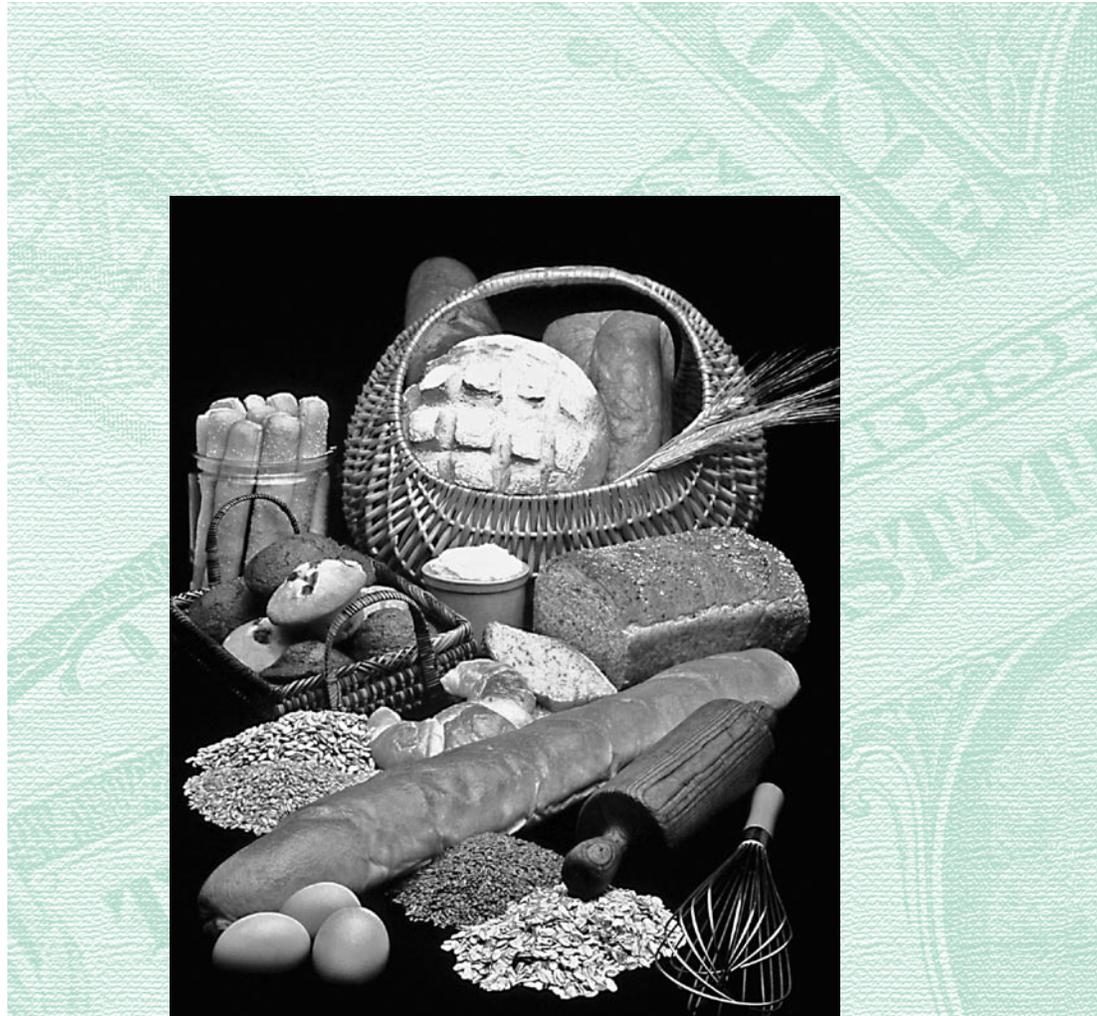


UNDERSTANDING PRICING OBJECTIVES AND STRATEGIES

For the Value-Added Ag Producer



PENNSTATE



COLLEGE OF AGRICULTURAL SCIENCES
AGRICULTURAL RESEARCH AND COOPERATIVE EXTENSION



**CHOOSING
A PRICING
OBJECTIVE AND
ASSOCIATED
STRATEGY IS
AN IMPORTANT
FUNCTION OF
THE BUSINESS
OWNER AND
AN INTEGRAL
PART OF THE
BUSINESS PLAN
OR PLANNING
PROCESS.**

It is more than simply calculating your cost of production and tacking on a markup. Another article (see “What Do I Charge?” at <http://farmbusiness.psu.edu/>) discussed how to determine product prices. This publication will describe the many pricing objectives that business owners may use. Once a pricing objective has been chosen, a pricing strategy that meets the pricing objective must also be selected. Advantages and disadvantages of the objectives and strategies will also be discussed.

