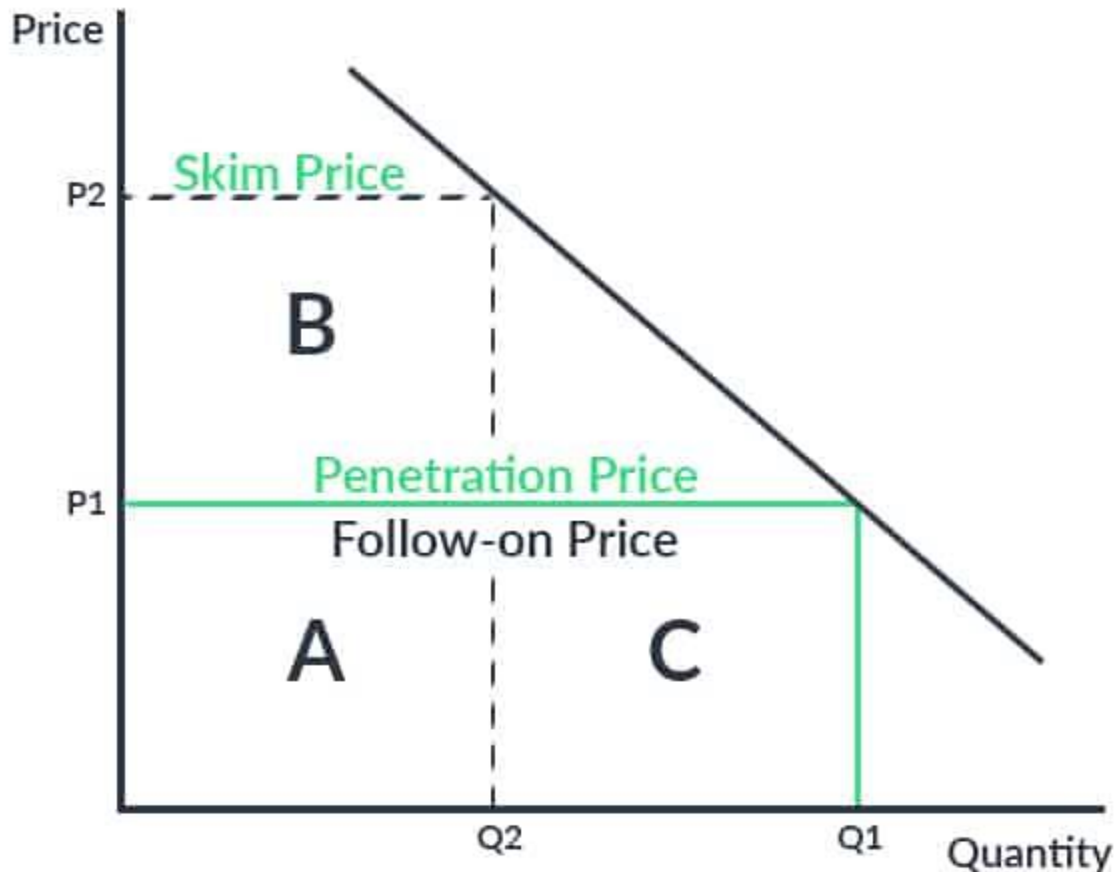
UNIT-III

PRICING STRATEGIES & BREAK-EVEN ANALYSIS

1.PENETRATION PRICING

What is penetration pricing?

Penetration pricing is entering the market of a product with below-average prices. Any size or type of business use this tactic when they're highlighting a new product or service or wish to enter a new market. It's a great strategy to add to your marketing mix to grab a huge portion of the potential customer base early on or to capture customers from your rivals.



Pricing penetration use cases

Walmart, the American retail giant usually penetrates the market with a below-average price. However, unlike others, the company doesn't increase prices over time and holds on to the 'cheapest' positioning in the market.

How come others don’t do the same?

Walmart’s operations are bigger than most of its competitors’. The company has a significant cost advantage. It purchases products at a much lower cost-per-unit and sells them at a below-average price.

Some of you will recall Netflix when it charged $7.99 for the standard plan in 2010. The company gradually raised the monthly charge of the standard package to $12.99 in 2019.

Merits and Demerits of penetration pricing

Pros

- Setting low prices can be a marketing tool raising brand awareness.
- A quick way to gain market share and enter a competitive industry.
- It enables a firm to benefit from economies of scale, which enables lower average costs and a firm to compete.
- Over time, prices can increase and the firm becomes more profitable.

