Making Money in a Tough Economy

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Pricing is one of the most important, and perhaps one of the trickiest aspects of business design and operation, but it's critical to profitability. Price too low, and you leave money on the table and reduce the legitimate profit you could have had. Low margins mean less money for payroll, less money for top-notch facilities, less money for R&D, less money for marketing, less cushion for a downturn or setback, less money to give away, and less money for the owner(s). Price way too low...and you go out of business. Price too high and you risk customers shopping your competition, you risk losing sales, you risk diminishing customer satisfaction, you risk producing overly demanding customers, and you risk alienating customers forever.

Establishing optimal pricing is not easy in any economic environment, even a relatively stable one. One constant pricing challenge has to do with the ongoing commoditization of products and services in the market. This is partly caused by the ever-increasing ease with which a customer can "shop" a product or service offering using technology in search of the best deal. Other factors in commoditization are technological advances, the availability of competitive intelligence, and international manufacturers and service providers willing and able to produce and sell for low prices.

As tough as it is to price effectively in the face of all the above, things get exponentially more challenging in inflationary, recessionary and stagflationary environments. Therefore, since 2023-24 is likely to continue to be economically turbulent, it's timely to evaluate your pricing strategies, and wherever possible to move to value-based pricing.

Pricing Strategies.

Businesses set prices in a variety of ways. Here are seven examples:

1. Guesswork. I have lost track of how many business plans I've reviewed that present financial projections using pricing based solely on guesswork. Clearly this is problematic.

2. Need. Pricing is sometimes based on the seller's "need." The seller has a financial challenge, and that's how they set an asking price. The predictable customer response to this approach is, "Not my problem."

3. Greed. In this approach, the price is set based on what the seller thinks they can get away with. This used to be a strategy of traveling salesmen. They would hit a small town hard, make as many sales as fast as possible at the highest price possible and move on. Every so often, I still meet a business owner who confesses they're just going to keep raking in off exorbitant prices until customers wise up. Obviously, this is not an appropriate strategy for an ethical business.

4. Response to Supply and Demand. This can work both ways. In times of low demand, businesses sometimes chase the market down by lowering prices. Conversely, in times of high demand, businesses sometimes jack prices up to take advantage of customer's strong need or desire to buy. The Great Recession illustrated this approach on the low side, and the last two years of high demand/low supply have illustrated this approach on the high side. It's a roller coaster ride for all concerned.

5. Market-Based. This is a common approach, especially when selling a product or service that is readily available from many competitors. Competition sets the bar, businesses price accordingly and live with the resulting margin. Market-based pricing is predicated on studying competitors and knowing their pricing. The result of this competitive analysis often shows you how much you can charge. Perhaps the biggest problem with this approach is that the business owner implicitly places their me-too offering directly in the commodity zone, thus eliminating opportunities for differentiation.

6. Cost-Plus Pricing. This is also a very common approach to pricing. A business determines its cost of producing and delivering a product, decides on the profit margin it wants, and prices based on cost, plus the desired margin. This approach has pros and cons. One advantage is that the business can be reasonably assured of making a predictable profit. One negative is that this approach restricts your upside profit opportunity, as the business' offerings remain in a commodity category and are thus subject to negotiations on how much profit margin a customer will accept.

7. Value-Based Pricing. The highest levels of profit, and interesting enough, the path to high levels of customer satisfaction, lie in what's known as value-based pricing. Value-based pricing is driven by the buyer's assessment of their level of delight…in other words, how much value they are receiving in relation to how much they are paying. The seller tries, through surveys, market research and customer inquiry, to make their own assessment about the value a buyer will perceive from the product or service offering and will set prices accordingly. Assessed value can sometimes be objectively determined. In other words, customers gain quantifiable value from the seller's product or service, and everyone can see it. Assessed value can also be subjective. This happens frequently with luxury items, where prestige and enjoyment of a "high-end" product may make the buyer's assessment of value far beyond any cost-plus pricing model. Although the value may be very subjective, it's quite real to the customer and they are willing to pay for it. A more advanced approach to value-based pricing is to deliberately design a product or service from the outset to objectively produce significant and measurable value to customers. This value is then explained and sold to command a high-margin price that, again, the customer is happy to pay.

Pricing for Maximum Margin.

Out of the seven strategies above, the strategy that offers the most opportunity to ethically generate and sustain high profit margins (regardless of economic circumstances) is value-based pricing. Value-based pricing is just one component in the design of competitive business practices that we refine in our 10x Groups. It requires intentionality, creativity, excellent marketing strategy and innovative sales methods, but the outcome is a superior marketplace advantage, and optimized profit margins. Michael Sipe is mergers and acquisitions advisor and local business coach.

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