Pricing Strategy

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Definition

Pricing strategy is the policy a firm adopts to determine what it will charge for its products and services. Strategic approaches fall broadly into the three categories of cost-based pricing, competition-based common factor among pricing strategies is that, in the end, the total revenue generated from the price set multiplied by the units sold has to cover the costs of operation and to allow a sufficient profit margin, which secures an acceptable return on investment. The process of doing this differs according to industry and market conditions, the underlying available competitive advantage, and in some cases regulatory constraints. Pricing strategy is a key variable in financial modeling, which determines the revenues achieved, the profits earned, and the amounts reinvested in the firm's growth for its long-term survival.

Conceptual Overview

There are several options open to the firm in assessing pricing strategies, which are significantly influenced by a number of key factors. Given the customers' demand schedule, the cost function of the business, and the pricing strategy of competitors, a number of pricing strategy options are available, including those mentioned in the following text.

Markup pricing. The most common strategy used involves adding a markup on the product costs. Many companies compute the cost of producing a product and add a specific margin. Retail corporations such as Auchan, Carrefour, and Wal-Mart adopt a markup pricing strategy on the majority of brands retailed through their stores (except in the case of promotional pricing strategies, described in the following text).

Target return on investment pricing. In industries that require a high capital investment, target return on investment pricing is adopted as a safeguard to recuperate the costs of setting up complex infrastructure. The formula used to calculate the price includes a percentage return on investment that varies with different volumes of production in a given period. Firms implementing target-pricing strategies include automobile manufacturers and telecommunications, electricity, and gas service providers.

Perceived value pricing. Many companies base their pricing on perceived value as identified by the buyer. The price is set to maximize the value that the buyer assigns to the product based on its utility. The perception of value is a combination of tangible factors (such as the price of supplementary goods, the usefulness, or utility of the product) and intangible factors (such as product quality, service, or brand attributes). This type of pricing strategy is adopted in scenarios where the perceived value of the product is much higher than its cost. Perceived value pricing is used for a large number of the brands owned by LVMH Moët Hennessy, the French multinational luxury goods conglomerate. Brands under its corporate umbrella include Fendi, Donna Karan, Givenchy, Louis Vuitton, Tag Heuer, and Bulgari.

Competition-based pricing. In this form of pricing, prices are decided relevant to those of competitors. Such a method may well apply to medium-share companies competing against high-share competitors (such as local hotels competing with international hotel chains) or for products with low differentiation (such as gasoline).

Penetration pricing. This form of pricing strategy, also known as promotional pricing, involves temporarily setting prices below the market price or even lower than cost price. This is often used to maximize rapid market entry into new markets, or the market entry of new products into existing markets. The strategy was used effectively in the early days of mobile telephony for telecommunications providers to gain sufficient subscribers to sustain their networks. Dot-com companies are particularly likely to engage in pricing products below cost, or even giving them away for free to build a strong customer base. The customer base is then used to generate income from selling the company or its stocks, or generating revenue from advertising on the user platform. Skype,

Wiley Encyclopedia of Management, edited by Professor Sir Cary L Cooper.

Google, Facebook, and LinkedIn engage in this type of pricing policies for their prime users. (Their pricing strategies with advertisers would follow other approaches, such as value-based pricing where the tangible value of reaching large-scale audience populations is the prime determinant of price.)

Skimming pricing. This type of strategy is used to maximize profits by maintaining the highest price possible of new products that face a high demand from specific market segments. Examples would be the high cost of the latest versions of Samsung, Nokia, and Huawei smart phones, which would appeal to a market that is ready to pay a premium for the most recent technologies.

Factors Impacting Price Strategies

The choice of pricing strategy adopted by the firm will depend on the overall corporate strategy, buyer expectations and behavior, competitor strategies, industry changes, and regulatory boundaries. Other factors affecting the nature of pricing strategies are mentioned in the following text.

Corporate image. The external image of the corporation affects its ability to adopt a specific pricing strategy. For example, a producer of low-cost automobiles would find it extremely difficult to move up to an image of a producer of luxury cars. A mid-market supermarket chain would find it difficult to move up market in price. The corporation also needs to consider the impact of its pricing strategies on others, such as shareholders, consumer pressure groups, regulatory authorities, and government agencies.