Cons

- It might involve selling at a loss for first few months.
- It is risky – if consumers have brand loyalty then may not switch – despite low prices.
- A firm needs to gear up with high output straight from the start,
- It might start a price war with existing firms cutting prices to discourage entry.
- Consumers with inelastic demand will gain large increase in consumer surplus.

Evaluation – when is penetration pricing beneficial for a firm?

- It suits large multinationals who can afford to run at a loss for a few months and take the risk.
- It is more desirable for markets where the price is an important factor, e.g. where demand is price elastic – food, internet provision. It might be damaging for a market where brand image and perceived quality are more important. For example, selling a new brand of clothing – low price might reflect low quality.

2.SKIMMING PRICE

What is Price Skimming?

Price skimming, also known as skim pricing, is a pricing strategy in which a firm charges a high initial price and then gradually lowers the price to attract more price-sensitive customers. The pricing strategy is usually used by a first mover who faces little to no competition. Price skimming is not a viable long-term pricing strategy, as competitors eventually launch rival products and put pricing pressure on the first company.

Rationale Behind Price Skimming

Price skimming is used to maximize profits when a new product or service is deployed. Therefore, the pricing strategy is largely effective with a breakthrough product, where the firm is the first to enter the marketplace. In such a strategy, the goal is to generate the maximum profit in the shortest time possible, rather than to generate maximum sales. This enables a firm to quickly recover its sunk costs before increased competition and pricing pressure arise.

Consider the diffusion of innovation, a theory that explains the rate at which a product spreads throughout a social system. Innovators are those who want to be the first to get a new product or service. They are risk takers and price insensitive. A price skimming strategy tries to get the highest possible profit from innovators and early adopters. As the demand from these two consumer segments fills up, the price of the product is reduced, to target more price-sensitive customers such as early majorities and late majorities.

Illustration and Example of Price Skimming

Company A is a phone manufacturing company that recently developed a new proprietary technology for its phones. Company A follows a price skimming strategy and sets a skim price at P1 to recover its research and development cost. After satisfying demand at P1, the company sets a follow-on price at P2 to capture price-sensitive customers and to put pricing pressure on competitors that enter the market.

In the price skimming strategy above, Company A generates revenue = A + B with sales of Q1. With their follow-on pricing, the company generates additional revenue = C with sales of Q2-Q1. The company generates total revenue of A + B + C, with total sales of Q2.

Advantages of Price Skimming

- **Perceived quality**: Price skimming helps build a high-quality image and perception of the product.
- **Cost recuperation**: It helps a firm quickly recover its costs of development.
- **High profitability**: It generates a high profit margin for the company.
- **Vertical supply chain benefits**: It helps distributors earn a higher percentage. The markup on a $500 product is far more substantial than on a $5 item.

Disadvantages

- **Deterrence**: If the firm is unable to justify its high price, then consumers may not be willing to purchase the product.
- **Limitation of sales volume**: A firm may not be able to utilize economies of scale if a skim price generates too few sales.
- **Inefficient long-term strategy**: Price skimming is not a viable long-term pricing strategy, as competitors will eventually enter the market with rival products and exert downward pricing pressure.

- **Consumer loyalty**: If a product that costs $1,000 at launch has a follow-on price of $200 in a couple of months, innovators and early adopters may feel ripped off. Therefore, if the firm has a history of price skimming, consumers may wait a couple of months before purchasing the product.

3. ECONOMY PRICING

What is economy pricing?

Economy pricing is a volume-based pricing strategy wherein you price goods low and gain revenue based on the number of customers who purchase your product. It's typically used for commodity goods, like generic-brand groceries or medications, that don't have the marketing and advertising costs of their name-brand counterparts.

How do you execute economy pricing?

At its core, an economy pricing strategy is similar to a cost-plus pricing strategy. You take a product with relatively low production costs and set a price for it that provides you with a small profit.

Production Cost + Profit Margin = Price

With such a low price, economy pricing is very much a volume play. The only way you'll make a profit is if you bring in a large amount of customers on a consistent basis. That makes acquisition incredibly important because you won't be able to rely on existing customers to drive revenue over time.

Common products that use economy pricing

Economy pricing is used a lot in the commodity goods market. It's a great strategy for companies that have low overhead costs and the ability to sell a larger number of products to new customers on a regular basis. Here are a few examples of economy pricing in today's market:

Supermarket store brands

Every grocery store you go into has their own version of popular brands. Companies like Trader Joe's and ALDI are two examples that capitalize on economy pricing to drive their growth.