Pricing is one of the major components of your marketing plan, which is a component of a full business plan. Assigning product prices is a strategic activity. The price you assign will impact how consumers view your product and whether they will purchase it. Price also helps differentiate your product from those of your competitors. However, the price you assign must be in line with your other marketing strategies and the product attributes. Whether or not you develop a formal marketing plan, performing some of the research necessary for a marketing plan prior to determining the pricing strategies you will implement is important. The knowledge gained from the research will help in assigning appropriate prices to your products or services—prices that reflect the quality and attributes your product offers the consumer. Your marketing goals and knowledge of the industry, your competition, and the market are essential. Here are some questions you’ll need to consider to help determine objectives and strategies that will contribute to the success of your business:

- **What mix of products are you offering?** The mix of products you have available will either limit or broaden the pricing strategies available for you to use. If you feel that a particular strategy would assist you in achieving your pricing objective, then you may want to consider making changes to your product mix.
- **Who or what is your target market?** The demographics of your target market will help you identify appropriate pricing objectives and strategies. Are target customers interested in value, quality, or low cost?
- **Are you distributing your product wholesale or retail?** Your method of product distribution can impact the pricing objectives and strategies you are able to use. Direct marketing gives you more control than wholesale marketing over how products are grouped, displayed, and priced.
- **What is the estimated life cycle of your product/service?** The life cycle of your product can impact your choice of pricing objectives and strategies. With a short estimated life cycle, it will be necessary to sell greater quantities of product or generate larger profit margins than with products where the life cycle is longer. Longer life cycles give you more time to achieve your pricing objective.
- **What is the projected demand for the product?** When demand for a product is expected to be high, you have more flexibility in choosing pricing strategies because customers are less likely to be concerned with price and packaging since they really want your product. For example, consider the prices people are willing to pay when new video game consoles debut.
- **Are there other entities, such as the government, that may dictate the price range for your product?** Some products, such as milk, have government-imposed regulations limiting the price that can be charged. Be familiar with any pricing regulations that apply to your industry or product.

Certain combinations of an objective and strategies work together while other combinations contradict each other. At the end of this publication you will find a diagram illustrating pricing objectives and the strategies that can be employed to meet each objective. You’ll notice that some strategies can be employed with more than one objective.

PRICING OBJECTIVES

Many pricing objectives are available for careful consideration. The one you select will guide your choice of pricing strategy. You'll need to have a firm understanding of product attributes and the market to decide which pricing objective to employ. Your choice of an objective does not tie you to it for all time. As business and market conditions change, adjusting your pricing objective may be necessary or appropriate.

How do you choose a pricing objective? Pricing objectives are selected with the business and financial goals in mind. Elements of your business plan can guide your choices of a pricing objective and strategies. Consider your business's mission statement and plans for the future. If one of your overall business goals is to become a leader in terms of the market share that your product has, then you'll want to consider the quantity maximization pricing objective as opposed to the survival pricing objective. If your business mission is to be a leader in your industry, you may want to consider a quality leadership pricing objective. On the other hand, profit margin maximization may be the most appropriate pricing objective if your business plan calls for growth in production in the near future since you will need funding for facilities and labor. Some objectives, such as partial cost recovery, survival, and status quo, will be used when market conditions are poor or unstable, when first entering a market, or when the business is experiencing hard times (for example, bankruptcy or restructuring). Brief definitions of the pricing objectives are provided below.

Partial cost recovery—a company that has sources of income other than from the sale of products may decide to implement this pricing objective, which has the benefit of providing customers with a quality product at a cost lower than expected. Competitors without other revenue streams to offset lower prices will likely not appreciate using this objective for products in direct competition with one another. Therefore, this pricing objective is best reserved for special situations or products.

Profit margin maximization—seeks to maximize the per-unit profit margin of a product. This objective is typically applied when the total number of units sold is expected to be low.

Profit maximization—seeks to garner the greatest dollar amount in profits. This objective is not necessarily tied to the objective of profit margin maximization.

Revenue maximization—seeks to maximize revenue from the sale of products without regard to profit. This objective

can be useful when introducing a new product into the market with the goals of growing market share and establishing long-term customer base.

Quality leadership—used to signal product quality to the consumer by placing prices on products that convey their quality.

