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Selecting an Appropriate Pricing Strategy

Nancy Giddens, Joe Parcell, and Melvin Brees
Department of Agricultural Economics

The focus of this publication is the selection of an appropriate pricing strategy for value-added agricultural products. Selecting a pricing strategy for your product is critical, because price is the most highly visible element of all marketing efforts. Consumers and competitors easily can access pricing information on goods sold at the retail level.

Suitable pricing is important for price-quality signaling. Price-quality signaling occurs when the price of a good indicates the perceived quality of a good. Price-quality signaling is an observable incident that affects consumer purchasing behavior. Whether or not input materials are, in fact, higher quality does not matter necessarily, because the consumer believes the inputs to be of higher quality.

To price products appropriately, you need to know the following:

- ***Costs and profit objectives*** – MU publication G648, *Break-even Pricing, Revenue and Units,* explains the process used to determine break-even prices for products.
- ***Customers (demand)*** – What value and benefits do customers perceive in the product and how willing are they to pay for it?
- ***Competition*** – How many competitors and similar products are in the market and in what price structure?

A complete understanding of production costs, profit objectives, customers, competition, and other market information helps you determine the pricing strategy that best fits your product and company. With this information, you know the minimum price you can charge to break even and the maximum price you can charge based on an estimate of customer demand. Together, costs and demand estimates provide you with the amount of price flexibility available in pricing your product. Competition and profit objectives will then factor in to determine the price you can charge for your product.

To illustrate this process, consider pricing soybean candles. To establish an appropriate retail price for soybean candles, the initial information you need is the break-even asking price, or the minimum price to consider charging customers. MU publication G649, *Break-even Pricing, Revenue and Units,* explains this example in detail and determines a break-even asking price of $3.69. This number represents the minimum price the soybean candle producer should consider charging. To establish a maximum price, the soybean candle producer needs to determine what value customers place on a soybean candle that burns longer and cleaner. Suppose that through surveys or focus groups the producer determines that the most customers would pay is $7.14. Given these upper and lower price constraints, the price flexibility in this scenario is $3.45 ($7.14 - $3.69).

To determine the price to be charged given price flexibility, the producer will need to factor in the effects of competition and profit objectives. This is difficult due to the subjectivity and estimates involved. To ease subjectivity, most companies subscribe to one of five main pricing strategies:

- Premium pricing
- Value pricing
- Cost/plus pricing
- Competitive pricing
- Penetration pricing

To compare these strategies, consider the following scenario. The soybean candle producer and marketer revisits the focus group mentioned earlier. This focus group consisted of nine potential customers who fit the selected demographic profile and who used the product

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for one month. This group reported that the soybean candles burned about 60 percent longer and had 100 percent less smoke than regular petroleum-based candles, the main market competitor. With these attributes in mind, the group reported they were willing to pay 43 percent more on average for a soybean-based candle than for a petroleum-based candle.

With consumer information, you begin to assess your competition and find that petroleum-based candles of the same size sell for an average of $4.99. A 43 percent increase equals $7.14 — the upper constraint of the price flexibility range.

Now, use this scenario to further examine the five pricing strategies.

Premium pricing

Premium pricing is used when the product has one or more unique characteristics. This uniqueness differentiates the product greatly from competition and creates a significant competitive advantage. This strategy demands a high-quality item to merit the high price. Because of the extremely high price, premium pricing generally is a short-term strategy as competitors are attracted to markets with high-margin items. The length of time you can charge customers a premium price depends on the sustainability of the competitive advantage — the greater the sustainability, the longer time premium pricing is a viable option.

A premium pricing strategy yields the highest product prices of the strategies available. It is best to use premium pricing when there are no substitutes for your product, substantial barriers to enter the market exist, and your potential customers are price insensitive because they value the benefits provided by the product. Also, economies of scale are not necessary for this strategy to work. The most important detail to remember is that ***you cannot use premium pricing when facing competition***. Competition would undercut your price, leaving you with an ineffective pricing strategy and poor product sales.

