

The Science & the Art of Pricing & Revenue Management

Kelley M. Lynch

Summary of what we will review:

Pricing is both a **Science** and an **Art**:

- The science tells you what the data says
- The art is deciding what the customer will value, how you communicate that value, and when to act.

I am going to focus on how to think about pricing when you are building a business.

- What do you hope to learn today?
- If you could leave today knowing one thing about pricing, what would it be?



Pricing is a
Business
Decision NOT
a Math
Problem



Exercise: If you were starting a new business in the food industry, how much would you charge for a cup of coffee?

Shout out answers

What Information did you use to arrive at that number?



There isn't a "right"
price. There is a right
price for a particular
customer, product,
market and business
model

Pricing sits at the intersection of:

***Finance → Economics → Marketing →
Psychology → Strategy***

*You must choose what pricing
strategy works best for your business*

Quick Example of a Pricing Decision

	Option 1	Option 2	Variance
Price:	\$10	\$12	+\$2
Variable Cost:	\$ 6	\$ 6	--
Contribution:	\$ 4	\$ 6	+\$2
Quantity Sold:	1000	800	(200)
Total Revenue:	\$10,000	\$9,600	(\$400)
Total Contribution	\$4,000	\$4,800	+\$800

Which one would you choose?

What information would you need before making the decision?

The Entrepreneurs Pricing Decision

There are three
variables that you
need to understand
for pricing

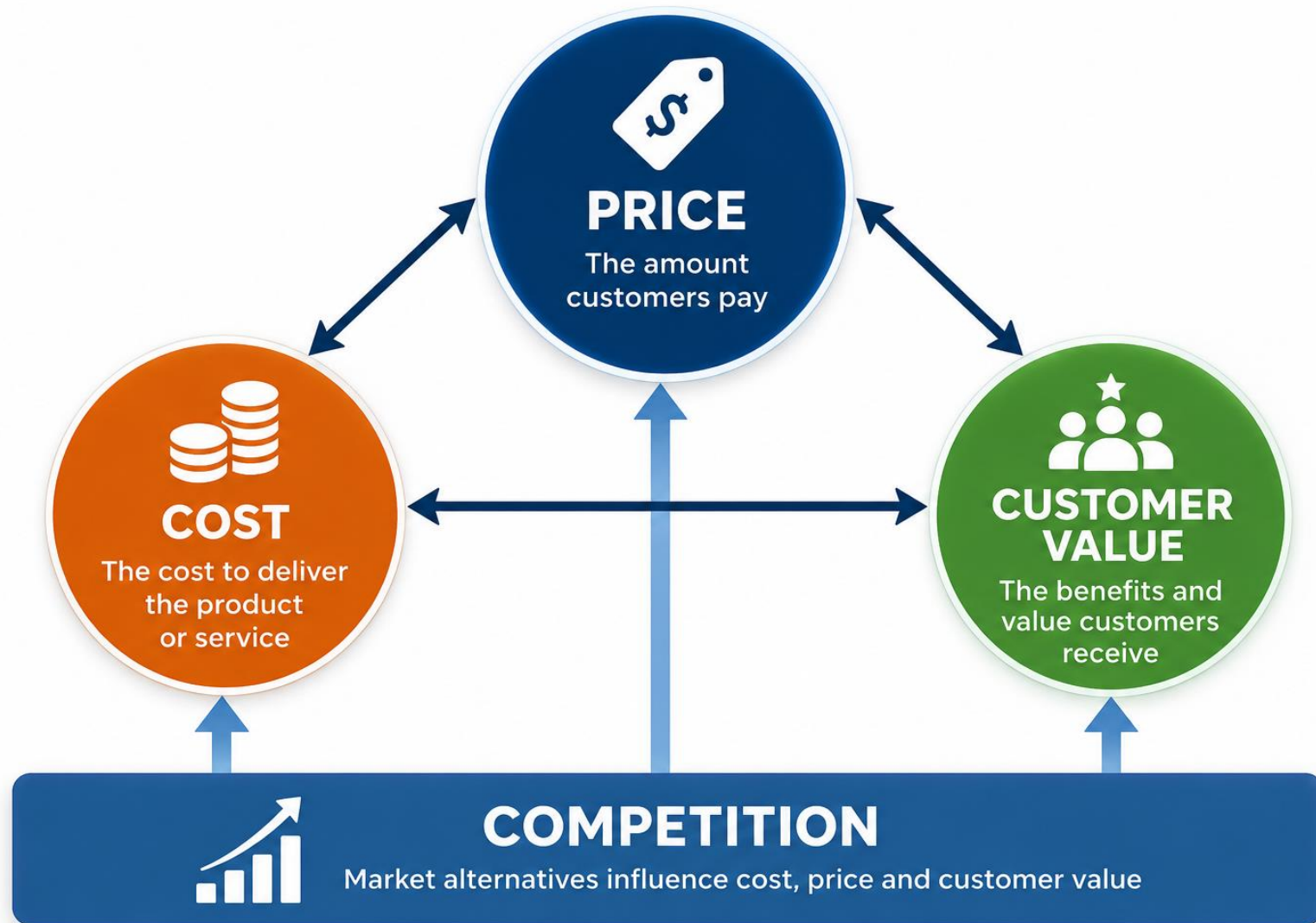
Your costs

The Competition

- Internal & External

Customer Value

- What problem are you solving –
and what is that problem worth to
the customer





The Science of Pricing

First – let's understand Price Elasticity and its effect on Revenue

Price elasticity is not just about whether customers buy less when you raise price.

