It would be stating the bleeding obvious to say that pricing has a significant effect on your business, but the effect may be bigger than you realise and in ways that you may not expect. Your prices determine not only your profit, but the health of your business, your ability to fund growth and how much you and your staff get paid. It also affects your market positioning and the flow-on impacts your satisfaction, motivation and your personal life.

Getting your pricing to work can be tricky, but it is definitely more science than black art, with processes you can follow to set your prices with confidence. Get ready, because it does take diligence and discipline. You need a thorough understanding of your business finances and (at times) a touch of courage. If you need professional help with this, go get it!

Most small businesses set prices through a trial-and-error combination of other businesses' prices, what seems reasonable at the time and/or what they can get away with. The most common method I have seen goes like this:

i. Start with competitors' price

ii. Add or subtract a margin to achieve the desired market perception - either higher or lower. For example, if they want to be perceived as more cost effective, they reduce their price by (say) 5-10% over their competitors'. Alternatively, if they want to be perceived as a premium supplier they will increase it.

This approach incorporates one part of the pricing process - market feedback - but does leave a gaping hole: prices are not linked to business costs or profitability. You may be positioning yourself in the market but not making any money. Basing your prices on your competitors' in isolation is not a sound practice, since you have no knowledge of your competitors' costs or their level or profitability (if any). One of my manufacturing clients used this approach, offering their products at a much lower level to offer a competitive advantage, but when we analysed their costs, we found that they were actually losing money. It turned out that their 'advantage' was killing the business.

Your price also plays a role in determining your brand image and where your business sits in your market. Buyers will make assessments about your business partially because of your price, often without knowing anything else. Once your brand is established, buyers will make value decisions before they even consider doing business with you.

Price and value

Whilst the topic of this chapter is pricing, value plays a big role in what buyers are willing to pay and is intrinsically linked to price, so must be considered in the discussion. Whilst price is easily assessed by buyers, value is much more complicated; assessments of price are always overlayed with assessments of value. Property is a great example, where exactly the same object will fetch wildly different prices at different times, based on the perceived value.

Your buyers will have limits on the price they will pay, which are physical and emotional. The physical limitation is the amount of funds that they have to spend, which is very black-and-white: you either have it or you don't. Businesses can help this factor in some cases (through finance, for example) but there is not a huge amount you can do to overcome your buyers' available funds. Those buyers who do not have funds to afford your product or service are just not your target market.

The second limitation is emotional. Let's assume that your buyers have the funds to spend, so the decision to buy from you is based on the value that they perceive, in short, the benefit vs. price. This emotional limit is often a price range rather than an absolute number and, since it is a subjective value it can move. How many times have you paid more for something than you originally planned because you thought the more expensive item was better value?

Value drivers of value may relate to a measurable benefit or perceived (non-measurable) benefit, as shown in the following diagram.

Let's imagine that you are shopping for a watch. You could spend $2 for an unreliable, cheaply made fashion piece, up to many thousands of dollars for a prestige brand. How do you decide which one to buy? It could be price, quality, colour, materials, the brand, the store, the salesperson, your personal image, the brand or what your friends will think of it. All these competing factors will be weighed up against the price for each to make your final choice. These are the same decisions that your clients make when they decide whether to buy from you.

Assessing value takes more time and thinking for your clients, so it also takes more effort for you to convey. If you operate at the discount end of your market, price speaks loudly. As you get further up the price scale you will need to invest more into communicating the value behind your price.

A travel agent I worked with offered travel advice in a rapidly shrinking market, due to online purchasing and freely available online advice. This business decided to focus on luxury travel market. Established in a highly affluent area with an older local population, pricing was pitched at the higher end with an extremely attentive service that their clients loved. The business grew solidly by providing a service that matched the price.

Price scale

For your business to be viable, the pricing must fall somewhere between two extremes: an Upper Limit and Lower Limit, as shown in the Price Scale below. This scale ranks different prices based on your business viability and how receptive the market it. As you look at the scale, mentally plot some of your prices on here to see where they fit.

Price too high. In this range your price is above your buyers' limits or else the market for your product or service is too small to sustain your business at that price.

Upper Limit: the price point that moves into the Price too high range.

Price is Right: the sweet spot for your pricing; you have profitability and the price is attractive to your buyers.