In the soy-based candle scenario, the candle manufacturer could implement a premium pricing strategy effectively because of little or no competition. Research from the focus group combined with the candles' unique market position results in a premium price of $7.14 per candle. Your candles merit the premium price because of longer burning time, reduced smoke, and no competition.

Value pricing

Value pricing is an abbreviated version of the premium pricing strategy. Put simply, value-priced products are priced a bit lower than premium products because they face moderate market competition. A value pricing strategy is used best when only a few competitors exist, barriers to entering the market are relatively high, and potential customers value the benefits provided the product. A business should select a value pricing strategy when its product has a competitive advantage that is *unsustainable* because of the likelihood that competitors will enter the market. Generally, value priced products attract many competitors because the price for products is high in relation to the barriers to entering the market.

Returning to the soy-based candle scenario, the manufacturer may choose a value pricing strategy if competitors can easily enter the market by simply changing a few inputs. The candle would be priced at $5.69 to compete more effectively with new market players.

Cost/plus pricing

Cost/plus pricing is used when a company has a two-tiered focus: costs and return on sales. Companies implement cost/plus pricing when market share and profit are the objectives. To establish a price using a cost/plus strategy, the company needs to determine its break-even price by calculating all costs involved in the production and distribution of the product. MU publication G648 explains the calculation of break-even price.

Once the break-even price is known, the firm establishes a markup for each unit to be sold. The markup must be large enough to provide a sufficient profit, but should not exceed what customers are willing to pay. Suppose that the firm decides on a 12 percent margin for its soybean candles. Since it already knows the break-even price is $3.69, it sets the price at $4.13 ($3.69 x 1.12). The $4.13 price tag better enables the candle manufacturer to focus on costs, to reach its gross sales objectives.

Competitive pricing

Competitive pricing is a basic pricing strategy focused on cost reduction. Costs of production, marketing, and distribution are kept to a minimum. To determine a price using a competitive pricing strategy, a firm can simply identify and record competitors' prices and price its product accordingly – a little more or a little less depending on differentiation. Competitive pricing maintains price status quo in product categories that use this strategy. Consider the cereal industry for example. There are many competitors with many brands to offer cereal consumers. However, cereal manufacturers have reached a delicate balance over time by pricing their products competitively. No manufacturer would benefit greatly by undercutting the prices of its competitors. Undercutting competitors' prices would result in price wars that would lower profits for each company involved.

Obviously, competitive pricing is not appropriate for soybean candles given the added benefits valued by customers.

Penetration pricing

Penetration pricing is used when a company launches a product in a market with several competitors.

Initially, the price for the product is set low to grow product sales and increase market share. Doing this attracts new customers more quickly and easily than other strategies. Once market share is gained, price is increased. This strategy is effective when potential customers are price sensitive and economies of scale can be exploited. Although this strategy might seem to work for small, value-added enterprises, few will have the infrastructure and size to operate at economies of scale.

Like competitive pricing, penetration pricing is not appropriate for soy-based candles. Soy-based candles offer a competitive advantage in longer burning times and less smoke than other candles. Targeted customers value these qualities and are willing to pay for them. This willingness to pay reduces price sensitivity and, consequently, the effectiveness of penetration pricing.

Guide to strategy selection

Knowing and understanding production costs, profit objectives, customers and competition will help you select an appropriate pricing strategy. Pricing is difficult but should reflect the value and benefits your product provides customers.The following table can be used to select appropriate pricing strategies in specific market situations.

Selecting an appropriate pricing strategy depends on market conditions.

Strategy	Substitutes	Entry barriers	Price sensitivity	Economies of scale	Goal
Premium	None	Very high	None	None	High/unit margin
Value	Few	High	Low	Low	Profit
Cost/plus	Some	Medium	Medium	Medium	Market share and profit
Competitive	Many	Low	High	High	Protect market share
Penetration	Many	Low	High	High	Market growth and leadership

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