Quantity maximization—seeks to maximize the number of items sold. This objective may be chosen if you have an underlying goal of taking advantage of economies of scale that may be realized in the production or sales arenas.

Status quo—seeks to keep your product prices in line with the same or similar products offered by your competitors to avoid starting a price war or to maintain a stable level of profit generated from a particular product.

Survival—put into place in situations where a business needs to price at a level that will just allow it to stay in business and cover essential costs. For a short time, the goal of making a profit is set aside for the goal of survival. Survival pricing is meant only to be used on a short-term or temporary basis. Once the situation that initiated the survival pricing has passed, product prices are returned to previous or more appropriate levels.

PRICING STRATEGIES

After selecting a pricing objective you will need to determine a pricing strategy. This will assist you when it comes time to actually price your products. As with the pricing objectives, numerous pricing strategies are available from which to choose. Certain strategies work well with certain objectives, so make sure you have taken your time selecting an objective. Careful selection of a pricing objective should lead you to the appropriate strategies. If the pricing strategy you choose seems to contradict your chosen pricing objective, then you should revisit the questions posed in the introduction and your marketing plan. As a reminder, the diagram at the end of this publication illustrates which pricing strategies work well with each of the pricing objectives previously discussed.

Additionally, different pricing strategies can be used at different times to fit with changes in marketing strategies, market conditions, and product life cycles. For example, if you're working under a status quo pricing objective with competitive pricing as your strategy due to poor market conditions, and a year later you feel that the market has improved, you may wish to change to a profit margin maximization objective using a premium pricing strategy. Brief definitions of some pricing strategies follow.

Competitive pricing—pricing your product(s) based on the prices your competitors have on the same product(s). This pricing strategy can be useful when differentiating your product from other products is difficult. So, let's say you produce fruit jams such as blueberry, strawberry, blackberry, and raspberry. You may consider using competitive pricing since there are many other jams on the market and you are unable to differentiate your jams to an extent that customers may be willing to pay more for yours. Thus, if the price range for jams currently on the market is \$1.45 to \$1.85 per jar, you may price your jams at \$1.65 per jar to fall in line with the competition.

The strategy of competitive pricing can be used when the pricing objective is either survival or status quo. When the objective for pricing products is to allow the business to either maintain status quo or simply survive a difficult period, competitive pricing will allow the business to maintain profit by avoiding price wars (from pricing below the competition) or falling sales (from pricing above the competition).

Good, better, best pricing—charges more for products that have received more attention (for example, in packaging or sorting). The same product is offered in three different formats, with the price for each level rising above that of the previous level. For example, the manager of a farm market that sells fresh apples may place some portion of apples available for sale in a large container through which the customers have to sort to choose the apples they wish to purchase. These apples would be priced at the “good” price. Another portion of apples could also be placed in a container from which customers can gather, but these apples would have been presorted to remove less desirable apples, such as those with soft spots. These would be priced at the “better” price. The “best” apples—those priced higher than the rest—may have been presorted, just as the “better” apples, but have also been prepackaged for customer convenience. As demonstrated in this example, the “better” and “best” levels require more attention by management or labor but, if priced appropriately, may be worth the extra effort.

This pricing strategy should be used when pursuing revenue maximization and quantity maximization objectives. Revenue maximization should occur as a result of quantity maximization. Quantity maximization should occur from the use of this pricing strategy because product is available to customers in three price ranges.

Loss leader—refers to products having low prices placed on them in an attempt to lure customers to the business and to make further purchases. For example, grocery stores might use bread as a loss leader product. If you come to their store to purchase your bread, you are very likely to purchase other grocery items at their store rather than going to another store. The goal of using a loss leader pricing strategy is to lure customers to your business with a low price on one product with the expectation that the customer will purchase other products with larger profit margins.

The loss leader pricing strategy should be paired with either the quantity maximization or partial cost recovery pricing objectives. The low price placed on the product should result in greater quantities of the product being sold while still recovering a portion of the production cost.

Multiple pricing—seeks to get customers to purchase a product in greater quantities by offering a slight discount on the greater quantity. In the display of prices, a price for the purchase of just one item is displayed along with the price for a larger quantity. For example, a farm market may price one melon at \$1.69 and two at \$3.00. Pricing in this way offers the customer an apparent discount (in this example \$0.38) for purchasing the greater quantity. Customers feel like they're getting a discount since \$1.50 ($\$3.00 \div 2$) is less than the \$1.69 price for one melon. However, \$1.50 is the price you would typically charge if you were not employing a multiple pricing strategy. If you think the majority of your customers will purchase the greater quantity, you will want to price the quantity so that your costs are covered and your profit margin is maintained. A customer purchasing just one item will pay more for the item than what you would typically charge if you were not using a multiple pricing strategy.