Geography. Many companies charge different prices for goods and services in different geographic regions, depending upon local market conditions and regulations.

Discounts. Many corporations offer discounts based on demand for both volume and value. Large users can usually command significant discounts. Discounts may also be offered for early payments and penalties imposed for late payments.

Price discrimination. Many companies differentiate between customers, product or service form, place, and time. Strategic brand architecture creates brands that are differentiated from the competition, thereby reducing the number of substitutes in the marketplace. The price elasticity of demand becomes low, allowing the company to increase prices and improve profitability.

Price discrimination is a common practice where demand varies significantly according to circumstances, as in the case of spectator sports and seasonal travel. The relatively new practice of charging more for games between teams with a high following in the Premier League in England and the Budesliga football clubs has attracted media attention and criticism from sports fans. The practice of price discrimination has been in place in other industries for several years, at a higher level of sophistication. Air, rail, and sea travel pricing varies according to the time of the year and increases when demand is at its highest. Air travel pricing varies not just with the seasons but also with up to the minute demand levels. Pricing software automatically adjusts pricing on business-to-business and business-to-consumer sales platforms according to the remaining seat availability and the fluctuations in the rate of sales of the seats.

Price sensitivity. Buyers are less price sensitive under the following conditions:

- Substitute awareness effects, when buyers are unaware of alternatives.
- Difficult comparison effects, when they are unable to differentiate between product offerings.
- Total expenditure effects, when the purchase use is a low part of discretionary expenditure.
- End-benefit effects, when the cost is a small proportion of the total cost.
- Shared cost effects, when costs are shared with another party.
- Sunk investment effects, when costs are related to a cost that has already been incurred.

Future Directions for Pricing Strategy

Pricing strategy has been affected by changes in the market structure through retail consolidation, changes in manufacturers' selling policies, advances in technology, and the rapid emergence of internet retailing.

Retail consolidation. Through retail consolidation, large-scale retailers have centralized their purchasing function to reduce the cost of handling intermediaries. For large chains such as McDonalds and Nordstrom, it is standard practice to buy through a central office. The power in the supply chain has shifted toward the central buyer and pricing policies set by the manufacturers are established within these constraints. It is common for the buyer to dictate the price brackets of the products that they purchase.

Manufacturers selling costs and trade allowances. As a consequence of retail consolidation, manufacturers are focusing on selling direct to corporate buyers. The cost of selling is reduced when they deal with larger chain stores and fewer independent retailers. Another change from the manufacturing side is the reduction of trade promotions. Manufacturers pay as much as 50% in trade allowances or promotional discounts to stores. The allowances are intended to give the retailer the option of conducting in-store promotions. Over the years, fewer benefits have been passed on to the consumers. The disparities in the manufacturers' objectives and the retailers' practices are likely to decrease trade allowances at source or to lead to regulation.

Price optimization modeling. Through technological advances, more companies are adopting price optimization techniques through statistical modeling and data mining. Sellers that are more sophisticated are moving away from rule-based pricing decisions such as markup or seasonal pricing. The mathematical models used to determine optimum pricing are sensitive to changes in the market and provide decision support for merchandising and revenue management. Optimization techniques forecast the demand for individual products based on past pricing, sales revenue, pricing of competing products, shifts in local geodemographics, levels of inventory, and marketing data.

Internet pricing disparity. So far, online price disparity is as high as offline price disparity. Multichannel retailers (with online and traditional outlets) have higher prices than e-retailers since they have to show consistency in pricing across all their channels. By default, the highest price becomes the default price for all the vendor's channels. Variations in shipping costs add another disparity in the final price paid for a product. The growth in online shopping is leading to a faster availability of price information, resulting in pressure from consumers for retail prices to converge.

Future trends in pricing policies are likely to focus on information-based optimization through cost reduction of inefficiencies in the supply chain, the reduction of trade allowances, an increase in responsiveness to changes in market conditions, greater pricing flexibility, and a reduction of pricing disparity across different retails channels.

See also *complementary products*; *elasticity*; *substitute products*; *value chain*

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