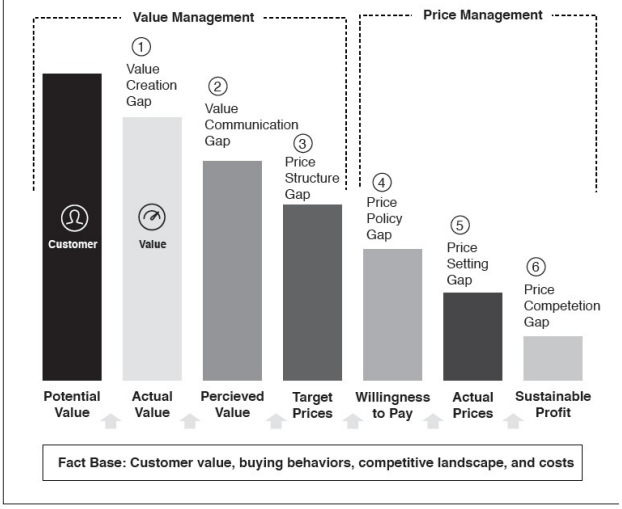
Exhibit 1-2: The Value Cascade: Strategic Pricing Requires Effective Management of Both Value and Price



The Value Cascade

Source: The Strategy and Tactics of Pricing

41

41

The Pricing Pyramid

Copyright © 2006, Strategic Pricing Group, a member of Monitor Group

42

42

Lessons From Tactical Pricing Failures 2

Reality 1
Customer resistance to a price is not by itself a good reason to cut it.

Reality 2
If you must discount to reflect value, do so selectively with segmented pricing.

Reality 3
First understand customer value, then customer WTP.

43

43

Wrong vs. Right (2)

The sales question in pricing is not:
What level of price are buyers *currently* willing-to-pay?

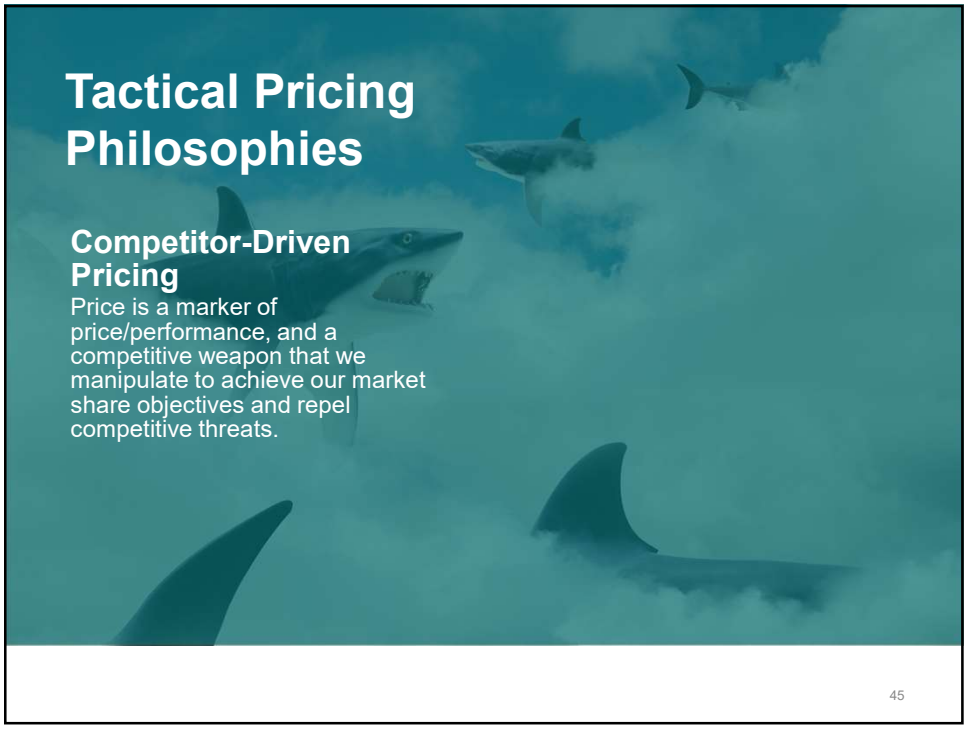
The sales questions in pricing are:
What level of price can we convince buyers is justified by the value of our product (or service) to them?

How can we better segment the market for pricing to reflect differences in value to different types of customers?

How can we better segment the market for pricing to reflect differences in WTP for different types of customers?

44

44



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Lessons From Tactical Pricing Failures 3

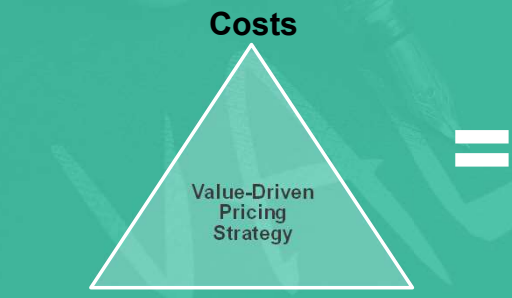
Reality 1
"Winning" a game of price competition is often not worth the fight.

Reality 2
Price is usually not the best competitive weapon, especially for competitors with large market shares.

46

46

Profit Driven Pricing



= 3C's

47

47

Profit-driven Pricing

The goal of pricing is to capture the value of a company's products or services to maximize long-run profitability.

You cannot achieve superior long-run profitability by following short-run, tactical pricing rules.

Long-run profitability requires a pricing strategy

1. That takes into account Costs, Customers, Competition, and Value.
2. That specifies how the company will balance the inherent tradeoffs among them.

48

48

Tesla Discussion Questions

Read the article "Tesla's Price Cuts are Roiling the Market". Then discuss the following questions:

1. **If you are the CEO of GM or Ford, how will you respond? Why? What considerations will inform your decision?**

2. **Was Tesla right to cut prices? Why or why not?**