Generic drugs and medications

Much like supermarket store brands, there are lots of different types of generic over-the-counter medications available through companies like CVS and Rite-Aid.

Big box stores

Companies like Costco and BJ's take the economy pricing model to the next level by selling primarily their own brands. While name brands are still available, the major draw of these types of stores is the quality-to-price ratio of their generic brands.

Budget airlines

Many airlines will provide economy pricing to fill seats in their planes, offering much lower prices for the first seats that are purchased and scaling up the price as availability decreases (which incorporates premium pricing as well).

In the SaaS and subscription markets, economy pricing is less prevalent, but there have been examples of subscription ecommerce businesses that thrive with economy pricing.
One economy pricing example that comes to mind is Dollar Shave Club, which used the strategy to draw customers away from established brand names like Gillette. To do so, it needed to factor in the increased marketing and advertising costs that aren't typical for most economy pricing companies.

Pros and cons of economy pricing

Economy pricing can be a valuable acquisition strategy for SaaS and subscription businesses. But as subscriptions are built on recurring customer relationships, the unit economics of selling at such a low price makes it difficult to build a revenue base over time.

Pros and cons of economy pricing

Pros:

- Easy to implement
- Keeps customer acquisition costs low
- Appeals to price sensitive customers

Cons:

- Relies on small margins
- Requires a steady stream of new customers
- Doesn't connect to product value

Merits of economy pricing

Economy pricing presents some interesting benefits for larger, more established companies. It's easy to implement, keeps costs low, and makes your product or service appealing to buyer personas who are particularly interested in "getting a deal." There tend to be lower customer acquisition costs (CAC) than other pricing strategies, coupled with the fact that you can acquire customers faster.

Being able to enter a market quicker and cheaper can help new entrants find their foothold as well, but the tradeoff is a decrease in pricing power. Economy pricing is more of an acquisition strategy than a pricing one.

Demerits of economy pricing

When you're considering economy pricing, it's important to understand that it only works in very specific market conditions. Companies that have no market share or brand awareness won't be able to keep their operational costs low enough to make this pricing model work. And if you're just starting out, economy pricing can negatively impact the customers' perception of value for your brand.

The model relies on thin profit margins to keep prices low and requires a consistent volume of new customers to maintain revenue. Pricing your product or service so low makes it hard for potential customers to connect the value of the product with its price and makes it difficult to raise prices or capture expansion revenue in the future.

4. PEAK LOAD PRICING

Definition: The **Peak Load Pricing** is the pricing strategy wherein the high price is charged for the goods and services during times when their demand is at peak. In other words, the high price charged during the high demand period is called as the peak load pricing.

This type of price discrimination is based on the efficiency, i.e. a firm discriminates on the basis of **high usage, high-traffic, high demand times and low demand times**. The consumer who purchases the commodity during the high demand period has to pay more as compared to the one who buys during low demand periods.

The peak load pricing is widely used in the case of **non-storable goods** such as electricity, transport, telephone, security services, etc. These are the goods which cannot be stored and hence their production is required to be increased to meet the increased demand. Thus, the **marginal cost** is also high during the peak periods as the capacity to produce these goods is limited. And, hence, the price is set at its highest level with an aim to shift the demand or at least the consumption of goods and services to attain a balance between demand and supply.

For example, during summers, the electricity consumption is highest during the daytime as several offices and educational institutes are operational during the day time, called as a **peak-load time**. While the electricity consumption is lowest during the night as all the office establishments and educational institutes are closed by this time, called as **off-peak time**. Thus, a firm will charge a relatively higher price during the daytime as compared to the price charged at night.

5. VALUE BASED PRICING

What is Value-Based Pricing?

Value-based pricing is a strategy for pricing goods or services that adjusts the price based on its perceived value rather than on its historical price. The value-based pricing strategy is used to increase revenue by increasing prices without a significant effect on volume.

When is Value-Based Pricing Used

Value-based pricing is used when the perceived value of the product is high. The strategy tends to involve products that possess a certain level of prestige in ownership or are completely unique.

Designer apparel companies are well-known for using value-based pricing. While a designer shirt may cost nominally more than a non-designer shirt to produce, the status carried by the designer brand increases the perceived value of the shirt. Many companies capitalize on such perception, increasing their margins greatly, while minimally reducing sales volume.

