

Retail Pricing

CHAPTER 14



Questions

- What factors do retailers consider when pricing merchandise?
- What are the legal restrictions on retail pricing?
- How do retailers set retail prices?
- How do retailers make adjustments to prices over time and for different market segments?
- Why do some retailers have frequent sales while others attempt to maintain an everyday-low-price strategy?
- What pricing tactics do retailers use to influence consumer purchases?

Why is Pricing Important?

- Pricing decision is important because customers have alternatives to choose from and are more informed than ever before.
- Customers are in a position to seek good value.

$$\text{Value} = \frac{\text{perceived benefits}}{\text{price}}$$

- So, retailers can increase value and stimulate sales by increasing benefits or reducing price.



Pricing Strategies: High/Low Pricing

- Discount the initial prices through frequent sales promotions
- **Advantages**
 - Increases profits through price discrimination
 - Sales create excitement
 - Sells merchandise
- **Disadvantages**
 - Train people to buy on deal and wait
 - Have an adverse effect on profits



Pricing Strategies:

Everyday Low Pricing

- Emphasizes the continuity of retail prices at a level somewhere between the regular non-sale price and the deep-discount sale price of high/low retailers.
- Doesn't mean lowest price
- Retailers have adopted a low price guarantee policy to reinforce their EDLP strategy.
- Advantages:
 - Assures customers of low prices
 - Reduces advertising and operating expenses
 - Reduces stockouts and improves inventory management

Pricing Strategies

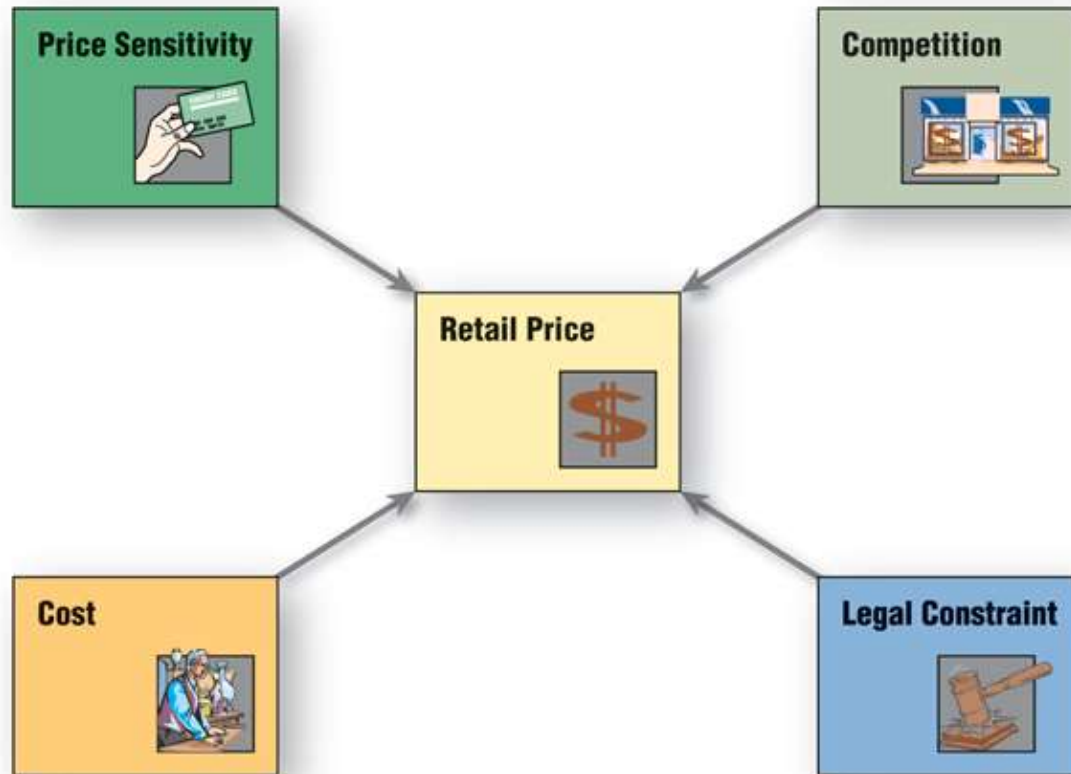
EDLP

- Assures customers low prices
- Reduces advertising and operating expenses
- Better supply chain management
 - Fewer stockouts
 - Higher inventory turns

