

# MK 322 Retail Management

## Chapter 14: Retail Pricing

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# Value

- Value is ratio of what customers receive (the perceived benefit of the products and services offered by the retailer) to what they have to pay for it.
- Retailers can increase value and stimulate more sales (exchanges) by either increasing the perceived benefits offered or reducing the price

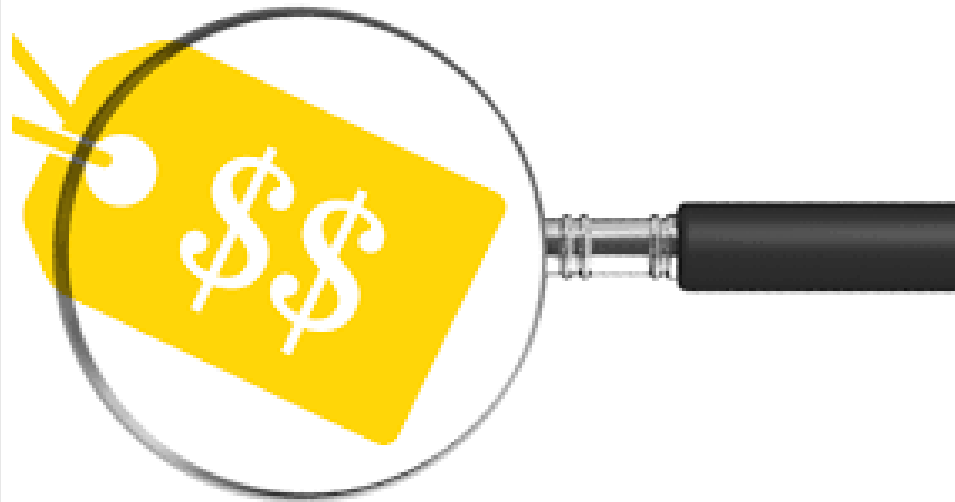
# Value

$$\text{Value} = \frac{\text{Perceived benefits}}{\text{Price}}$$



# Pricing Strategies

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# Pricing Strategies

Two basic pricing strategy

- ✓ High/ low pricing strategy
- ✓ EDLP

# High/Low Pricing

- Retailers use this strategy frequently
- Often weekly
- Discount the initial prices for merchandise through sales promotions
- Customers learn to expect frequent sales and simply wait until the merchandise they want goes on sale and then stock up at low prices

# Pricing Strategies



The retailer on the left is using a high/low pricing strategy, whereas the one on the right is using everyday low pricing strategy.

# Everyday Low Pricing (EDLP)

- This strategy emphasizes the continuity of retail prices at a level somewhere between the regular nonsale price and the deep-discount sale price of high/low retailers
- They occasionally have sales
- Although retailers use EDLP, may not be lowest price in the market, but their sale may be lowest

# Advantages of High/Low Pricing

The high/low pricing strategy has the following advantages:

- *Increases profits.* High/low pricing allows retailers to charge higher prices to customers who are not price-sensitive and will pay the “high” price and to charge lower prices to price-sensitive customers who will wait for the “low” sale price.
- *Creates excitement.* A “get them while they last” atmosphere often occurs during a sale. Sales draw a lot of customers, and a lot of customers create excitement. Some retailers augment low prices and advertising with special in-store activities, such as product demonstrations, giveaways, and celebrity appearances.
- *Sells slow moving merchandise.* Sales allow retailers to get rid of slow-selling merchandise by discounting the price.

# Advantages of Everyday Low Pricing (EDLP)

The EDLP approach has its own advantages, as follows:

- *Assures customers of low prices.* Many customers are skeptical about initial retail prices. They have become conditioned to buying only on sale—the main characteristic of a high/low pricing strategy. The EDLP strategy lets customers know that they will get the same low prices every time they patronize the EDLP retailer. Customers do not have to read the ads and wait for items they want to go on sale.
- *Reduces advertising and operating expenses.* The stable prices caused by EDLP limit the need for the weekly-sale advertising used in the high/low strategy. In addition, EDLP retailers do not have to incur the labor costs of changing price tags and signs and putting up sale signs.
- *Reduces stockouts and improves inventory management.* The EDLP approach reduces the large variations in demand caused by frequent sales with large markdowns. As a result, retailers can manage their inventories with more certainty. Fewer stockouts mean more satisfied customers, resulting in higher sales. In addition, a more predictable customer demand pattern enables the retailer to improve inventory turnover by reducing the average inventory needed for special promotions and backup stock.