A similar strategy may also be used when the purchasing decision is emotionally driven. For example, while a famous painting may sell for millions of dollars at an auction, the cost of

creating that painting is meaningless relative to the sale price. The value and price are being derived from the prestige of the artist, as well as other emotional aspects that the buyer may connect with.

Value-based pricing is also often used when scarcity is involved. For example, at a concert, bottled water may be on sale for $6. However, you can buy the same bottle from a vending machine outside of the concert area for $1 only. The difference in pricing is reflected in the scarcity of water at the concert, and the need for concertgoers to drink water.

Cost-Plus Pricing vs. Value-Based Pricing

To better understand value-based pricing, you need to understand how it differs from cost-plus pricing. In cost-plus pricing, the seller simply takes the cost of producing the good or service and adds a premium. In this sense, the main determiner of price in a cost-plus pricing strategy is the cost of producing that item. In value-based pricing strategies, prices are always equal to or higher than in cost-plus pricing strategies.

The above diagram shows that a cost-plus pricing strategy adds a certain markup, making the price of the item dependent on its cost. The value-based pricing strategy is used on items that demonstrate a level of perceived value much greater than the cost.

Issues with Value-Based Pricing

Value-based pricing may not always be the best pricing strategy for a company, and implementing it can come with several obstacles. It can be very difficult to evaluate the perceived value of a product or service. With cost-plus pricing or competition-based pricing, a price can be decided relatively easily by evaluating costs or the competitor's prices. The value-based pricing strategy involves guesswork and is more qualitative in nature.

Execution of Value-Based Pricing Strategy

The way that a product is marketed and perceived by consumers is especially important in a value-based pricing strategy. As the price level is going to be higher than a cost-plus strategy, the perceived value needs to be strong. This can cause implementation costs to be more with value-based pricing, as extensive research must be done to arrive at a pricing decision. Also, differentiating the product from similar competing products may require a substantial investment.

Example

Assume an individual works for a film production company and is tasked with pricing merchandise for an upcoming Spiderman film. The production company owns all rights over Spiderman-branded merchandise, meaning it won't need to compete with other companies on price. Additionally, the new Spiderman stars Tobey Maguire, a fan favorite.

The merchandise would be the perfect candidate for a value-based pricing strategy. First, as other companies can't legally produce the merchandise, you won't need to worry about lowering the price to remain competitive. Additionally, the fact that Tobey Maguire is starring in the film means that the fans are willing to pay more for the same item. Therefore, the perceived value of the product increases.

6.BUNDLING PRICING

What is price bundling?

Price bundling is a marketing strategy where businesses combine complementary products or services into one package deal. This bundled price is usually lower than the sum of the individual prices of the products sold separately.
Although each item in the bundle is technically sold at a reduced price, using a bundling strategy can potentially increase average revenue per user (ARPU) and user engagement. This is because the perceived value of bundled products is greater than individual products.

Common examples of price bundling

Price bundling is used in many industries to entice potential customers to purchase additional products or services that companies know will be valuable. You've likely experienced this in situations like the following:

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    - Mobile devices sold with a data plan
    - Microsoft Office 365 and G Suite
    - Soup, salad, and breadsticks

In each of these examples, the customer is able to purchase everything they need at a single price, whether it's software tools or dinner. The company selling these products provides more value in a single purchase than if each item in the product bundle were purchased separately. Think about it: your phone would be less useful without a data plan, and breadsticks really tie a meal together.We've even seen successful subscription ecommerce retailers like Dollar Shave Club implement this strategy for their own products.

Two types of price bundling

Price bundling falls into two broad categories: pure bundling and mixed bundling. Within pure bundling, there are two subcategories based on how customers get value from different products or features.

Pure bundling

Pure bundling takes place when a customer only has the choice to purchase the bundle as-is or not at all. This type of price bundling is simplest to accomplish, because the creation of a bundle is entirely controlled by you. Joint bundling and leader bundling look at the different features in your bundle and how they work together.

Mixed bundling

Mixed bundling isn’t as strict as pure bundling. When you create a mixed bundle, you’re giving customers the option to purchase each feature together, or individually for a higher price. Microsoft Office 365 offers mixed bundles as well as the ability to purchase stand-alone instances of either Excel or PowerPoint.

Benefits of price bundling

Price bundling helps you overcome the difficulty of getting potential customers to make a purchase of specific products or services. It simplifies their buying experience and can potentially increase average order values through the combination of high-value and low-value products.