Hi-Lo

- Higher profits
- More excitement
- Build short-term sales and generates traffic

Considerations in Setting Retail Prices



Customer Price Sensitivity and Cost

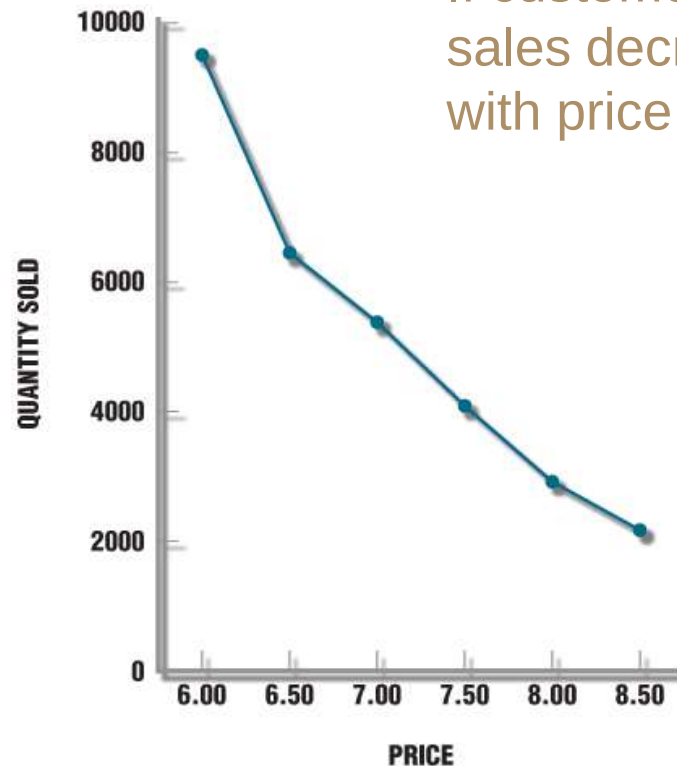
Price Experiment **EXHIBIT 14-1**

(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

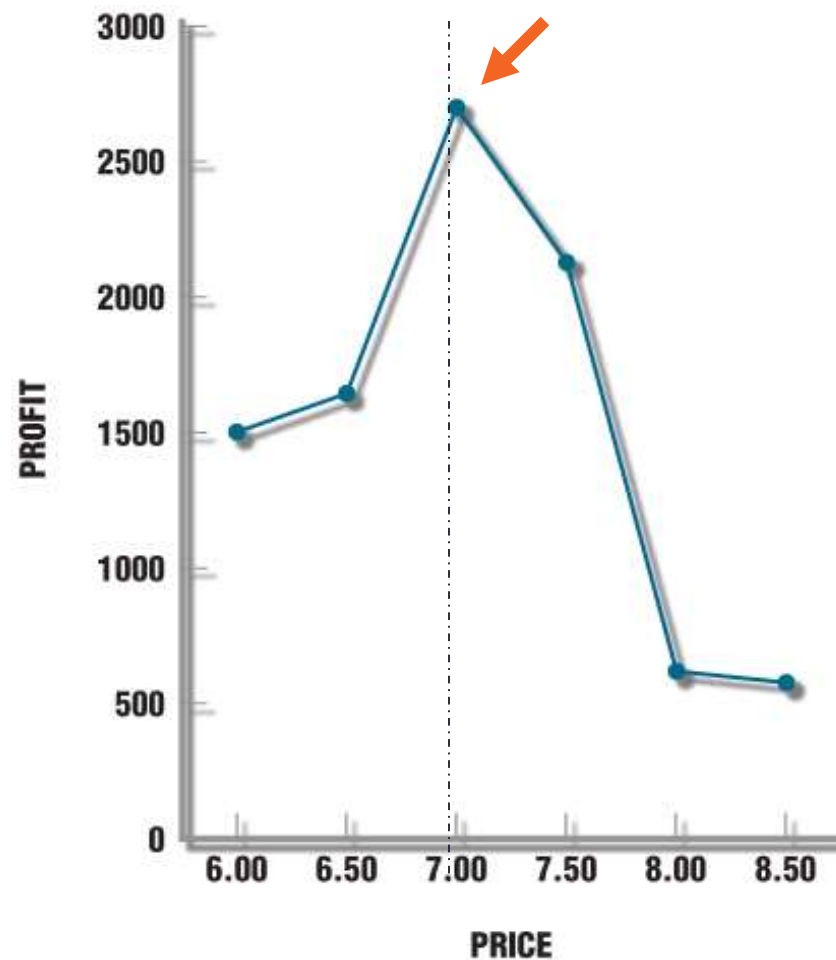
Price sensitivity of customers (demand curve)