The multiple pricing strategy works well with the profit maximization and quantity maximization objectives. By enticing your customer to purchase more than one item you are generating more profit since you have set the price for just one item so that you receive a greater profit margin than for which you would typically price. Essentially, the customer is being penalized for purchasing just one item. In addition, multiple pricing should increase the quantity of items being sold, hopefully resulting in less product loss or fewer unsold items.

Optional product pricing—used to attempt to get customers to spend a little extra on the product by purchasing options or extra features. For example, some customers may be willing to spend a little extra to be assured that they receive product as soon as it becomes available. This can be an excellent strategy for custom operators. Let's say you are

a custom operator providing forage harvesting services. Your base service option provides producers with basic harvesting. Available options that the producer could purchase in addition to the harvesting service could include trucking to the storage site, packing, preservative application, and serving as a member of the producer's advisory committee. The purchase of each of these options adds value to the service that the producer is receiving. With this strategy it is important that the extra fee for the option(s) is reasonable; otherwise, you may lose business to a competitor with a more appropriate pricing structure for the extra services offered.

Optional product pricing is best used when the pricing objective is revenue maximization or quality leadership. By enticing customers to purchase one or more of the options offered to them, you will be increasing your revenue since the customers may not have purchased the option if it were not offered or may have gone elsewhere to purchase it. By offering optional products to complement your base product or service, you are projecting an image of quality to your customers. They will likely recognize your offer of additional products or services as awareness of and sensitivity to their needs.

Penetration pricing—used to gain entry into a new market. The objective for employing penetration pricing is to attract and grow market share. Once desired levels for these objectives are reached, product prices are typically increased. Penetration prices will not garner the profit that you may want; therefore, this pricing strategy must be used strategically. Let's say you have created a new hot and spicy mustard product. Your market research indicates that the price range for competitors' mustards is \$1.89 to \$2.99. Since numerous mustards are already available and you are new to the mustard market, you decide to use penetration pricing to entice customers to purchase your mustard. Therefore, you price your mustard at \$1.85 for the first six months because it covers your cost of production yet is lower than what you believe is a good price for your product and is below the lower end of the market range, which should entice people to purchase your mustard over the other higher-priced mustards.

The strategy of penetration pricing can be used when your pricing objective is either revenue or quantity maximization. The lower price set on products by using penetration pricing is done to entice the maximum number of customers possible to purchase your product. Large numbers of customers purchasing your product should maximize your revenue and the quantity of product sold. If the price were higher, you would expect fewer purchases, thus leading to lower revenues.

Premium pricing—employed when the product you are selling is unique and of very high quality, but you only expect to sell a small amount. These attributes demand that a high, or premium, price be attached to the product. Buyers of such products typically view them as luxuries and have little or no price sensitivity. The advantage of this pricing strategy is that you can price high to recoup a large profit to make up for the small number of items being sold. To demonstrate, let's say that you have a flock of sheep and you shear, dye, and spin your own yarn. Your yarn is known in the industry as being of extremely high quality. Some of that yarn you use to knit sweaters, blankets, and scarves. Since your yarn and knitting are very high quality and you know that you probably won't be making and selling a large quantity of your knitted items, you decide to employ premium pricing. Your customers already know of the fine quality of your yarns or they are in higher income brackets, so they will most likely pay a premium price for your premium knitted products.

Premium pricing can be employed with the profit margin maximization or quality leadership pricing objectives. The premium price charged for the uniqueness and quality of your product allows you to generate large profit margins on each item sold. Your product will also demonstrate your commitment to quality, and customers will think of you when they desire such quality.

Product bundle pricing—used to group several items together for sale. This is a useful pricing strategy for complementary, overstock, or older products. Customers purchase the product they really want, but for a little extra they also receive one or more additional items. The advantage of this pricing strategy is the ability to get rid of overstock items. On the other hand, customers not wanting the extra items may decide not to purchase the bundle. This strategy is similar to product line pricing, except that the items being grouped together do not need to be complementary. For example, you have remaining stock of Christmas-related items after the holidays. If you prefer not to store these items until next year, you could put a variety of items in a small bag and sell the bag at a discounted price.

