## Pricing Strategies

There are three ways that businesses usually approach price setting:

* The cost of goods plus a percentage
* What the customer is prepared to pay
* Competitor pricing.

Businesses tend to choose one method but to be effective price setting needs to include all three approaches and be reviewed regularly.

Pricing of products and services needs to take into consideration a whole range of factors including

1. How much does it cost you to provide your product and service?

This includes costs of your product and service delivery as well as your total overheads, sales and marketing expenses.  This can mean a whole range of things like EFTPOS terminal fees, packaging, credit card fees, payment gateway charges, showroom or storage costs. Don't forget to factor in rising costs such as increasing superannuation payments and electricity.

1. How much is the customer prepared to pay?

It’s important to know what customers think they should be paying for your product. Customers may see extraordinary value from something that isn’t expensive to make or deliver.  To set your price to cover costs in this instance may be robbing you of profits. Deciding whether your price will attract bargain hunters or people looking for quality is part of your marketing strategy and is important to consider.

However, don't forget if your product or service is more expensive to provide than customers are prepared to pay, there is a problem.

1. What is the demand and lifecycle of your product?

How long can you sell your products or services at the premium price?  For example leading up to Easter, shops can charge a premium price for Easter eggs but as soon as Easter has finished the demand is low and then the prices drop. For those in the tourism industry there are clear peak times and off peak times which result in different rates.  Does this apply to your industry?

If it’s a new product like new technology customers will often pay top dollar to be one of the first to own the product but as soon as it’s not considered new, the price will need to drop to attract customers. This practice is also known as 'price skimming' where businesses maximise their profits by charging a higher price when demand is high and gradually lower the price over time. This is a particularly important strategy for products perceived as rare or high quality.

1. How much do your competitors charge?

It's important to understand what your competitors are charging and if possible the reasons for their price.

If there is a difference in price it is important to be able to communicate to customers the reason for the difference e.g. quality, cost savings, after sales service, experience etc. Never assume your competition has got their pricing right.

## Forecasting Sale

While building the sales forecast for a subscription business the key input parameters are

1. How much customer base on average is expected by the business? This is of course and forecasted figure, in the start merely based on merchant’s experience. Later the forecasting gets refined with analysis of historical data.

Example: As ABC company I would expect on an average 2000 subscribers per month, at the start of the business. Because currently I am handling 4500 customers for the current (instantaneous) business who have been loyal to me since long and I expect at least 40% would turn as my subscribers in my new business.

1. How much average subscription value per customer is expected by the business? This too is an experience based figure to start with and later gets refined based on analysis of historical data.

Example: All my loyal customers have been providing average 3000 Rs per month business to me. So expect that for new business I will be able to sale 60% of it through subscriptions. So I expect average 2000 Rs per customer subscription business per month.

1. How many Cancellations, I should expect every month? Cancellations is the number of customers who have chosen to cancel your service each month. Though we can start with some projected figure for this, but going forward it should be taken as real cancellation figure per month.

Cancellations will provide you “Churn”. Churn is the rate at which customers are cancelling and leaving the subscriptions. Low churn means happy customers whereas high churn indicates a leakage in the bucket which may not ever fill even if you are adding new customers into it.

**Churn = Cancellations during month/Subscribers at the start of the month.**

## Calculate revenue from subscriptions

## To start calculating how much money a merchant will make, we need to estimate the “**Average Revenue per Subscriber (ARPS)**”.

## Example: As mentioned in the above inputs I am expecting Rs. 2000 per subscriber as ARPS.

## Using churn percentage and ARPS you can calculate **Subscriber Lifetime Value(SLV)** as.

## **SLV= ARPS/Churn Percentage**

## So if your ARPS is 2000 Rs and churn percentage is 5% then using the example figures above: SLV= 2000 / 0.05= 40,000 Rs is the Subscriber Lifetime Value.

And Average Subscriber Lifetime(ASL) would be

**ASL = SLV/ARPS or also =1/Churn %**

Using above figures it will come to

ASL =40,000/2000= 20 months (also with alternate formula 1/0.05=20 months)

## Now we will calculate **Monthly Recurring Revenue (MRR).** Monthly Recurring Revenue is the amount of money a merchant will make every month.

