Is Pricing Low A Good Idea?

Especially when starting up a business the perceived wisdom can be that you should price low. If you price low you can win more customers. More customers mean more sales and that's the key to success……or is it?

The tendency is to think I'm new, I'm small, I can do it cheaper. But in fact there are four problems with this thinking.

1. One of the most common mistakes made by business owners is to underestimate their costs.
2. Small businesses generally don't have the right attributes to be able to get significant cost reductions in comparison with larger and more established ones.
3. Unless you have significant sources of capital to fund your business over a long period, all your competitors have to do is drop their own prices until they've driven you out of the market.
4. Any cost advantage you do have is normally only temporary, as other businesses put energy into matching you.

That's not to say it can't be done, but just following a simplistic 'price-low' strategy without being aware of all the factors is likely to end in disaster.

The fundamental flaw in the 'price-low' thinking is that it's not really sales that are most important to a business. It's profit. And the prices you set can have a dramatic effect on profit.

Consider an example…

Pricing Example

Let's suppose we're selling widgets and our profit and loss account for the last month looked like this.

Sales (1000 widgets at €100 each)
Cost of sales (1000 widgets at €100 each)
Gross profit
Overheads
Profit

We want to know if we'd be better off by reducing prices by 10% or increasing them by 10%. So we do some market research and find out that:

- Option 1 – Reducing prices by 10% would result in a 20% increase in the quantity sold.
- Option 2 – Increasing prices by 10% would result in a 20% fall in the quantity sold.

Which option would you choose?

Most will plump for option 1. 20% more sales with a price cut of only 10% will surely be better. We gain more in volume than we lose in price so it must be more profitable.

Are they right?

Let's check the numbers.

Sales
(1200 widgets at €90 each)
(800 widgets at €110 each)
Cost of sales
(1200 widgets at €70 each)
(800 widgets at €70 each)
Gross profit
Overheads
Net loss/profit

Is option 1 more profitable? No. In actual fact raising prices despite the fall in number of sales is €8,000 more profitable.

The business that pursues option 1 is making a loss and if that continues the business will fail. And as well as being worse off than option 2, such a business is worse off than if it had left prices where they were.

What does this all mean?

This isn't an unusual example.

The general truth is that cutting prices may increase sales, but at the same time can have a catastrophic effect on your profit. This is because lowering prices generally means you have to significantly increase sales volumes to make more profit.

In our example, to maintain a profit of €5,000 with a price cut of 10%, the volume of sales would have to increase by 50%. That means finding 1 new customer for every 2 you currently have! Would that be realistic?

On the other hand a price increase of 10% means you could afford to lose up to a quarter of your customers and you'd still maintain that €5,000 profit. That's a lot less work for the same money!

Of course, every situation will vary depending on your profit margins, which is why it's so important to do the numbers.

Is low pricing an impossible strategy?

Low pricing doesn't automatically result in less profit. There are very successful businesses out there that are based on offerings at a low price.

Henry Ford with his Model T car, Ikea and McDonalds are examples of hugely successful businesses whose strategy was based on providing products at a low price.

But, and here's the point, they made their products available for a significantly cheaper price and so tapped into a mass market. Their sales volume increased exponentially and so although the margin between sales price and production cost is tight they're able to turn large profits.

The key for those businesses, though, is that they clearly understood how profits work. They didn't just reduce prices and hope that increased sales would take care of the rest.

They carefully manufactured and designed their products, services and processes to be as efficient and simple as possible. Then these much reduced costs made it possible to set the low prices that attracted a mass market of customers.

So pricing low isn't impossible, but it's difficult. Why?

Most businesses don't operate in the mass market. Unless mass market domination is the aim, pricing low is usually a faulty strategy that leads to unrewarded work, low profits and often losses. And it's best avoided.

To see the effect on your profit of changing prices download the Parfrey Murphy App (

http://parfreymurphy.ie/the-parfrey-murphy-app/) and simply enter your details in the 'Increased Profit' calculator. The App is completely free of charge and is available for iOS and Android devices.