

Marketing Strategy

Pricing

Session 3

Fall 2009

1. Pricing - Introduction

- Managers' biggest marketing headache
- What is the objective? What is the right price?
- Pricing is the firm's attempt to capture the value created by the product. Value pricing.
- But costs...

2. Pricing Problem

You have just transferred from another division and been appointed manager of a division that sells replacement parts for air conditioners to wholesalers. The division has been losing money during the last 2 years, and your mandate is to turn the situation around quickly.

You decide to examine all aspects of the division's performance. You appoint five members to a pricing committee and ask them to recommend a procedure for reviewing the pricing decisions for major parts sold by the division.

Consider part 1006. The price history of part 1006 is that the price was \$20 per unit until April 1, 2007, when it increased by 50% to \$30.

Demand

Month	2006	2007	2008	2009
January	12	14	12	7
February	13	13	15	8
March	18	20	16	11
April	25	23	18	14
May	29	27	20	19
June	32	30	23	24
July	42	33	26	26
August	48	31	29	
September	38	28	24	
October	38	25	18	
November	20	14	12	
December	10	9	5	

Costs

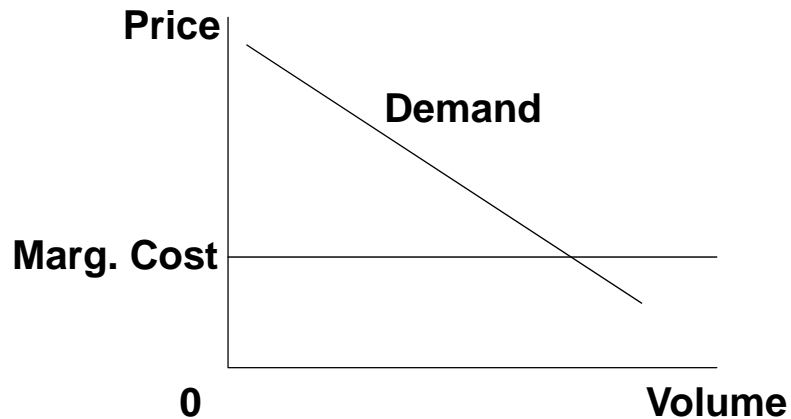
- The equipment necessary to produce this part costs about \$20,000 (depreciated in 10 years), and the marginal cost of production of the part is about \$10 per unit.
- How would you go about choosing the best price for each of the parts? How do you apply this methodology to part 1006?

Issues

- Demand sensitivity
- Costs
- Complements or substitutes
- Dynamics: loyalty, experience curves
- Information
- Psychological issues
- Competition

Basic Trade-off

Margin per Unit <-> Total demand



3. Main Result

$$\text{Contribution Margin} = \frac{1}{\text{Price Elasticity}}$$

where: -Contribution margin = $\frac{\text{Price} - \text{Marg. Cost}}{\text{Price}}$

-Price Elasticity = Percentage change in demand induced by 1% change in Price

- Notes: • fixed costs do not matter?
- • price-elasticity 1

Factors Affecting Price Sensitivity

Customer economics

- Will the decision-maker pay for the product him or herself?
- Does the cost of this item represent a substantial percentage of the total expenditure?
- Is the buyer the end-user? If not, will the buyer be competing on price in the end-user market?
- In this market, does a higher price signal higher quality?

Customer Search and Usage

- Is it costly for the buyer to shop around?
- Is the time of the purchase or the delivery significant to the buyer?
- Is the buyer able to compare the price and performance of alternatives?
- Is the buyer free to switch suppliers without incurring substantive costs?

4. Multiple Products (Company selling multiple products)

1. Related Demands, Independent Costs

2. Independent Demands, Related Costs

Related Demands, Independent Costs

Complements: raising the price of one brand decreases demand for the other

Examples: • TVs and VCRs

Price of TVs => Demand for VCRs

Result:

Contr. Marg.	$\frac{1}{\text{Price Elasticity}}$
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Related Demands, Independent Costs Investment in Goodwill, W-O-M

Cuts in price in the present increase demand in the future.

Examples: • launching new products

- new restaurants
- new car models

Price Penetration:

Contr. Marg.	$\frac{1}{\text{Price Elasticity}}$
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Related Demands, Independent Costs

Substitutes: raising the price of one brand increases demand for the other

Examples: • ice-cream & frozen-yogurt
• chicken or lamb plate
(at a restaurant)

Price of ice-cream => Demand for Frozen-Yogurt

Result:

$$\text{Contr. Marg.} = \frac{1}{\text{Price Elasticity}}$$

Selling a Durable Product

Who buys first?

Example:

- Two periods
- Three types of consumers. Valuation per period
 $v_1=1, v_2=2, v_3=3$.

Price skimming

Strategic behavior by consumers

Multiple Products **(Company selling multiple products)**

1. Related Demands, Independent Costs
- 2. Independent Demands, Related Costs**

Independent Demands, Related Costs **Experience Curves**

Average cost decreases with cumulative production

Examples: airplanes, semiconductors, computers

Result 1: Contr. Marg. $\frac{1}{\text{Price Elasticity}}$

Result 2: Adjust Marginal Cost to the average of marginal costs throughout the future

Result 3: Prices go down through time

5. Conclusion

Pricing as capturing value being created – value pricing

Price sensitivity

Golden rule of pricing

Multiple products

- complements

- substitutes

- penetration pricing

- price skimming – durables

- experience curves

Price discrimination – segmentation?

Competition?