# Considerations in Setting Retail Prices

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# Considerations in Setting Retail Prices

1. The price sensitivity of consumers
2. The cost of the merchandise
3. Competition
4. Legal constraints

# Customer Price Sensitivity and Cost

- Generally as price of product increase, and sales decrease due to fewer customers feel the product is good value
- Price sensitivity of consumers determines how many units will be sold at different price levels
- Price-sensitive reactions to a price decrease?

# Customer Price Sensitivity and Cost

- Experiment



To determine the most profitable price for a riblet basket, a restaurant chain may set different prices at different locations.

# Customer Price Sensitivity and Cost

One approach that can be used to measure the price sensitivity of customers is a price experiment. Consider the following situation: A restaurant chain wants to determine the best price for a new item, a riblet basket. It selects restaurants in the chain with very similar trade areas and sets prices at different levels in each of the restaurants for a week. Assume that the variable cost of the riblets is \$5 per plate and the fixed cost of operating the restaurant for a week, the cost for rent, labor and energy, is \$8,000.

The results of this experiment are shown in Exhibit 14-1. Notice in Exhibit 14-1a that as prices increase, the fixed costs remain the same, sales and variable costs both decrease, but sales decrease at a faster rate than variable costs (Exhibit 14-1b). So the



# Customer Price Sensitivity and Cost

highest profit level occurs at a \$7 price (Exhibit 14–1c). If the restaurant considers only customers' price sensitivity and cost in setting prices, it would set the price for the riblet basket with these demand characteristics at \$7 to maximize profits. Retailing View 14.2 highlights how showrooming and mobile apps are increasing consumers' price sensitivity.



# Customer Price Sensitivity and Cost

Price Experiment EXHIBIT 14-1

(a) Data from Price Experiment EXHIBIT 14-1a

(1) Theater	(2) Price	(3) Quantity Sold	(4) Column (2) × Column (3) = Revenue	(5) Column (3) × \$5 Variable Cost per Riblet Basket = Variable Cost	(6) Fixed Cost	(7) Column (4) – Column (5) – Column (6) = Contribution to Profit
1	\$6.00	9,502	\$57,012	\$47,510	\$8,000	\$1,502
2	6.50	6,429	41,789	32,145	8,000	1,644
3	7.00	5,350	37,450	26,750	8,000	2,700
4	7.50	4,051	30,383	20,255	8,000	2,128
5	8.00	2,873	22,984	14,365	8,000	619
6	8.50	2,121	18,029	10,605	8,000	-577