Lower Limit: the price point that moves into the Price too Low range.

Price too low. In this range your price does not generate sufficient profit to satisfy your needs or you could generate a better return investing elsewhere.

Your goal is to get as high as you can in the ‘Price is right’ range to sustain your business.

Where to start – the Lower Limit

The lower limit is the first place to start when you are determining pricing because you need to be profitable. You cannot operate your business long term without generating profit, which is obvious. Sooner or later a business losing money will go out of business or alternative sources of funds will be needed to maintain the business (usually your own).

To get your Lower Limit price, you need to know your costs. Many small businesses do not have regular financial reporting, so don’t have an up to date P&L to use. In this case, take the time to analyse costs. Guesswork is not acceptable. If you are just starting your business then you will need to establish your costs to the highest level of accuracy possible, which means getting actual quotes from suppliers.

There are common ratios used in most industries to calculate prices at least as a starting point. For example, when I owned a restaurant we multiplied cost of sales x 4 then added GST to arrive at menu price. Find out what the common practices are for your industry so you know where to start. Knowing what is going on in your industry is vital, but only so you know where your business sits. Always find better ways to do things that give you an advantage.

One of my clients was a small home-based small manufacturer, a brother and sister team that created unique designs. The market was at the very early stages, with clear differentiation in an untapped market and very good marketing. This business marked their input costs x 9.

You always need to know your profits and margins by percentages and keep a close eye on them in your regular financial reporting.

Your Lower Limit will also depend on the level of profit that you consider acceptable, depending on your personal situation, expectations and values. When deciding this, you may consider

Your own financial value. The value that you place on your involvement in the business (time, money and effort). Your expectations of financial return for your time, investment and emotional involvement will determine your Lower Limit. For example, you may spend more of your own time for lower return if you have a burning passion for a particular activity, for a particular cause or a belief in the long-term future of the business. You may also accept a lower profit if you are a passive owner in a business. At the opposite end of the spectrum, you may feel that your value is high and demand a high return. For example, consultants often expect very high hourly rates because they want to cash in on years of education and experience.

Your return. The return you could earn elsewhere. If you could earn more working for someone else or leaving your money in shares, why bother with a business?

Aiming to be the lowest price by a significant margin should not be your aim. If you choose to position your business as the 'budget' alternative that is fine, but it cannot be at the expense of viability. The only prize for having the lowest price by a significant margin is lower profit than you can have.

The Upper Limit

How nice would it be to just increase your prices to suit yourself? In fact, a client once asked me “how high can I make my price?”, to which I replied “as high as you buyers are willing to pay.” In other words, your buyers will set a limit on how high you can go.

Knowing exactly how high is a tricky business, because you could price yourself out of business and burn future buyers. If you are in an established market, your buyers will have expectations of the price range that they are willing to pay. This can be increased, so long as you can demonstrate additional value. If you are starting a new business or have a new product, do your best research before you set the price – it is often easier to take your prices up than down. If you want to push your price up to test the limit, do so with care, at a slow pace and do your research first. Sales results and buyer feedback will help to tell you if you are approaching the Upper Limit, but losing sales is not the best way to find out. You will need to watch, ask your clients and particularly the unsuccessful sales to keep your finger on the pulse. If your clients start telling you they have been offered a better price or stop buying, heed the warning signs.

Just remember that people will pay higher for something they can’t get anywhere else; if they think if is the same product or service as elsewhere they won’t pay a higher price.

If you set your prices high, you need to have confidence that you can deliver on expectations. Usually you would command a higher price if you have experience in your industry, know how it works and what you can deliver.

One of my clients was a sole trader that provided specialised consulting services to corporates, including executive coaching, etc. He had an opportunity to offer competitive pricing, with the lower cost base because it was a home based business, but rather chose to brand himself as a premium supplier with prices at the very top end of the market. This approach was not entirely successful, as selling the higher price even to executive level takes more time and effort. The market at this end was smaller, especially after the economic downturn.

Listening to the market.

Pricing doesn’t exist only on paper. It lives in a fierce market where competitors are always trying to take business and buyers want a better price. To maintain competiveness, you must periodically review it. Feedback will come from both buyers and competitors on where your price sits and how that affects your business. The overall cycle is shown below.