Product bundle pricing can be employed with revenue maximization or quantity maximization objectives since bundling products may result in the sale of products that may have gone unsold. Quality leadership can be achieved since some customers will appreciate having the opportunity to purchase a group of items at a discount. The partial cost recovery or survival objectives can be fulfilled from a product bundling pricing strategy when products likely would have gone unsold otherwise and selling the products at a discount

allows you to recover some portion of the production cost or generates enough of a profit to stay in business or keep from having to remove the product from market.

Product line pricing—used when a range of products or services complement each other and can be packaged together to reflect increasing value. This pricing strategy is similar to the multiple pricing strategy. However, rather than purchasing a greater quantity of one item, the customer is purchasing a different item or service at a higher price that is still perceived as a value when compared to the price for the individual product or service. Let's say that in your farm market you sell jams, syrups, and pancake mixes, among other items. These items can be considered complementary since people usually put jam and syrup on pancakes. In addition to selling each of these items individually, you could create a gift box that packages one of each item together. The price for this gift box would be slightly less than what a customer would pay in total when purchasing each of the same items individually.

The product line pricing works well with the profit maximization and quality leadership pricing objectives since you are increasing profit by encouraging the purchase of a greater number of products that may not have been purchased individually. Additionally, some customers will value the ability to purchase a group of complementary products.

Skim pricing—similar to premium pricing, calling for a high price to be placed on the product you are selling. However, with this strategy the price eventually will be lowered as competitors enter the market. This strategy is mostly used on products that are new and have few, if any, direct competitors when first entering the market. Let's say you develop a carbonated, flavored, milk-based beverage packaged in 10-ounce plastic bottles. Since there are few drinks of this sort on the market, you could use skim pricing until more products come to market. Knowing that other similar beverage products will likely enter the market within a year or two, you may decide to price at \$1.95 per bottle when your product debuts. Assuming that other similar beverages have come to market after a year, you then lower the price of your drink to \$1.55 to remain competitive.

The skim pricing strategy should be reserved for when your pricing objective is profit maximization, revenue maximization, or profit margin maximization. Employing this strategy when your product is new on the market and there is no competition generates greater revenue, profit, and profit margins since you are the only one selling the product—customers must buy from you if they want what you

are selling. You must use caution, though, so as to not price so high though that customers aren't willing to buy your product even though there are no competitors.

SUMMARY

Choosing a pricing objective and a related strategy requires you to carefully consider your business and financial goals, the state of the market (including its past and future), and the products and prices of your competition (and possibly their business goals). You want to select objectives and strategies that will position your product and business for success. Choosing an objective and strategies that are appropriate for your business at the current time does not prevent you from changing objectives or employing different strategies in the future as your business grows or changes.

REFERENCES

Giddens, N., J. Parcell, and M. Brees. *Selecting an Appropriate Pricing Strategy*. <http://www.extension.iastate.edu/agdm>. Ames: Iowa State University Extension, 2005.