# Customer Price Sensitivity and Cost

EXHIBIT 14-1b

(b) Quantity Sold at Different Prices

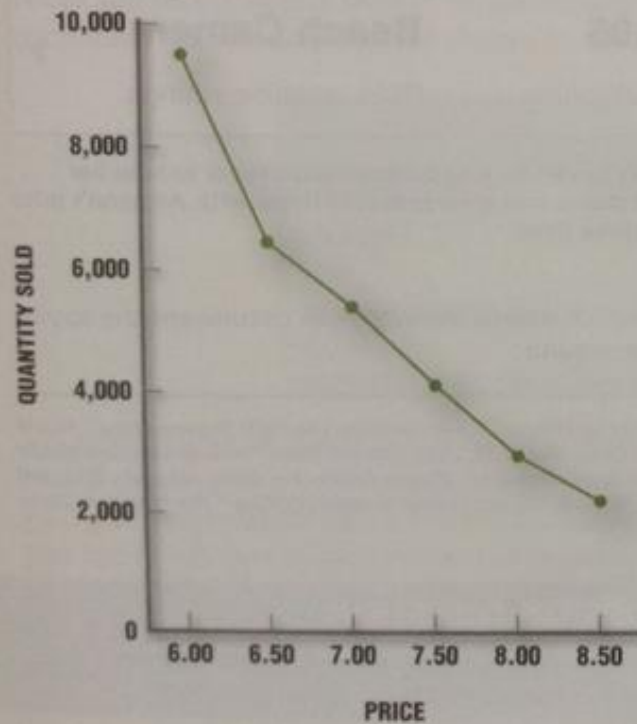
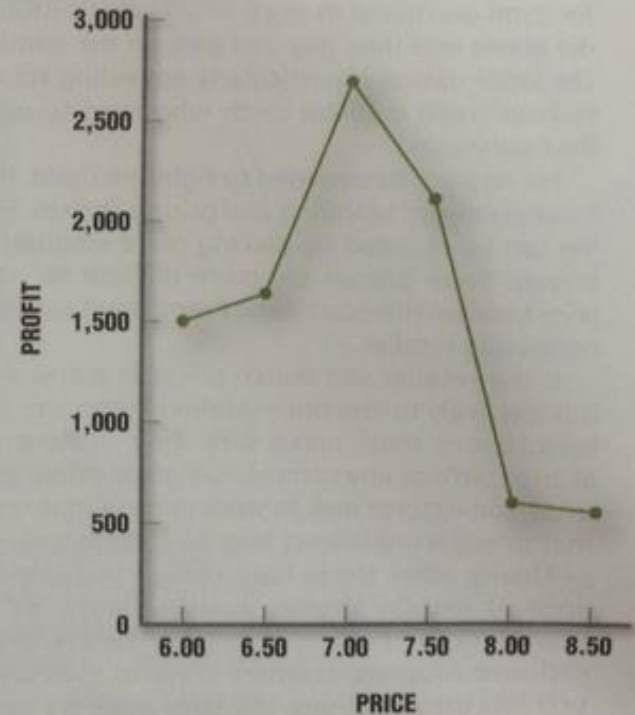


EXHIBIT 14-1c

(c) Profit at Different Prices



# Customer Price Sensitivity and Cost

- Factors affecting price sensitivity
  1. Substitutes- fastfoods (price-elastic)
  2. Products and Service that are necessity – medicare (price-inelastic)
  3. Products that are expensive relative to consumer's income- cars (price-elastic)

# Customer Price Sensitivity and Cost

$$\text{Elasticity} = \frac{\text{Percentage change in quantity sold}}{\text{Percentage change in price}}$$

Assume that a retailer originally priced a private-label DVD player at \$90 and then raised the price to \$100. Before raising the price, the retailer was selling 1,500 units a week. When the price increased, sales dropped to 1,100 units per week. The calculation of the price elasticity is as follows:

$$\begin{aligned}\text{Elasticity} &= \frac{\text{Percentage change in quantity sold}}{\text{Percentage change in price}} \\ &= \frac{(\text{New quantity sold} - \text{Old quantity sold}) \div (\text{Old quantity sold})}{(\text{New price} - \text{Old price}) \div (\text{Old price})} \\ &= \frac{(1100 - 1500)/1500}{(10 - 9)/9} = \frac{-0.2667}{.1111} = -2.4005\end{aligned}$$

# Customer Price Sensitivity and Cost

Various factors affect the price sensitivity for a product. First, the more substitutes a product or service has, the more likely it is to be price-elastic (sensitive). For example, there are many alternatives for a riblet basket at a restaurant like Applebee's, and thus fast-food prices are typically price-elastic, but branded luxury goods have almost no substitutes and are price-inelastic (insensitive). Second, products and services that are necessities are price-inelastic. Thus, medical care is price-inelastic, whereas airline tickets for a vacation are price-elastic. Third, products that are expensive relative to a consumer's income are price-elastic. Thus, cars are price-elastic, and books and movie tickets tend to be price-inelastic. The estimated elasticities for some commonly purchased items are shown in the following table.<sup>1</sup>

Product Class	PRICE ELASTICITY	
	Short Run	Long Run
Clothing	-0.90	-2.90
Wine	-0.88	-1.17
Jewelry and watches	-0.44	-0.67
Gasoline	-0.20	-0.60

# Customer Price Sensitivity and Cost

$$\text{Profit-maximizing price} = \frac{\text{Price elasticity} \times \text{Cost}}{\text{Price elasticity} + 1}$$

So, if the private-label DVD player described in the preceding example costs \$50, the profit-maximizing price would be:

$$\begin{aligned}\text{Profit-maximizing price} &= \frac{\text{Price elasticity} \times \text{Cost}}{\text{Price elasticity} + 1} \\ &= \frac{-2.4005 \times \$50}{-2.4005 + 1} = \$85.70\end{aligned}$$

# Competition

- Retailers need to consider competitor's pricing when setting their own
- Routinely collect price data and adjust prices to remain competitive

# Pricing Strategies



Target is reinforcing its low prices by highlighting its price match guarantee.