It is about how sensitive demand is to the price change.

Let's review a couple of examples:

Example 1	Option 1	Option 2	% Var
Unit Price	\$100	\$110	10%
# of Customers	1000	850	-15%
Revenue	\$100,000	\$93,500	-6.5%

Example 2	Option 1	Option 2	% Var
Unit Price	\$100	\$110	10%
# of Customers	1000	970	-3%
Revenue	\$100,000	\$106,700	6.7%

Elasticity shows how much does demand change when price changes

Now we need to look at how this decision affects the bottom line

Contribution Margin and Break-Even

Contribution Margin

Contribution Margin funds the business

- Calculation: Price less Variable Cost = Contribution Margin
- Determines how much a product contributes to covering fixed costs
- Example of Contribution Margin:

Per Unit:	
Price	\$100
Variable Cost	\$ 40
Contribution Margin	\$ 60

Break Even

- What does the total Contribution Margin need to be to cover your fixed costs?
- If your Fixed Costs are \$60,000, then based on the previous per unit Contribution of \$60, you would need to sell 1,000 units to break even ($\$60,000 / \$60 = 1,000$)

So here are examples of why pricing matters:

Per Unit:	<u>Option 1</u>	<u>Option 2</u>	<u>Option 3</u>
Price	\$100	\$90	\$120
Variable Costs	\$40	\$40	\$40
Contribution	\$60	\$50	\$80
Fixed Costs	\$60,000	\$60,000	\$60,000
Breakeven # of Units	1000	1200	750

Pricing doesn't just determine how much money you make. It determines how many customers you need to survive.

The Art of Pricing

Everything we have discussed so far assumes customers behave rationally and they would follow the easy math. But as we all know – they/we don't always act rationally.

Behavioral Pricing

Anchoring	\$150 → \$75
Decoy Pricing	Basic: \$10 Pro: \$20 Premium: \$23
Framing	\$100/month or \$3.30/day Vs \$1200/Year
Choice Architecture	Instead of asking, “which product do you want?” You can ask, “Which of these three solutions best fit your needs?”

Are these actually different prices? Or are we changing how the customer perceives the price?

Value-Based Pricing

Cost Plus Pricing vs Value-Based Pricing

- It costs us \$50, so we will charge \$75 vs.
- This will save our customers \$15,000 a year. What is that value worth?

Example: What is your software worth?

Your software saves a company:

10 hours/week

X \$30/hour

X 50 weeks/year

= \$15,000 annual value created

What would you charge?

\$500, \$1,000, \$5000, \$10,000....



What is the answer?

There isn't enough information yet to know.

Because you still need to understand:

- How important is the problem?
- How urgent is it?
- Who is the buyer?
- What alternatives exist?
- How much does the customer trust you?
- How difficult is implementation?
- How much of the \$15,000 value can you capture?
- What are your company's objectives?

Real World Pricing Models

Model	Example	Why it works
One-time purchase	Furniture	Simple
Subscription	SaaS	Recurring revenue
Freemium	Software	Reduces adoption barrier
Usage-based	Cloud computing	Price tracks consumption
Tiered	SaaS	Captures different willingness to pay
Marketplace	Airbnb	Monetizes transactions
Commission	Sales platforms	Aligns revenue with customer activity
Dynamic pricing	Airlines	Matches price to demand
Bundling	Cable/streaming	Increases perceived value

Don't ask: “What should I charge?”

Ask: “What pricing structure best aligns my revenue with the value my customer receives?”

Price is **NOT** the business model.

Price is **PART** of the business
model

Pricing must involve many disciplines to help determine

Revenue Management is selling
the right product,
to the right customer,
at the right price,
at the right time.

*Let's review a very familiar pricing strategy we all have seen
in the Airline Industry*



The same seat can sell for:

\$199 → \$299 → \$499

The product hasn't necessarily changed.

What did change?

- Demand
- Timing
- Customer segment
- Remaining inventory
- Competitive environment
- Willingness to pay

Circling back to the Pricing Triangle, you should ask yourself:

Who is my customer? –
not everyone

What problem am I
solving? – be specific

What is the problem
worth? – quantify the
value if possible

What alternatives do
my customers have? –
both external and
internal

What does my data tell
me? – price, volume,
conversion, retention,
profitability, what are my
revenue/customer goals

How might
psychology/behavior
affect the customer's
decision?

What happens if I am
wrong?

If you are
wrong – then
make
changes!

Pricing is a hypothesis.

SET IT → TEST IT → MEASURE IT → LEARN → ADJUST

You don't have to get pricing perfect on Day 1.

You do have to be willing to learn.

Pricing is both science and art:

The data tells you what happened and your
judgement decides what you try next



REVIEW WHY YOU CAME HERE
TODAY AND WHAT YOU HOPED TO
LEARN ABOUT PRICING



WHAT CHANGED IN HOW YOU THINK
ABOUT PRICING?

Any Additional Questions?