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Selecting an Appropriate Pricing Strategy

Consumers and competitors easily can access pricing information for goods sold at retail and use this information for various purposes. One example is that a product's price can signal its perceived quality. Consumers may view a high-priced product as high quality and a low-priced product as low quality.

This "price-quality signaling" ultimately can affect consumer purchasing behavior. For example, whether a high-priced product is made from high-quality materials does not matter necessarily because its high price signals to consumers that the product's inputs have good quality. The perceived high quality may then motivate consumers to buy the product.

Because price is so highly visible and it shapes consumer perceptions and behaviors, the pricing strategy you choose for your value-added agricultural product is critical. To price products appropriately, you need to know the following:

- **Costs and profit objectives**
  MU Extension publication G648, [Break-even Pricing, Revenue and Units](https://extension.missouri.edu/publications/g648) (https://extension.missouri.edu/publications/g648) explains the process used to determine a product's break-even price.
- **Customers (demand)**
  What value and benefits do customers perceive in the product, and how willing are they to pay for the product's benefits?
- **Competition**
  How many competitors and similar products are in the market, and what price structures do they follow?

Completely understanding 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 customer demand. Together, costs and demand estimates indicate the flexibility you have when pricing your product. You can ultimately set a price after considering the prices your competitors charge and the profit objectives you set for your business.

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The pricing process

To illustrate how to set an appropriate retail price, consider the following three steps and how they're applied to soy candles as an example (Figure 1).

Figure 1. Pricing soy candles — like all value-added agricultural products — involves knowing the product's break-even price and assessing consumers' maximum willingness to pay. To set a price, find a point between the break-even price and maximum consumer willingness to pay that takes competition and profit objectives into account.

Know the minimum price to charge

You first need to know a product's break-even price, which is the minimum price to consider charging customers. MU Extension publication G648, [Break-even Pricing, Revenue and Units](https://extension.missouri.edu/publications/g648) (https://extension.missouri.edu/publications/g648) explains how to determine the soy candle break-even price, which is $3.69 per candle assuming you sell 19,000 candles.

Gauge the maximum price to charge

To establish a maximum price, the soy candle producer needs to determine what value customers place on a soy candle that burns longer and cleaner.

Assume that the soy candle producer hosts a nine-person focus group to collect perspectives from potential customers who fit the target demographic profile and tried a soy candle for one month. This group reported that the soy candles burned about 60% longer and had

100% less smoke than regular petroleum-based candles — the main market competitor. With these attributes in mind, the focus group participants reported they were willing to pay 43% more on average for a soy-based candle than a petroleum-based candle.

After gathering this consumer information, the candle maker assesses its competition and finds that petroleum-based candles of the same size sell for $4.99 on average. A 43% increase equals $7.14 — the most customers would pay per soy candle.

Choose a price between the minimum and the maximum

Given the upper ($7.14) and lower ($3.69) price constraints, the price flexibility in this scenario is $3.45 per soy candle ($7.14 - $3.69).

To determine the specific price to charge, the soy candle producer will need to consider the effects of competition and profit objectives. This is difficult due to the subjectivity and estimates involved. To ease subjectivity, most companies follow a pricing strategy.

5 pricing strategies

Marketers typically choose one of five main pricing strategies:

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

Now, using the soy candle scenario, the following discussion examines these five strategies.

Premium pricing

Marketers use premium pricing when their products have one or more unique characteristics. This uniqueness greatly differentiates a product from its competition and creates a significant competitive advantage. The premium pricing strategy demands a high-quality item to merit the high price. Premium pricing generally is a short-term strategy as markets for high-margin items attract competitors. The length of time you can charge a premium price depends on your competitive advantage's sustainability — the greater the sustainability, the longer you can use premium pricing as a viable strategy.

Relative to the other strategies available, a premium pricing strategy yields the highest product prices. Premium pricing works best when a product has no substitutes, substantial barriers to enter the market exist, and your potential customers are price-insensitive because they value the product's benefits. 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. Competitors would undercut your price and leave you with an ineffective pricing strategy and poor product sales.

In the soy candle scenario, the candle manufacturer could implement a premium pricing strategy effectively because of little or no competition. Based on the focus group research and the candles' unique market position, the manufacturer could charge a premium price of $7.14 per candle. The 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 entry are relatively high, and potential customers value the product's benefits.

A business should also select a value pricing strategy when its product has a competitive advantage that is unsustainable because of competitors likely entering the market. Generally, value-priced products attract many competitors because product pricing is high relative to the market entry barriers.

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

Cost/plus pricing

Companies with a two-tiered focus — costs and return on sales — use a cost/plus pricing strategy. They implement cost/plus pricing when they choose market share and profit as objectives. To establish a price using a cost/plus strategy, you must determine your break-even price by calculating all costs incurred to produce and distribute your product. MU Extension publication G648, Break-even Pricing, Revenue and Units (https://extension.missouri.edu/publications/g648) explains how to compute a break-even price.

Once you know the break-even price, you can establish a markup for each unit sold. The markup must be large enough to provide a sufficient profit, but it should not exceed customers' willingness to pay.

Suppose that the candle maker decides on a 12% margin for its soy candles. Because it already knows its 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

The competitive pricing strategy focuses on cost reduction. It requires keeping production, marketing and distribution costs to a minimum. To determine a price using a competitive pricing strategy, simply identify and record competitors' prices. Then, price your product accordingly — a little more or a little less than the competition depending on differentiation.

Product categories that use the competitive pricing strategy maintain price status quo. Consider the cereal industry for example. Many cereal competitors sell many cereal brands. 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 soy candles given the candles provide added benefits that customers value.

Penetration pricing

When companies launch products in markets that have several competitors, they use penetration pricing. With this strategy, companies set a low price initially to encourage product sales and increase market share. Doing this attracts new customers more quickly and easily than other strategies allow. Once market share is gained, the price increases.

This strategy is effective when potential customers are price-sensitive and companies can exploit economies of scale. Although this strategy might seem to work for small, value-added enterprises, few will have the infrastructure and size to capture economies of scale.

Like competitive pricing, penetration pricing is not appropriate for soy candles. Soy 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, makes penetration pricing less effective.

Guide to strategy selection

Knowing and understanding your production costs, profit objectives, customers and competition will help you select an appropriate pricing strategy. Pricing is difficult, but it should reflect the value and benefits your product provides to your customers.

Use the following table to select appropriate pricing strategies in specific market situations.

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Table 1. 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 per-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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