## **MRR=ARPS\*(Subscribers at start of the month + New Subscribers joined in that month)**

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Attribute** | **Month1** | **Month2** | **Month3** | **Month4** | **Month5** | **Month6** | **Month7** | **Month8** | **Month9** | **Month10** | **Month11** | **Month12** |
|  |  |  |  |  |  |  |  |  |  |  |  |  |
| Average Revenue per Subscriber(ARPS) | 2000 | 2000 | 2000 | 2000 | 2000 | 2000 | 2000 | 2000 | 2000 | 2000 | 2000 | 2000 |
| Starting subscribers | 0 | 290 | 580 | 755 | 1040 | 1350 | 1520 | 1645 | 1705 | 1775 | 1795 | 1785 |
| New Subscribers | 300 | 300 | 200 | 300 | 350 | 200 | 150 | 100 | 100 | 50 | 10 | 0 |
| Cancellations | 10 | 10 | 25 | 15 | 40 | 30 | 25 | 40 | 30 | 30 | 20 | 20 |
| Net Additions | 290 | 290 | 175 | 285 | 310 | 170 | 125 | 60 | 70 | 20 | -10 | -20 |
| Ending Subscribers | 290 | 580 | 755 | 1040 | 1350 | 1520 | 1645 | 1705 | 1775 | 1795 | 1785 | 1765 |
|  |  |  |  |  |  |  |  |  |  |  |  |  |
| Churn Rate | #DIV/0! | 0.03448276 | 0.04310345 | 0.01986755 | 0.03846154 | 0.02222222 | 0.01644737 | 0.02431611 | 0.01759531 | 0.01690141 | 0.01114206 | 0.01120448 |
| Average Subscriber Lifetime(ASL) | #DIV/0! | 29 | 23.2 | 50.3333333 | 26 | 45 | 60.8 | 41.125 | 56.8333333 | 59.1666667 | 89.75 | 89.25 |
| Projected Subscriber Lifetime Value(SLV) | #DIV/0! | 58000 | 46400 | 100666.667 | 52000 | 90000 | 121600 | 82250 | 113666.667 | 118333.333 | 179500 | 178500 |
| Total Monthly Recurring Revenue(MRR) | 600000 | 1180000 | 1560000 | 2110000 | 2780000 | 3100000 | 3340000 | 3490000 | 3610000 | 3650000 | 3610000 | 3570000 |

## What Next:

The forecasting exercise give us approximate monthly revenue(amount of total Sale, after purchasing required goods items as well as after bearing all overhead expenses) based on the changing customer base and average customer spend per month.

But amount of profit made is dependent on what products are selected by customers. If a customer adds most high demand items which usually yield less to customer, in the 2000 Rs basket then the profit from that customer will be minimal whereas if someone adds more upcoming/moderate demand items then the merchant profit will increase.

## Bonus Offering Pricing Strategy

Among the range of products being sold under retail, some of them are well established brands, whereas others are relatively less popular and trying to establish themselves. The popular brands usually offer lesser profit margins for the merchants (due to their monopoly) as compared to their less popular competitors. So a merchant/retailer needs to balance the sales targets as well as retail prices for both types of brands, so as to ensure repeatable and consistent profit margins on the reliable brands whereas putting extra efforts on enhancing the sale of less popular brands, thereby making more money on them. For enhancing the sale of medium/low demand brands typical ways to maximize sale is by offering them at discounted prices or provide some schemes (one free on the other etc.) on them etc.

For every product the intended profit target is considered to have been reached if the target sales volume (for the specified period) is sold at the carefully calculated target retail price, all other parameters (purchase price) being constant.

Usually the target exceeds for some products whereas for some it falls short of its targets. For the selected retail price, if the volume of sale exceeds beyond target, the additional profit (in addition to targeted profit) will be considered as the “**bonus**” for that item. Alternatively achieving same/closer sales for an increased retail price (then the intended retail price) can also be considered as “bonus”.

There is more likelihood of guaranteed profits (though limited per unit volume) on established brands. So these products should be considered as vehicles for sustainable business with gradual growth. In order to get considerable bonus from them the volume of sale (sale target per unit period) should be substantially high as these items usually yield lower profit margins per unit for the retailers. So the unique sales proposition for selling established brands is to earn a very high volume of business for them. Alternatively even though merchants affords to offer some discounts on them, lesser discounts can be offered and similar effect can be achieved.

