



## Common pricing strategies

### Introduction

The price you set for your product or service is one of the most important business decisions you will make. REDF has found that many social enterprises do not have a strong methodology when setting the prices they charge, and they do not reevaluate those assumptions often enough or at all. This means that many social enterprises are mispricing their products or services, forgoing much needed revenue.

This learning guide, the third in a series on pricing for social enterprises, will explore common pricing strategies by which to do so.

### Understand Your Costs

Before your social enterprise can evaluate different pricing strategies for its products, it must first understand two crucial pieces of information. The first is the costs associated with making its products or delivering its services, known as the “cost structure” of a business. The second is the price or the volume that it would require to break-even. We cover the steps it takes to conduct a break-even analysis in another learning guide which we recommend you review before reading on.

### Establish Goals

Once your social enterprise understands its costs, it must establish its financial goals. For most businesses, the goals are fairly straightforward – maximize profit. For social enterprises, this shouldn't be particularly different, though it must also understand how its business and social purposes are intertwined. For those social enterprises run by a parent non-profit organization, there may be more flexibility in terms of the contribution of the social enterprise business line towards operating costs.

Prices need to be set at a level your customers are willing to pay. You will also want the price of your offering to cover some or all of your costs. How much of your costs must be covered depends on whether you are able to subsidize any of your costs. For example, some nonprofits are able to raise funds for the social costs they incur by providing extra employee training.

Once clear financial goals are established, your social enterprise can evaluate different strategies for determining the price you charge for your goods or services.

### Common Pricing Strategies

Once you have established your goals and have a firm understanding of your cost structure, there are a number of different strategies your social enterprise can explore. We will review five of the most common strategies below, including:

- Market penetration
- Value-based
- Variable/Real-Time
- Cost-plus
- Contribution margin

## Market Penetration

Market penetration pricing is when a company sets a price for its products that is below prevailing market prices. This strategy is most common for commodity products in mature markets with high price elasticity – in other words, for products where the demand changes dramatically with small changes in price.

Let's take the fictional Soцент Booksellers as an example. This social enterprise has direct costs of \$5.00 and operating costs of \$2.00 per book. They have conducted competitor research and discovered that other retailers are charging \$9.99 for the same book. If they were to adopt market penetration pricing, they would price their book at \$8.99 to ensure the lowest price in the market, resulting in a sale at a \$1.99 profit.



This strategy may not be appropriate for businesses whose costs – both operating and fixed costs – are greater than the selling price. In the above example, if the bookseller had operating costs of \$6 per book (in addition to the \$5 direct cost), selling at \$8.99 or even \$9.99 would result in a loss on every book sold. In that case, they should not enter the market or consider exiting if already in the market.

However, if this business was trying to grow its customer base for a period of time and priced below its costs to draw in customers and build its brand. Once the brand is established and has built a loyal customer base, it may be able to raise its pricing and hopefully end up with more customers at the end than they would if it started at \$11.

## Value-Based

Value-based pricing determines the price of a product based on the value to consumers. This strategy is appropriate for products that have a value to consumers which is significantly above the cost to produce. This includes particularly strong brands and luxury goods, and products with differentiated features and limited alternatives.

Let's take the fictional Soцент Food Co. as an example. Customers value products made by Soцент Food Co. because of the organization's mission and outstanding product quality. Prevailing prices are \$1.49 to \$1.99 from large manufacturers, while more premium products, such as organic and locally-sourced offerings, typically charge twice that price. Accordingly, Soцент Food Co. could set their price at \$3.00 to \$3.99.



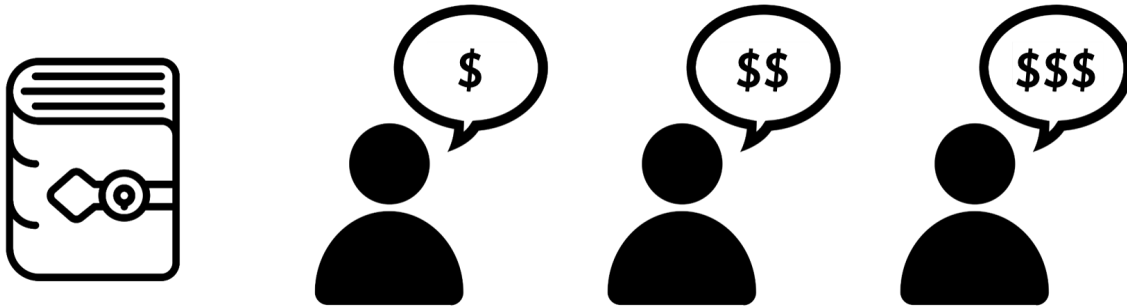
This type of pricing can be effective for social enterprises because it allows them to capitalize on the unique aspects of their business or manufacturing process. To a segment of consumers, knowing that their purchase is contributing to a social good will be worth the extra cost of that product to them. However, REDF has found that customers are often willing to make a one-time purchase based on mission, but in order to become a repeat customer, it ultimately has to meet price/quality expectations.