Quantity Sold at Different Prices



If customers are very price sensitive, sales decrease significantly with price increases

Profit at Different Prices



Price Elasticity

A commonly used measure of price sensitivity:

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

How Can Retailers Reduce Price Competition?

- Develop lines of private label merchandise.
- Negotiate with national brands manufacturers for exclusive distribution rights.
- Have vendors make unique products for the retailer.

Pricing Services

Challenges due to :

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



Determining Service Quality

Customers are likely to use price as an indicator of both service costs and service quality This can depend on several factors:

Other information available to the customer
(Cues > Price)

- When service cues to quality are readily accessible
- When brand names provide evidence of a company's reputation
- When the level of advertising communicates the company's belief in the brand

The risk associated with the service purchase
(Price as a surrogate for quality)



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Setting Retail Prices

How Do Retailers Set Retail Prices?

Theoretically, retailers maximize their profits by setting prices on the basis of the price sensitivity of customers and the cost of merchandise.

In reality, retailers need to set price for over 50,000 SKUs many times during year.

- Set prices based on pre-determined markup and merchandise cost
- Make adjustments to markup price based on customer price sensitivity and competition

Retail Price and Markup (MU)

Margin
\$50



Markup as a Percent
of Retail Price
 $40\% = \$50/\125

$$\text{MU}\% = \frac{\text{retail price} - \text{cost}}{\text{retail price}}$$

Retail Price
\$125

Cost of
Merchandise
\$75

Retail Price = cost + markup

Retail Price

- Retail price = Cost of merchandise + Markup
- Retail price = Cost of merchandise + Retail price x Markup %
- Retail price =
$$\frac{\text{Cost of merchandise}}{1 - \text{Markup \%}}$$