On the contrary less popular/secondary demand products do everything to conquer considerable portion of market and hence yield much higher profit margins for the retailers even for a moderate volume of sale. Their consumption turnover may not be guaranteed and can change across geographies. A clever retailer needs strategies to promote sale of few carefully chosen such products (without compromising his reputation) in order to rip more profits and eventually start gaining bonuses from them. The investment on promotional measures for these products can be provisioned form the “bonus” gained from high demand/monopolistic items.

But all low demand items do not necessarily yield greater profits, as few of them cannot pick up well in the market, despite of adequate promotional measures. How to choose right products which are eligible for increased promotion? And how to decide on how much promotional investment to be made on every item (obviously it will be different for every product based on its proven historical merits)?

First let’s see what can be the strategies to earn more and more bonus. First let’s make an assumption that few products exceeded their target sale at target retail price and hence won some “bonus”.

This strategy considers use of the accumulated “bonus” from various items to aid in determining

* The revised price of the same item (which has yielded some bonus in last period) for new subscriptions, so as to lift more “bonus” on them.
* To make provision against near future challenges such as price hikes due to inflation/shortages etc.
* For determining and sustaining the price of low demand items, who are unable to make their targets.
* For maintaining the corpus to yield additional benefits to subscribers such as offers, loyalty points, basket level discounts, brand loyalty discounts etc.

## Setting targets for a product.

This section discusses on, how to rightly set sales targets of every product so as to ensure at least break even business and earn profits wherever possible.

To successfully run a business without making loss you should always know gross margin, mark-up and breakeven figures.

**Net sales** are the total value of sales for a given period less any discounts given to customers and commissions paid to sales representatives. This is the header where provisioning for discounts should be made.

**Gross margin** is money left after subtracting the cost of the goods sold from the net sales and can be a dollar value (gross profit) or a percentage value.

**Gross Profit (dollar value) = Net Sales - Cost of Goods Sold**

**Gross Margin (percentage value) = (Gross Profit dollars / Net Sales dollars) x 100**

Example: Consider ABC has purchased tyres at $31,200 and sold it at $52,000 then

Gross Profit: $52,000 - $31,200 = $20,800

Gross margin: $20,800/$52,000 x 100 = 40%

Here the gross profit is $20,800. The business overhead expenses must be less than this amount to gain some profit in this sale.

**Net margin** is your profit before you pay any tax (tax is not included because tax rates and tax liabilities vary from business to business). Net margin is your gross margin less your business overhead expenses.

**Net Profit (dollar value) = Gross Profit - Overhead Expenses**

**Net Margin (percentage Value) = (Net Profit dollars / Net Sales dollars) x 100**

So in above example if overhead expenses are $15,600 then

Net Profit (dollar value) = 20,800-15,600= 5,200

Net margin (percentage)= (5,200/52,000)\*100=10%

For every dollar of goods sold you will make 10 cents in profit before tax after all the cost of goods and overhead expenses have been paid.

**Markup** is the amount of money above the cost of purchase or manufacture you sell your goods for.

**Markup percentage value = (Gross profit / Cost of Goods Sold) x 100**

So in above example

Markup percentage = (20,800/31,200)\*100=66.67%

To reach the gross profit of $20,800 by selling motorbike tyres bought for $31.20, Joe will multiply his unit cost price by the markup percentage ($31.20 x 1.6667 = $52 ). Each tyre will have a minimum price of $52 each to earn enough money to cover business expenses.

The break even calculation identifies the number of sales to be made, (in dollars or units), before all the business expenses are covered and profit begins. (before tax).

If you know the unit’s sale price and cost price and the business operating expenses you can calculate the number of units you need to sell before you start making a profit.

Breakeven analysis is helpful information when preparing and updating your business plan and can be used to set sales targets.

The price of goods sold needs to cover the cost of goods plus overhead expenses and allow for profit to be earned.

**Breakeven dollar value needed before net profit = Overhead expenses/ (1 – (Cost of Goods Sold / Total Sales))**

**Breakeven number of units to be sold before net profit = Overhead expenses / (Unit selling price – unit cost to produce)**

As per above example:

Breakeven dollar value = $15,600/(1-($31,200/$52,000)=$39,000

Breakeven number of units to be sold=$15,600/($52.00-$31.20)= 750

ABC will need to sell $39,000 worth of stock or 750 units before the business earns any profit (before tax).