Simplify the buying experience

When you offer a bundle of normally separated products or features that, together, your customers need to accomplish their goals, you make the purchase decision easier. Instead of expecting them to cobble together different products or features, you’re offering a one-stop shop for them. That makes the experience of interacting with your business and purchasing your product simple and efficient.

Increase sales

Bundling is a great way to increase your sales and profit margins as well as the value you provide to customers. We see this in companies like Amazon, which often create dynamic product bundles based on complementary products their customers typically purchase. This allows Amazon to create larger margins for themselves while also offering a lower price than their competitors.

BREAK-EVEN ANALYSIS

FOCUS AREAS:

A. ASSUMPTIONS
B. BREAK-EVEN CHART
C. MANAGERIAL USES OF BEP
D. LIMITATIONS

BREAK-EVEN ANALYSIS

ASSUMPTIONS

The main assumptions of break-even analysis are:-

1. All costs are either perfectly variable or absolutely fixed over the entire range of the volume of production.

2. All revenue is perfectly variable with the physical volume of production.

3. The volume of sales and the volume of production are equal. Everything produced is sold and there is no change in the closing inventory.

4. In the case of multi-product firms, the product-mix should be stable. For a multi-product firm, the BEP is determined by dividing total fixed costs by an average ratio of variable profit (contribution) to sales. If each product has the same contribution ratio, the BEP is unaffected by changes in the product-mix. However, if different products have different contribution ratios, a shift in the product-mix may cause a shift in the break-even point.

Break-even point is normally explained in terms of physical units because it is convenient for the single-product firm. The break-even volume is the number of units of product which must be sold to earn enough revenue just to cover fixed and variable cost. The selling price of a unit covers not only its variable cost but also keeps a margin to contribute towards the fixed costs. The break-even point is reached when sufficient number of units have been sold so that the total contribution margin of the units sold is equal to the fixed costs. The formula for calculating the Break-even point is:

$$BEP = \frac{\text{Fixed Costs}}{\text{Contribution margin per unit}} = \frac{FC}{SP - VC}$$

Where BEP = Break-even point, FC = Fixed Cost, SP = Sales price, and

VC = Variable cost per unit.

Example : Suppose the fixed costs of a factory are Rs. 10,000 per year, the variable cost are Rs. 2 per unit and the selling price is Rs. 6 per unit. The break-even point would be:

$$BEP = \frac{Rs.\ 10{,}000}{(6 - 2)} = 2{,}500 \text{ units}$$

In other words, the company would not make any loss or profit at a sales volume of 2,500 units and it is shown below:

Sales		Rs. 15, 000
Cost of goods sold:		
Variable Cost @ Rs. 2.00	Rs. 5,000	
Fixed Costs	Rs. 10,000	Rs. 15,000
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Net profit	--	Nil
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BREAK-EVEN CHART

A break-even chart is given in Fig. A. Units of product are shown on horizontal axis OX and revenues and costs are shown on the vertical axis OY. The fixed costs is represented by