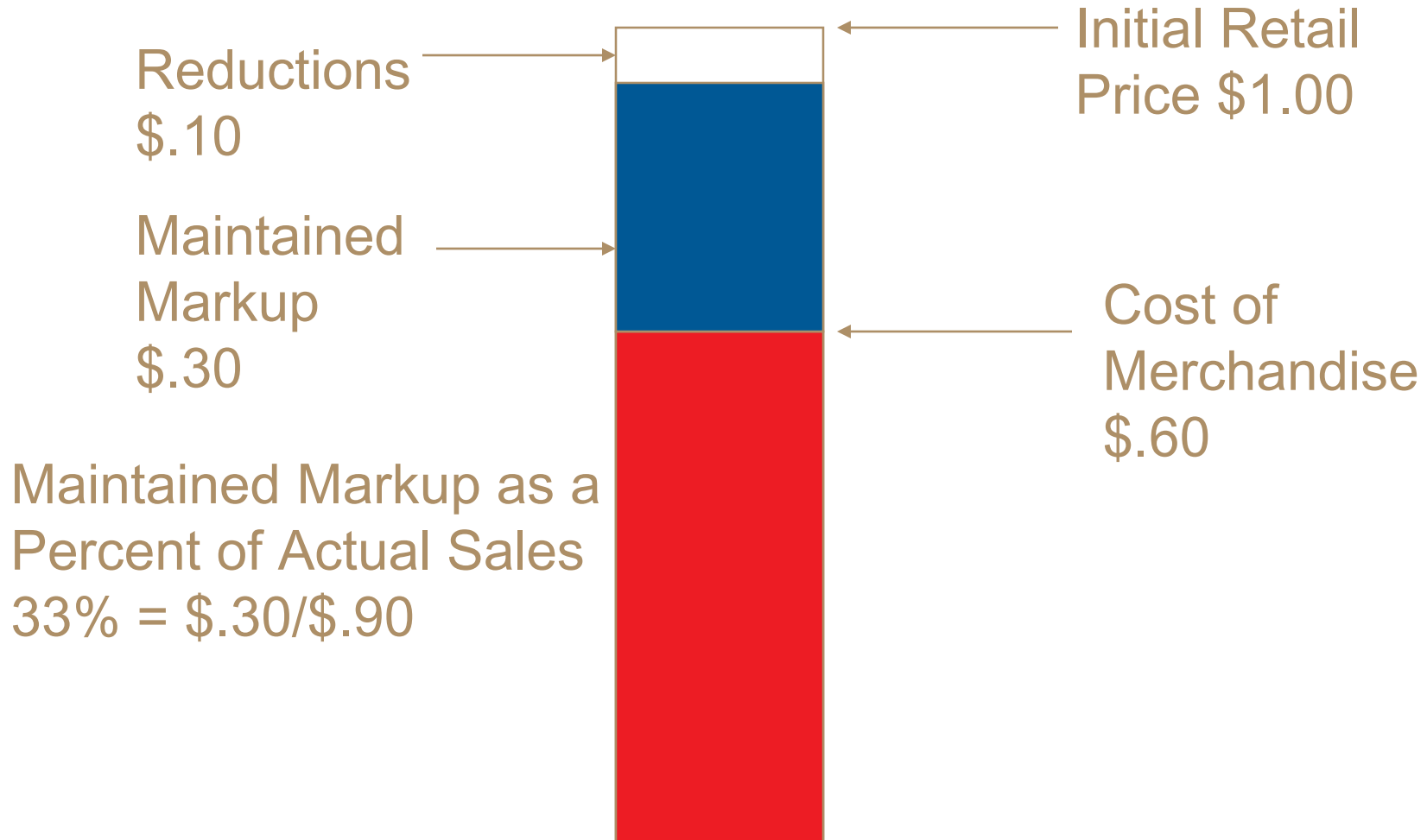
Markups

- Initial markup:
 - retail selling price initially set for the merchandise minus the cost of the merchandise.
- Maintained markup:
 - the actual sales realized for the merchandise minus its costs



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Initial and Maintained Markup



Initial Markup

$$\text{Initial markup \%} = \frac{\text{Maintained markup \% (as a percent of planned actual sales)} + \text{Reductions \% (as a percent of planned actual sales)}}{100\% + \text{Reductions \% (as a percent of planned actual sales)}}$$

Reductions



- Markdowns (Sales)
- Discounts to employees
- Inventory shrinkage due to shoplifting and employee theft

Initial Markup and Initial Retail Price

Merchandise costs \$.60. If the buyer planned on reductions of 10% of sales and wanted a maintained markup of 33% for the merchandise ,

$$\text{Initial markup \%} = \frac{33\% + (\$0.10/\$0.90 = 11.11\%)}{100\% + 11.11\%} = 40\%$$

$$\text{Initial retail price} = \frac{\text{Cost}}{1 - \text{Initial markup \%}} = \frac{\$0.60}{1 - 0.40} = \$1.00$$

Example of Setting the Initial Retail Price

Retail Price = \$100

Planned Initial Markup = 40% (of retail)

$\$100 = \text{Cost} + (40\% \times \text{Retail Price})$

Cost = \$60

Example of Setting the Initial Retail Price

Cost = \$100

Planned Initial Markup = 40% (of cost)

Retail Price = \$100 + (40% x Cost)

Retail Price = \$140

Retailers NEVER do it this way!