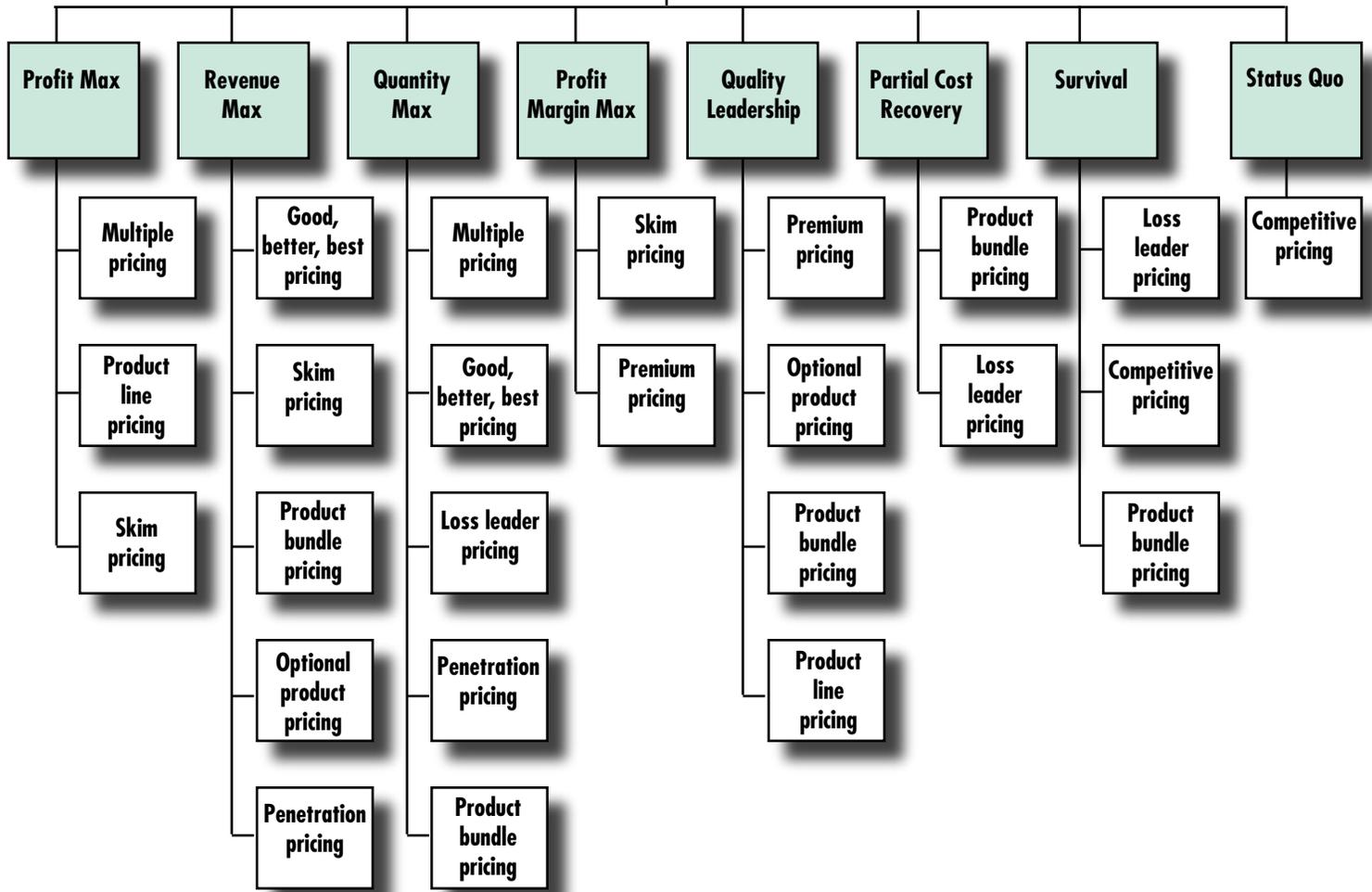
Marketing Teacher, Ltd. *Pricing Strategies*. http://www.marketingteacher.com/Lessons/lesson_pricing.htm. Accessed July 27, 2006.

NetMBA. 2005. *Pricing Strategy*. <http://www.netmba.com/marketing/pricing/>. Accessed July 27, 2006.

Uva, Wen-fei L. *Smart Pricing Strategies*. Ithaca: Department of Applied Economics and Management, Cornell University, 2001.

Prepared by Sarah A. Roth, senior extension associate in agricultural economics.

PRICING OBJECTIVE



Visit Penn State's College of Agricultural Sciences on the Web: www.cas.psu.edu

Penn State College of Agricultural Sciences research, extension, and resident education programs are funded in part by Pennsylvania counties, the Commonwealth of Pennsylvania, and the U.S. Department of Agriculture.

This publication is available from the Publications Distribution Center, The Pennsylvania State University, 112 Agricultural Administration Building, University Park, PA 16802. For information telephone 814-865-6713.

This publication is available in alternative media on request.

The Pennsylvania State University is committed to the policy that all persons shall have equal access to programs, facilities, admission, and employment without regard to personal characteristics not related to ability, performance, or qualifications as determined by University policy or by state or federal authorities. It is the policy of the University to maintain an academic and work environment free of discrimination, including harassment. The Pennsylvania State University prohibits discrimination and harassment against any person because of age, ancestry, color, disability or handicap, national origin, race, religious creed, sex, sexual orientation, gender identity, or veteran status. Discrimination or harassment against faculty, staff, or students will not be tolerated at The Pennsylvania State University. Direct all inquiries regarding the nondiscrimination policy to the Affirmative Action Director, The Pennsylvania State University, 328 Boucke Building, University Park, PA 16802-5901; Tel 814-865-4700/V, 814-863-1150/TTY.

Produced by Information and Communication Technologies in the College of Agricultural Sciences

© The Pennsylvania State University 2007

CODE # UA441 3M407MPC 4824