# Pricing Strategy Used by Services Retailers

- The need to match supply and demand
- The difficulties customers in determining service quality



# Pricing Strategy Used by Services Retailers



Airlines use yield management to adjust prices in response to demand.

# Matching Supply and Demand

- Yield management is the practice of adjusting prices up or down in response to demand to control sales generated
- Computerized programs monitor the reservations and ticketing for each flight and adjust prices according to capacity utilization
- Prices are lowered on flights when sales are below forecasts and there is significant excess capacity
- As ticket sales approach capacity, prices are increased

# Determining Service Quality

- Often difficult for customers to assess service quality due to intangibility
- Assessment offered to fees charge, ie. Legal service
- Higher risk situations tend to arise in relation to credence services – legal, medical services, and even hair salons
- Need to carefully select price as customers depend on price as cue for quality and helps retailers in capacity management

# Setting Retail Prices

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# Setting Prices Based on Costs

- Retail price = Cost of merchandise + Markup

Retail price = Cost of merchandise + Markup

The **markup** is the difference between the retail price and the cost of an item. Thus, if a sporting goods retailer buys a tennis racket for \$75 and sets the retail price at \$125, the markup is \$50. The appropriate markup is the amount that covers all of the retailer's operating expenses (labor costs, rent, utilities, advertising, etc.) incurred to sell the merchandise and produces a profit for the retailer.

The **markup percentage** is the markup as a percentage of the retail price:

$$\text{Markup percentage} = \frac{\text{Retail price} - \text{Cost of merchandise}}{\text{Retail price}}$$

# Setting Prices Based on Costs

Thus, the markup percentage for the tennis racket is:

$$\text{Markup percentage} = \frac{\$125 - \$75}{\$125} = 40\%$$

The retail price based on the cost and markup percentage is:

$$\begin{aligned}\text{Retail price} &= \text{Cost of merchandise} + \text{Markup} \\ &= \text{Cost of merchandise} + \text{Retail price} \times \text{Markup percentage} \\ &= \frac{\text{Cost of merchandise}}{1 - \text{Markup percentage (as a fraction)}}\end{aligned}$$

Thus, if a buyer for an office supply category specialist purchases calculators at \$14 and needs a 30 percent markup to meet the financial goals for the category, the retail price needs to be:

$$\text{Retail price} = \frac{\text{Cost}}{1 - \text{Markup percentage}} = \frac{\$14.00}{1 - 0.30} = \$20$$

# Profit Impact of Setting a Retail Price: The Use of Break-Even Analysis

Retailers often want to know the number of units they need sell to begin making a profit. For example, a retailer might want to know:

- Break-even sales to generate a target profit.
- Break-even volume and dollars to justify introducing a new product, product line, or department.
- Break-even sales change needed to cover a price change.

A useful analytical tool for making these assessments is **break-even analysis**, which determines, on the basis of fixed and variable costs, how much merchandise needs to be sold to achieve a break-even (zero) profit.

The **break-even point quantity** is the quantity at which total revenue equals total cost, and then profit occurs for additional sales.

The formula for calculating the sales quantity needed to break even is:

$$\text{Break-even quantity} = \frac{\text{Total fixed costs}}{\text{Actual unit sales price} - \text{Unit variable cost}}$$

# Markdowns

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# Reasons for Taking Markdowns