They think of markup as a percentage of the retail price.

Example of Setting the Initial Retail Price

Cost = \$100 Planned Initial Markup = 56.85%

Retail Price = \$100 + (56.85% x Retail Price)

Solve for Retail Price

.4315 x retail price = 100

Retail Price = \$100/.4315 = 231.75

**Initial Retail Price = Cost of Merchandise
(1-markup percentage)**

Price Optimization Software

- Setting prices by simply marking up merchandise cost neglect other factors (e.g., price sensitivity, competition, the sales of complementary products)
- Merchandising Optimization Software:
 - Utilizes a set of algorithms that analyzes past and current merchandise sales prices.
 - Estimates the relationship between prices and sales generated.
 - Determines the optimal (most profitable) initial price for the merchandise and size and timing for markdowns.

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

- 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.

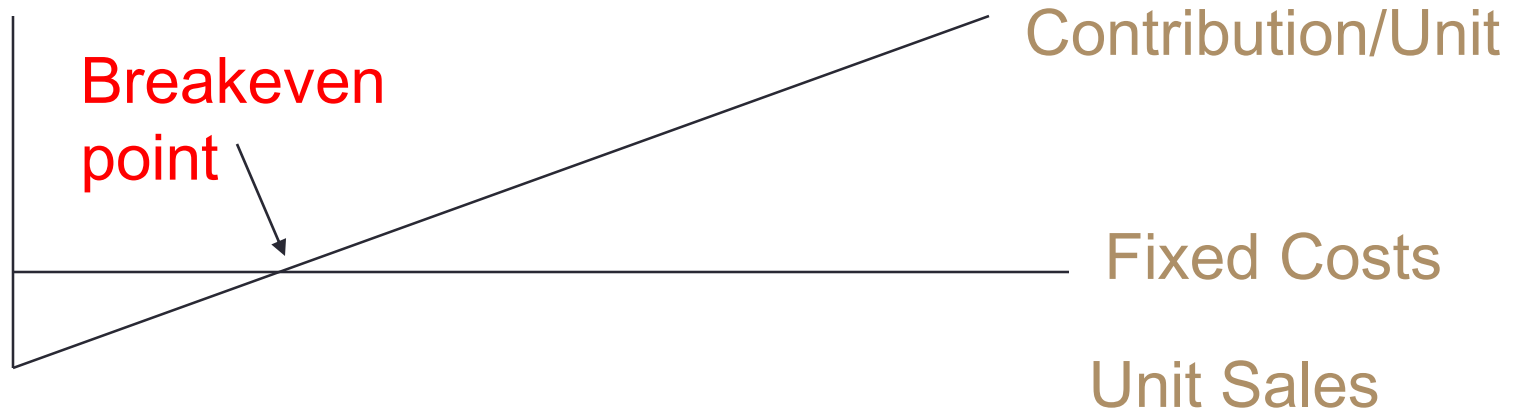


Profit Impact of Setting a Retail Price: The Use of Break-Even Analysis

- Break-even analysis:
 - Determines, on the basis of a consideration of fixed and variable costs, how much merchandise needs to be sold to achieve a break-even (zero) profit
 - Fixed costs: don't change with the quantity of product produced and sold.
 - Variable costs: vary directly with the quantity of product produced and sold (e.g., direct labor and materials used in producing a product)

Breakeven Analysis

Understanding the Implication of Fixed and Variable Cost



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

The quantity at which total revenue equals total cost, and then profit Occurs for additional sales

Price Adjustments

Retailers adjust prices over time (markdowns) and for different customer segments (variable pricing)

- Why do retailers take markdowns?
- How do they optimize markdown decisions?
- How do they reduce the amount of markdowns by working with vendors?
- How do they liquidate markdown merchandise?
- What are the mechanics of taking markdowns?