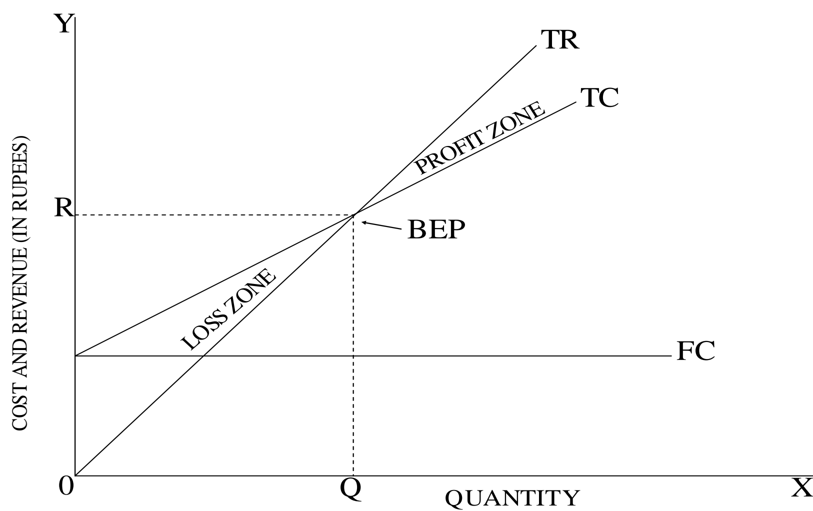

Fig A. Break – Even diagram

a straight line parallel to the horizontal axis. Variable costs are then plotted over and above the fixed costs. The resultant line is the total, cost line, combining both variable cost line in a graph; variable costs are represented by the vertical distance between the fixed cost and the total cost lines. The break-even point corresponds to the point of intersection of the total revenue and the total cost lines. Projecting a perpendicular from the BEP to the horizontal axis shows the break-even point in units of the product. Dropping a perpendicular from BEP to the vertical axis shows the break-even sales value in rupees. Below the BEP, total costs are more than total revenue and the firm would suffer a loss. Above the BEP, total revenue exceeds total costs and the firm would be making profits. Since profit or loss occurs between cost and revenue lines, the space between them is known as the profit zone and the loss zone respectively.

MANAGERIAL USES OF BREAK-EVEN ANALYSIS.

The main managerial uses of break-even analysis are:-

(i) It presents a microscopic picture of the profit structure of a business enterprise.

(ii) It sharpens the focus on certain leverages which can be operated upon to enhance its profitability.

(iii) It is possible for the management to examine the profit vulnerability of a

business firm to the possible changes in business

(iv) The analysis is immensely useful for sales prospects, changes in cost structure, etc.

(v) It is possible to devise managerial actions to maintain and enhance profitability of the firm.

The break-even analysis can be used for the following purposes:

(a) **Safety Margin**: The break-even chart can help the management to know at a glance the profits generated at the various levels of sales. The safety margin refers to the extent to which the firm can afford a decline in sales before it starts incurring losses. The formula for calculation of safety margin is:

$$\text{Safety Margin} = \frac{(\text{Sales} - \text{BEP}) * 100}{\text{Sales}}$$

Examples : Assume that our sales are 8,000 units and Break-even point is 6,000 units.

$$\text{Safety Margin} = \frac{(8{,}000 - 6{,}000) * 100}{8{,}000} = 25$$

This means that, we can afford to lose sales up to 25 per cent of the present level before incurring a loss. If the safety margin is dropping over a period of time, it would mean that the firm's resistance capacity to avoid losses has become poorer. A margin of safety can be negative as well. In that case, it reveals the percentage increase in sales necessary to reach the Break-even point so as to least to avoid losses. Thus, it reveals the minimum extent of sales effort expected of the management. Suppose in our example, sales are as low as 5,000 units. The safety margin would be:

$$\text{Safety Margin} = \frac{(5{,}000 - 6{,}000) * 100}{5{,}000} = -20\%$$

In other words, the management must strive to increase sales at least by 20 per cent to avoid losses.

(b) **Volume Needed to Attain Target Profit**. Break-even analysis may be utilized for the purpose of determining the volume of sales necessary to achieve a target profit. The formula is:

$$\text{Target sales volume} = \frac{\text{Fixed costs + Target profit}}{\text{Contribution margin per unit}}$$

Example :Let desired profit is Rs. 6,000, fixed cost is Rs. 6,000 and contribution margin is Rs. 5 per unit then the target sales volume would be calculated as follows:

$$\frac{6{,}000 + 6{,}000}{5} = 2{,}400 \text{ units}$$

(c) **Change in Price**. The management is often faced with a problem whether to reduce prices or not? Before taking a decision on this question the management will have to consider a number of points. A reduction in price leads to a reduction in the contribution margin. This means that the volume of sales will have to be increased even to maintain the previous level of profit. The higher the reduction in the contribution margin, the higher is the increase in sales needed to ensure the previous profit.

LIMITATIONS

The main limitations of break-even analysis are:-

(i) A basic assumption in break-even analysis is that the cost-revenue-volume relationship is linear and it is highly restricted.
(ii) Break-even analysis is not an effective tool for long-range use and its use should be restricted to the short run only. The break-even analysis is limited to the budget period of the firm normally it will be a year.

(iii) Break-even analysis assumes that profits are a function of output ignoring the patent fact that they are also caused by other factors such as technological change, improved management, changes in the scale of the fixed factors of production, and so on.

(iv) A straight-line total revenue curve presumes that any quantity might be sold at one price. This implies a horizontal demand curve and can be true only under conditions of perfect competition. This situation is very rare in the present world.

(v) Selling costs are difficult to handle in break-even analysis. This is due to the fact that changes in selling costs are a cause and not a result of changes in output and sales.

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