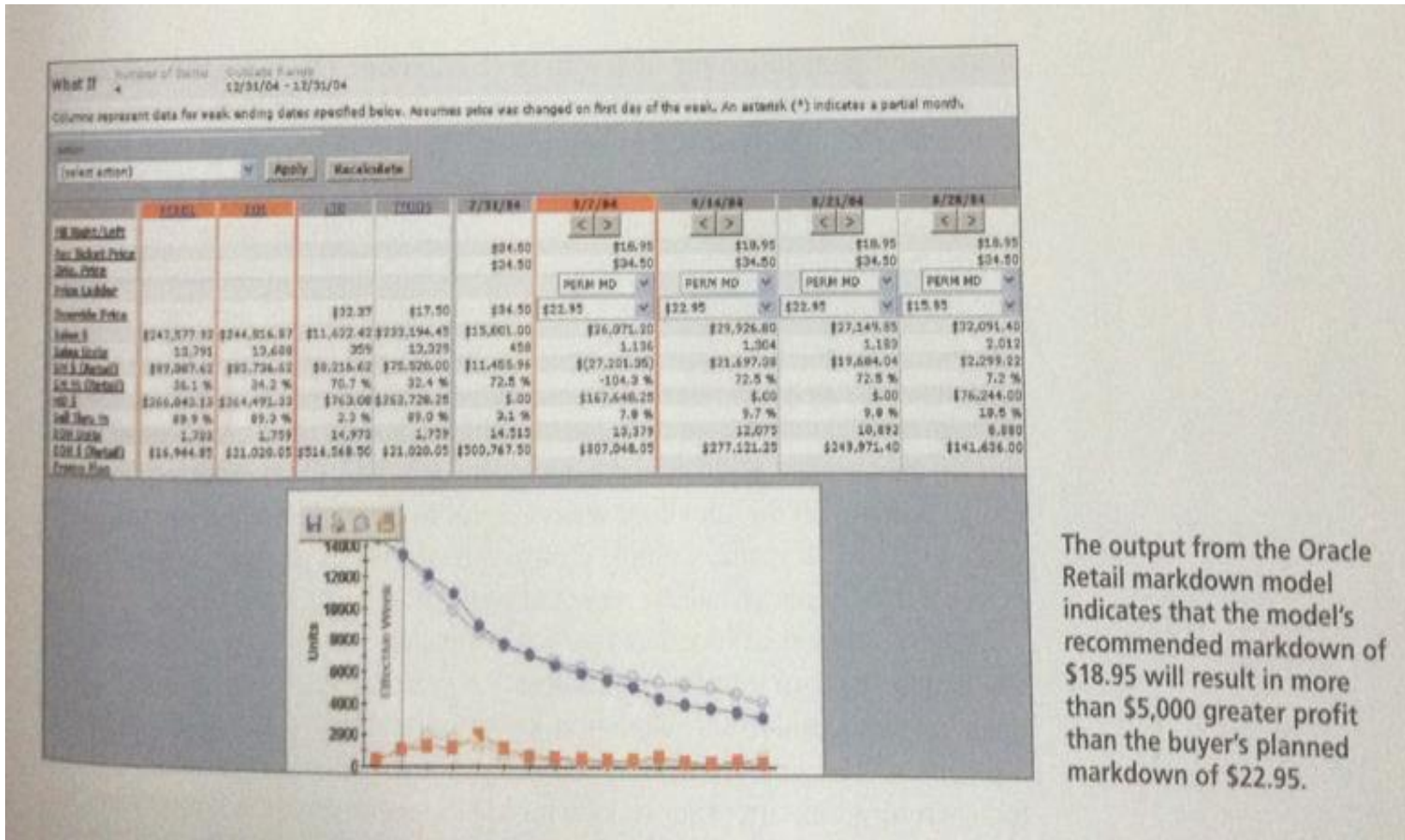
- Two reasons for taking markdowns
  1. Clearance – to dispose of merchandise
  2. Promotional- to generate sales

# Markdowns



Pricing Optimization software recognizes when sales for winter coats are slower than expected and suggests both the timing and amount of markdowns.

# Markdowns



# Pricing Techniques for Increasing Sales and Profits

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# Variable Pricing and Price Discrimination

- Individualized Variable Pricing – retailers could maximize their profits if they charged each customer as much as the customer was willing to pay
- First-degree price- Charging each individual customer a different price based on their willingness to pay, ie, auction bidding
  - legal, but difficult to assess customer's willingness to pay and retailer cannot change the posted prices

# Variable Pricing and Price Discrimination

The screenshot shows an eBay Motors listing for a 2008 Rolls-Royce Phantom Drophead Coupe. The listing includes a photo of the car, a current bid of US \$210,000.00, and a maximum bid of US \$215,000.00. The seller is located in Miami, Florida, and has a 100% positive feedback rating. The listing also features a 'Buy with Credit Card' button and a 'Vehicle History Report' link. The vehicle specifications are as follows:

Condition:	Used. A vehicle is considered used if it has been registered and issued a title. Used vehicles have had at least one owner.	VIN:	SCA2D8878UX16190   See the full history report
Year:	2008	Warranty:	Unspecified
Make:	Rolls-Royce	Vehicle Title:	Clear
Model:	Phantom	Options:	Sunroof
Mileage:	2,000	Safety Features:	Anti-Lock Brakes, Driver Side Air Bag
Sub Model:	Drophead Coupe	Power Options:	Air Conditioning, Cruise Control, Power Windows
Exterior Color:	Black	Fuel Type:	Gasoline
Interior Color:	Tan	For Sale By:	Dealer
		Days:	2

By selling on eBay Motors' online auction, this seller is using the first-degree price discrimination to get the highest price for Rolls Royce.