Effectively incorporating your unique value proposition and mission into your marketing is critical for all pricing strategies, but it is particularly important for value-based pricing. Understanding your customers' key purchasing criteria is essential in doing so.

### **Variable / "Real-Time"**

Variable or "real time" pricing is when the price is determined by real-time demand for the product or service. This is commonly used in markets with frequent and measurable demand fluctuations and low transaction costs for changing prices. Common examples include trading markets, hotels, ride share apps, and event tickets.

Let's refer back to our Soцент Booksellers from our first example. Let's say this social enterprise is selling a rare book. Soцент Booksellers could set up an online or in-person auction and market it to the most relevant customers (such as customers who've purchased similar rare books before) in order to generate demand. In real-time, the potential customers can name their price for the book, often competing with each other to increase the price offered. At the end of the auction, the book is sold to whichever customer bids the most.

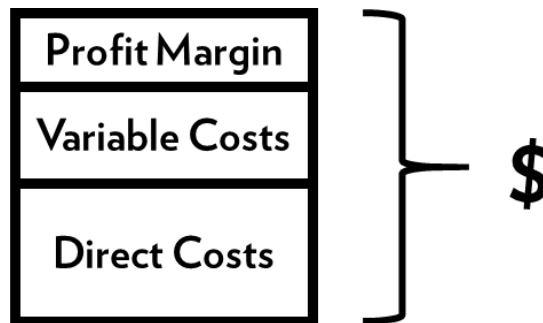


The advantage of this type of pricing is that it takes the guess work out of understanding a product's value to consumers. It also allows you to be more responsive to the principles of supply and demand: prices can go up if demand increases or supply decreases.

**Cost-Plus**

Under this method, the price is based on a predetermined profit margin above all costs. Unlike the pricing strategies discussed above which look outwardly at consumer value and the market to determine prices, cost-plus pricing looks inward. For this type of pricing strategy, a business simply adds up all of the direct and variable costs for a product and adds a markup percentage (the profit margin). The sum of these things is the price of the product or service. This method is commonly used for single buyer products produced to buyer's specifications, such as government contracts or large supplier agreements with a single buyer.

Let's say Soцент Maintenance Services is bidding for a janitorial contract in a business improvement district. The company determines that its combined costs (employee wages, supplies, overhead, etc.) are \$58,000 for the project and it targets a profit margin for program expenses of 10%. Accordingly, Soцент Maintenance Services would bid \$63,800 for the contract (\$58,000 in costs + \$5,800 in profit).



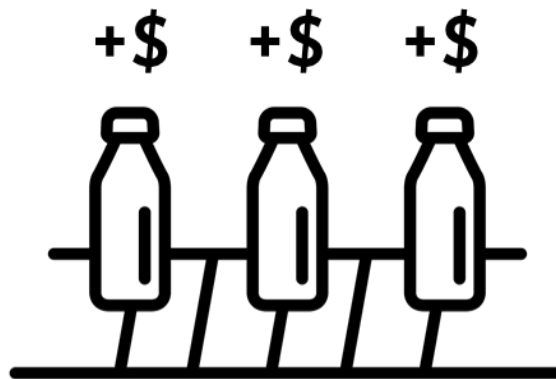
While this type of pricing is common and appropriate in bid contracts, it is commonly used in other markets where it may be less appropriate. Referring to the Soцент Food Co. example from above, their cost to produce may only be \$2 per can. If they were to adopt this type of pricing, they may end up charging only \$2.50 per can, leaving potential revenue on the table.

## Contribution Margin

A product's "contribution margin" is the measure of its selling price per unit, minus its per unit variable costs. Contribution margin pricing is a strategy that determines a price that maximizes total contribution margin for a product.

For example, let's say Soцент Manufacturing Company has a production capacity of 1,000 units per day. Management may target a contribution margin of \$1 per unit in order to cover overhead costs, assuming that operations are at full capacity. Accordingly, they must price products where:

1. Market demand is at least 1,000 units per day
2. Selling price minus variable costs is greater than \$1 per unit



If they manufacture multiple different products, it is important for them also to take into account the relative contribution margins of these different products. This type of approach is most appropriate for businesses with fixed production capacity and the ability to produce a variety of different products – manufacturing being a key example of such an industry.

## Conclusion

Determining a price for your goods or services is more of an art than a science. Your social enterprise will need to evaluate the appropriateness of each of these strategies for your products and your business goals. While there is not necessarily a "right" answer for a given industry or market, the steps outlined above will help ensure that you are making a more informed decision when setting prices. Perhaps the most important thing to remember is to **reevaluate your pricing decisions often**. Not regularly checking pricing may increase the likelihood of leaving revenue on the table.