Whenever you alter the sales price (and markup) of your goods and services it is important to understand how this will affect your profit margins and sales targets. To successfully run a sale without making a loss you should know your gross margin, markup and breakeven figures and how the discounted price will affect your profit.

From the table below you can use your gross margin figure (top row) to see how much your sales volume will need to increase (middle cells) when using different discount amounts (in the left hand column).

Example: if your gross margin is 40 per cent and you decide to discount your goods or services by 5 per cent, you will need to increase your sales volume by 14.3 percent in order to make a profit.

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| Checking the effect of discounts on the gross margin | | | | | | | |
| **If you cut your prices by...** | **and your present gross margin (%) is...** | | | | | | |
| **0%** | **15%** | **20%** | **25%** | **30%** | **35%** | **40%** |
| **5%** |  | 50.0% | 33.3% | 25.0% | 20.0% | 16.7% | 14.3% |
| **6%** | 150.0% | 66.7% | 42.9% | 31.6% | 25.0% | 20.7% | 17.6% |
| **8%** | 400.0% | 114.3% | 66.7% | 47.1% | 36.4% | 29.6% | 25.0% |
| **10%** |  | 200.0% | 100.0% | 66.7% | 50.0% | 40.0% | 33.3% |
| **12%** |  | 400.0% | 150.0% | 92.3% | 66.7% | 52.2% | 42.9% |
| **15%** |  |  | 300.0% | 150.0% | 100.0% | 75.0% | 60.0% |

<http://www.business.vic.gov.au/money-profit-and-accounting/pricing/calculate-your-breakeven-point-margin-and-markup>

## Why do products exceed their set target?

1. The product is extremely high demand due to the brand and quality attributes it carries. So obviously more and more subscribers want to buy these products. They will buy it more if they get lucrative discounts or some schemes on their retail price.(???)

1. The purchase price (wholesale price) of an item reduces due to additional discounts by the wholesaler (perhaps due to changed purchase strategies by a merchant), or direct purchase from manufacturer.

Example:

If a merchant has purchased 50,000 units of a product having MRP of 72 Rs and wholesale price of 45 Rs. So he has spent 45\*50,000=22,50,000 Rs. Anticipating the same purchase price he has set a mark-up price of Rs 60(33% higher) for the sale of this product and makes few months/an year commitments with subscribers.

So he has got 50,000 subscribers for this product for one year to whom the committed price is 60 Rs. Per unit.

Yearly sale target for the product is 50,000\*12= 600,000 units.

Assuming that wholesale price remains the same, merchant anticipated purchase cost= 6,00,000\*45=2,70,00,000 Rs.

Committed mark-up price is 60 Rs. So merchant expected revenue for the product= 600,000\*60 =3,60,00,0000

So anticipated profit = 3,60,00,000-2,70,00,000=90,00,000 Rs.( 30%)

After first two months the wholesale price of the item reduces from 45 Rs. to 40 Rs.(due to any of the reasons mentioned above). So purchase price will change as

For first two months (50,000 items per month): 1,00,000\*45=45,00,000 Rs

Next 10 months: 5,00,000\*40=2,00,00,000 Rs

Total wholesale cost = 45,00,000 + 2,00,00,000 = 2,45,00,000 (25,00,000 Rs. less than anticipated purchase price)

But due to customer commitments the mark-up price has to remain at 60 Rs. So expected revenue for the product will remain same=3,60,00,000 Rs

So the actual profit will be = 3,60,00,000-2,45,00,000=1,15,00,000 Rs (approx. 47%)

Thus the “bonus” or gain in profit (difference between actual profit and anticipated profit)=1,15,00,000- 90,00,000 =25,00,000 Rs.

1. The targets set by the merchant for the high demand product are less than its capabilities (under-estimated).

Example:

If a merchant purchased 50,000 units of a product having MRP of 72 Rs. and wholesale price of 45 Rs.. So he spent 45\*50,000= 22,50,000 Rs. towards purchase.

This product is capable of being sold 50,000 units per month and at 50%mark-up price 67.5 Rs. per unit( mark-up price = cost of item\*(1+(desired mark-up/100))=45\*1.5.