# Variable Pricing and Price Discrimination

- Dynamic pricing or individualized pricing refers to the process of charging different prices for goods and services based on the type of customer, time of day, week or even season, and level of demand
- Retailers may also charge customers different prices based on their loyalty status derived from their CRM systems – ie, the platinum customers receive lower prices than the silver ones

# Variable Pricing and Price Discrimination

- **Self-Selected Variable Pricing-** an alternative approach for dynamic pricing is to offer the same multiple-price schedule to all customers which encourages price-sensitive customers to take advantage of the lower price or also known as second-degree price discrimination

# Variable Pricing and Price Discrimination

- Second-degree price discrimination is when retailers offer
  - ❖ Promotional and clearance markdowns,
  - ❖ Coupons (Issued in newspapers, on products, on the shelf, at cash register, over the internet and mobile, via mail, in flyers)
  - ❖ Price bundling (KFC family meal 299 bt.)
  - ❖ Multi-unit pricing (quantity discounts)

# Coupons



Extreme couponing causes havoc on a retailer's supply chain when one customer buys all of a store's stock of a single SKU.

# Price Bundling



McDonald's uses price bundling when it combines a sandwich, French fries, and a soft drink in a value meal.

# Multi-Unit Pricing



Offering two or more similar products or services for sale at one lower price is called multiple-unit pricing.

# Variable Pricing and Price Discrimination

- Third-degree price discrimination : retailers charge different prices to different demographic market segments
- For example movie theaters have discounts for students and seniors



The sign features the Regency Theatres logo at the top, which includes a stylized 'X' shape above the text 'REGENCY THEATRES'. Below the logo, the title 'TICKET PRICES' is prominently displayed. The pricing information is listed in a clear, bold font, with categories and their corresponding prices.

Category	Price
ADULT	\$9.00
MATINEE*	\$7.00
SUNDAY'S	\$5.50
CHILDREN (2-11)	\$7.00
SENIOR (61 & better)	\$7.00
3D SURCHARGE	\$2.50



The advertisement features a background of faint mathematical equations and a cartoon boy pointing upwards. The main headline is in large, bold, red letters with a white outline. Below the headline, a sub-headline encourages students to use their passes. A list of ticket types and prices is presented in colored boxes, with the IMAX 3D ticket box including a small asterisk and explanatory text. At the bottom, a note directs students to the website for more details.

## MOST AFFORDABLE STUDENT TICKET YOU CAN GET!

Present your **STUDENT PASS** & enjoy movies at a special rate

Regular Tickets*	\$6.50
3D Movie Tickets*	\$9.00
IMAX Digital Tickets*	\$12.00
IMAX 3D Tickets* <small>*Except for Friday &amp; Opening Titles</small>	\$14.00

\*Terms & Conditions Apply • Visit [www.shaw.sg](http://www.shaw.sg) for more details

# Leader Pricing

- Leader Pricing or loss leader is the practice of pricing certain items lower than normal to increase traffic flow and boost sales of complementary products



# Price Lining

- Price Lining: Retailers frequently offer a limited number of predetermined price points within a merchandise category
- For example Kroger's vision for its store brands is to build loyalty among customers, with strong store brands that are exclusive to the retailer, it pursues a price lining store brand strategy to provide Kroger products to all customer segments

# Price Lining



When retailers like Kroger offer three SKUs for ice cream that reflect good, better, and best quality at three different price points, they are using a price lining technique.

# Odd Pricing

- Odd pricing refers to the practice of using a price that ends in a 9.



The practice of offering odd prices—a price that ends in an odd number, typically a 9—is more than 100 years old. Although empirical studies have mixed results, many retailers believe that the practice can increase profits.



**That's All Folks**