You may get intelligence from either source without looking for it, but (to be thorough) you will need to be systematic and do research. Always keep your ears pricked – you never know what you will find out. Know what is normal in your industry – not to be a follower, but so you are better informed in the decisions you make.

Buyers will give you great feedback on your pricing. Assume that they always want it cheaper, so ask carefully crafted questions to find out where your offering sits with their perception of value and what your competitors are charging. This is also where you will get feedback of whether your Upper Limit is too high (or getting too high). Warning signs: slowing of sales calls, clients take longer to decide, more resistance on price or your buyers are looking for cheaper options. Don’t be afraid to get feedback, especially from unsuccessful sales. If you can get your competitors’ price from your buyers that is even better, because they can tell you their opinion of that price at the same time.

Competitors will give you an indication of what is happening in the market and where you sit in it. The prices that you find out need to be weighed up in context of their value and place in the market. Getting accurate pricing information from competitors is generally not easy and will need some sleuthing, but some tenacity will get you results. Speaking to contacts, industry associations and their former clients are useful avenues.

Once you have completed your assessments, you may need to adjust your pricing. Always go back to financial fundamentals to make sure you are in the Price is right range.

What is normal?

There are so many industries and business types that it is not possible to speak accurately about ‘normal’ prices and ratios. I can make a few observations from the clients that I have worked with, as well as a few trends that are well established or that I have seen in my clients’ businesses.

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Price increases will (in general) occur over time with inflation, but market changes, competition and structural market or government changes can alter the trend. For example, if importers are able to bring in your product cheaper from overseas, prices may fall.

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If your industry becomes more competitive then you can expect more downward pressure on price.

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Most of the small businesses that I have worked with operated with gross profit (GP) in the 35-60% range, but one business that sold a new and novel product enjoyed over 90%! In this case, there was nothing on the market to compare it to.

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Innovations, increase in reputation and value in your client base may lead to increases above inflation. For example, computers are priced as commodities, but Apple charge a premium for a well-differentiated product that customers value.

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For existing products and services there is an industry-based pricing structure that you will, by default, fit into. Your buyers will have expectations of what is normal or acceptable. For new products this is not the case so often margins are much higher at the start and are gradually eroded as price competitors enter.

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Price increases are inevitable in business. It is a common mistake in small business to review prices in a reactive mode, at irregular intervals. By this time you have no choice but to make a big increase at once. It is preferable to review costs and prices regularly (e.g. annually) and pass on any increases in small increments.

- If there are any sudden increases in input costs, review your prices promptly and communicate the reasons.

- If you have supply contracts, build price increases into them.

- Smaller home based and service businesses can generally afford to offer lower prices than their bigger counterparts, as their operating costs are generally lower and they are more flexible.

- Buying power for small businesses is usually weaker, so product businesses will find it hard to compete with bigger players on price alone. Offering a unique product, niche product or better experience is key here to maintaining a competitive advantage. This is especially the case for retail businesses.

Innovation in pricing

Just putting your margin on all of your products in the same way is not the only way to get the maximum return for your business. Creative and innovative approaches to pricing may help to differentiate your product and increase your margins without your clients even knowing it! Here are some ideas that may help:

- Offer your products or services in packages or bundles. You can then play around with the contents of that package to include higher / lower margin contents that change the overall margins.

- Upsell higher margin add-ons (car dealers do this with extras).

- In your service delivery, increase the pricing or a bonus if you achieve certain goals.

- Build your pricing model around savings or additional sales that you make for your client, for example price is a % of additional profit or % of money saved.

- Offer a payment plan or instalment plan where you end up paying more (insurance companies do this.)

- Offer your product in more convenient packaging or smaller portions at an increased price per quantity. Supermarkets sell loose salad mix for half the price/kg of the packaged version. Coffee sold in pods rather than in bags is much more expensive per kg.

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I am a cultivator of great small businesses. I have a Ph.D in science but fell into the world of small business by accident and discovered my passion. My experience owning and consulting to small businesses now spans over 17 years. I like to solve problems using a scientific approach; looking objectively at businesses to see what is happening and applying first principles. In small business, outcomes reign over theory.

Practical, hands-on advice for small business owners is sorely lacking, since most 'experts' have never owned one. Most business information is targeted to big business and their employees.

My objective is to offer instructive, 'how to' information to make business ownership easier, less stressful and more enjoyable.

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