So if the merchant intends to sale 50,000 items at 67.5 Rs. Each, he would make 67.5\*50,000=33,75,000 Rs revenue.

So net profit =33,75, 000 – 22,50,000=11,25,000 Rs. which is 50% net profit.

Scenario1: Under-estimation of target sale volume

Merchant expected a mark-up price of 67.5 Rs. (50%) and kept a monthly target sale of 40,000 only (so wholesale price for target sale items would be 40,000\*45=18,00,000).

So if 40,000 units are sold then he would make 67.5\*40,000=27,00,000 Rs. Since wholesale price of 40,000 units is 40,000\*45=18,00,000 Rs, In this case he would make profit of 9,00,000 Rs. which is 50%. This is expected/target profit.

If 50,000 units of that product of sold in that month, merchant made 67.5\*50000=33,75,000 Rs. as against the set target of 67.5\*40,000=27,00,000 Rs. So he got actual profit of 6,75,000 Rs( 33,75,000-27,00,000) as against the expected profit of 6,00,000(24,00,000-18,00,000)

If we compute the original purchase price of 40,000 units of product =40,000\*45=18,00,000 (actually he has bought 50,000 units resulting in the total wholesale price= 50,000\*45= 22,50,000 Rs.)

If we compare the additional profit against the set target then it would be

Actual profit – expected/target profit=(33,75,000-27,00,000) – ( 24,000-18,00,000) = 75,000 Rs.

Scenario 2: Under-estimation of target sale (mark-up) price.

Merchant compromised at expected mark-up price and set it as of 60 Rs. (approx. 33%) and kept a monthly target sale of 40,000 only (so wholesale price for target sale items would be 40,000\*45=18,00,000).

So if 40,000 units are sold then he would make 60\*40,000=24,00,000 Rs. Since wholesale price of 40,000 units is 40,000\*45=18,00,000 Rs, In this case he would make profit of 6,00,000 Rs. which is 30%. This is expected/target profit.

But since he has kept the target price per item considerably less than possible price (60 Rs as against 67.5 Rs and against MRP of 72 Rs.), his sale exceeded much beyond his target volume and he was able to sale 60,000 units in that month. Since he needs additional inventory for this item he would procure it. So the purchase/wholesale price would be 45\*60,000=27,00,000 Rs.

So merchant made 60\* 60,000= 36,00,000 Rs. Thus actual profit is 36,00,000-27,00,000=09,00,000 Rs.(30%).

This example shows how a merchant exceeds targets in some product because he under-estimates

that product in terms of volume of sale or in-terms of mark-up price.

## Why do products fall short of target?

1. Product is relatively newer in the market or having relatively lesser demand than its competitors.
2. The purchase price (wholesale price) of an item increases during the target period.

Example: If a merchant has purchases 50,000 units of a product having MRP of 72 Rs and wholesale price of 45 Rs. So he has spent 45\*50,000=22,50,000 Rs. Anticipating the same purchase price he has set a mark-up price of Rs 60(33% higher) for the sale of this product and makes few months/an year commitment to the customer.

So he has got 50,000 subscribers for this product for one year to whom the committed price is 60 Rs. Per unit.

Yearly sale target for the product is 50,000\*12= 600,000 units.

Assuming that wholesale price remains the same, merchant anticipated purchase cost= 6,00,000\*45=2,70,00,000

Committed mark-up price is 60Rs. So merchant expected revenue for the product=600,000\*60=3,60,00,0000

So anticipated profit = 3,60,00,000-2,70,00,000=90,00,000 Rs.( 33%)

After first two months the wholesale price of the item changes from 45 Rs to 50 Rs.

Purchase price will change as

For first two months (50,000 items per month): 1,00,000\*45=45,00,000 Rs

Next 10 months: 5,00,000\*50=2,50,00,000 Rs

Total wholesale cost = 45,00,000 + 2,50,00,000 = 2,95,00,000 ( 25,00,000 Rs. more than anticipated purchase price)

But due to early commitment the mark-up price has to remain at 60 Rs. So expected revenue for the product will remain same=3,60,00,000 Rs

So the actual profit will be = 3,60,00,000-2,95,00,000=65,00,000 Rs (22%)

1. Demand of a product reduces than the anticipated value resulting into more purchase and lesser consumption (rare but realistic scenario)