Reasons for Taking Markdowns

- **Clearance Markdowns** to get rid of slow-moving, obsolete merchandise
- **Promotional Markdowns**
 - To increase sales and promote merchandise
 - To increase traffic flow and sale of complementary products generate excitement through a sale
- To generate cash to buy additional merchandise



Optimizing Markdown Decisions

- Traditional Approach- Use a set of arbitrary rules
 - **Sell-Through**: Identifies markdown items when its weekly sell-through percentages fall below a certain level.
 - **Rule-based**: Cuts prices on the basis of how long the merchandise has been in the store.

Optimizing Markdown Decisions

- **Markdown Optimization**

- Software is used to determine when and how much markdowns should be taken to produce the best results by continually updating pricing forecasts on the basis of actual sales and factoring in differences in price sensitivities

Liquidating Markdown Merchandise

- Sell the merchandise to another retailer
- Consolidate the unsold merchandise
- Place merchandise on Internet auction site
- Donate merchandise to charity
- Carry the merchandise over to the next season



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Variable Pricing and Price Discrimination

- Retailers use a variety of techniques to maximize profits by charging different prices to different customers
- Individualized Variable Pricing (First Degree of Price Discrimination)
 - Set unique price for each customer equal to customer's willingness to pay
 - Auctions, Personalized Internet Prices

Variable Pricing and Price Discrimination

- Self-Selected Variable Pricing (Second Degree of Price Discrimination) – Offer the same price schedule to all customers
 - Quantity Discounts
 - Early Bird Special
 - Over Weekend Travel Discount

Variable Pricing and Price Discrimination

- Clearance markdowns for fashion merchandise
- Coupons
- Price bundling
 - McDonald's Value Meal
- Multiple-unit pricing or quantity discount
- Variable pricing by market segments (Third degree of price discrimination) – Charge different groups different prices
 - Seniors discounts
 - Kids menu
- Zone Pricing (Third Degree of Price Discrimination) – Charge different prices in different stores, markets, regions

Solution to Problems in Implementing Price Discrimination

- Set prices based on customer characteristics related to willingness to pay
- Fashion sensitive customers will pay more so charge higher prices when fashion first introduced – reduce price later in season
- Price sensitive customers will expend effort to get lower prices – coupons
- Elderly customers eat earlier and are more price sensitive so offer early bird specials



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Pricing Techniques for Increasing Sales

- Leader Pricing
- Price Lining
- Odd Pricing



Leader Pricing

- Certain items are priced lower than normal to increase customers traffic flow and/or boost sales of complementary products
- Best items: purchased frequently, primarily by price-sensitive shoppers
- Examples: bread, eggs, milk, disposable diapers
- Might attract cherry pickers



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Price Lining

- A limited number of predetermined price points.
- Ex: \$59.99 (good), \$89.99 (better), and 129.99 (best)
- Benefits:
 - Eliminates confusion of many prices
 - Merchandising task is simplified
 - Gives buyers flexibility
 - Can get customers to “trade up”

Odd Pricing

- A price that ends in an odd number (.9)
- \$2.99
 - Assumption:
 - Consumers perceive as \$2 without noticing the digits
 - 9 endings signal low prices
 - Retailers believe the practice increases sales, but probably doesn't
- Does delineate:
 - Type of store (downscale store might use it.)
 - Sale

Internet and Price Competition

- The Internet offers unlimited shopping experience.
- Seeking lowest price? Use shopping bots or search engines.
- These programs search for and provide lists of sites selling what interests the consumer.
- Retailers using the electronic channel can reduce customer emphasis on price by providing services and better information.



Legal and Ethical Pricing Issues

- [Price Discrimination](#)
- [Predatory Pricing](#)
- [Resale Price Maintenance](#)
- [Horizontal Keywords](#)Price fixing
- [Bait Keywords and Switch tactics](#)
- Scanned vs. Posted Prices



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