15

Pricing Strategies

The real price of everything is the toil and trouble of acquiring it.

ADAM SMITH

Pricing has traditionally been considered a me-too variable in marketing strategy. The stable economic conditions that prevailed during the 1960s may be particularly responsible for the low status ascribed to the pricing variable. Strategically, the function of pricing has been to provide adequate return on investment. Thus, the timeworn cost-plus method of pricing and its sophisticated version, return-on-investment pricing, have historically been the basis for arriving at price. In the 1970s, however, a variety of events gave a new twist to the task of making pricing decisions. Double-digit inflation, material shortages, the high cost of money, consumerism, and Post-price controls behavior all made pricing important. Since then pricing continues to play a key role in formulating marketing strategy.

Despite the importance attached to it, effective pricing is not an easy task, even under the most favorable conditions. A large number of internal and external variables must be studied systematically before price can be set. For example, the reactions of a competitor often stand out as an important consideration in developing pricing strategy. Simply knowing that a competitor has a lower price is insufficient; a price strategist must know how much flexibility a competitor has in further lowering price. This presupposes a knowledge of the competitor's cost structure. In the dynamics of today's environment, however, where unexpected economic changes can render cost and revenue projections obsolete as soon as they are developed, pricing strategy is much more difficult to formulate.

This chapter provides a composite of pricing strategies. Each strategy is examined for its underlying assumptions and relevance in specific situations. The application of different strategies is illustrated with examples from pricing literature. The appendix at the end of this chapter summarizes each strategy by giving its definition, objectives, requirements, and expected results.

REVIEW OF PRICING FACTORS

Basically, a pricer needs to review four factors to arrive at a price: pricing objectives, cost, competition, and demand. This section briefly reviews these factors, which underlie every pricing strategy alternative.

Pricing Objectives

Broadly speaking, pricing objectives can be either profit oriented or volume oriented. The profit-oriented objective may be defined either in terms of desired net profit percentage or as a target return on investment. The latter objective has been more popular among large corporations. The volume-oriented objective may be stated as the percentage of market share that the firm would like to achieve. Alternatively, it may simply be stated as the desired sales growth rate. Many firms also consider the maintenance of a stable price as a pricing goal. Particularly in cyclical industries, price stability helps to sustain the confidence of customers and thus keeps operations running smoothly through peaks and valleys.

For many firms, there can be pricing objectives other than those of profitability and volume, as shown in Exhibit 15-1. Each firm should evaluate different objectives and choose its own priorities in the context of the pricing problems that it may be facing. The following list contains illustrations of typical pricing problems:

1. Decline in sales.
2. Higher or lower prices than competitors.
3. Excessive pressure on middlemen to generate sales.
4. Imbalance in product line prices.
5. Distortion vis-à-vis the offering in the customer's perceptions of the firm's price.
6. Frequent changes in price without any relationship to environmental realities.

EXHIBIT 15-1
Potential Pricing Objectives

1. Maximum long-run profits
2. Maximum short-run profits
3. Growth
4. Stabilize market
5. Desensitize customers to price
6. Maintain price-leadership arrangement
7. Discourage entrants
8. Speed exit of marginal firms
9. Avoid government investigation and control
10. Maintain loyalty of middlemen and get their sales support
11. Avoid demands for "more" from suppliers
12. Enhance image of firm and its offerings
13. Be regarded as "fair" by customers (ultimate)
14. Create interest and excitement about the item
15. Be considered trustworthy and reliable by rivals
16. Help in the sale of weak items in the line
17. Discourage others from cutting prices
18. Make a product "visible"
19. "Spoil market" to obtain high price for sale of business
20. Build traffic

Source: Alfred R. Oxenfeldt, "A Decision-Making Structure for Price Decisions," *Journal of Marketing* (January 1973): 50. Reprinted by permission of the American Marketing Association.

These problems suggest that a firm may have more than one pricing objective, even though these objectives may not be articulated as such. Essentially, pricing objectives deal directly or indirectly with three areas: profit (setting a high enough price to enable the company to earn an adequate margin for profit and reinvestment), competition (setting a low enough price to discourage competitors from adding capacity), and market share (setting a price below competition to gain market share).

As an example of pricing objectives, consider the goals that Apple Computer set for Macintosh:[1]

1. To make the product affordable and a good value for most college students.
2. To get certain target market segments to see the Macintosh as a better value than the IBM PC.
3. To encourage at least 90 percent of all Apple retailers to carry the Macintosh while providing a strong selling effort.
4. To accomplish all this within 18 months.

Cost

Fixed and variable costs are the major concerns of a pricer. In addition, the pricer may sometimes need to consider other types of costs, such as out-of-pocket costs, incremental costs, opportunity costs, controllable costs, and replacement costs.

To study the impact of costs on pricing strategy, the following three relationships may be considered: (a) the ratio of fixed costs to variable costs, (b) the economies of scale available to a firm, and (c) the cost structure of a firm vis-à-vis competitors. If the fixed costs of a company in comparison to its variable costs form a high proportion of its total costs, adding sales volume will be a great help in increasing earnings. Consider, for example, the case of the airlines, whose fixed costs are as high as 60 to 70 percent of total costs. Once fixed costs are recovered, any additional tickets sold add greatly to earnings. Such an industry is called volume sensitive. There are some industries, such as the consumer electronics industry, where variable costs constitute a higher proportion of total costs than do fixed costs. Such industries are price sensitive because even a small increase in price adds much to earnings.

If the economies of scale obtainable from a company's operations are substantial, the firm should plan to expand market share and, with respect to long-term prices, take expected declines in costs into account. Alternatively, if operations are expected to produce a decline in costs, then prices may be lowered in the long run to gain higher market share.

If a manufacturer is a low-cost producer relative to its competitors, it will earn additional profits by maintaining prices at competitive levels. The additional profits can be used to promote the product aggressively and increase the overall market share of the business. If, however, the costs of a manufacturer are high compared to those of its competitors, the manufacturer is in no position to reduce prices because that tactic may lead to a price war that it would most likely lose.

Different elements of cost must be differently related in setting price. Exhibit 15-2 shows, for example, how computations of full cost, incremental cost, and

EXHIBIT 15-2
Effect of Costs on Pricing

Cost Pricing

Costs	*Product A*	*Product B*
Labor (L)	$ 80	$120
Material (M)	160	80
Overhead (O)	40	80
Full cost (L + M + O)	280	280
Incremental cost (L + M)	240	200
Conversion cost (L + O)	120	200

Product Line Pricing

	Markup (M′)	*Product A*	*Product B*
Full-Cost Pricing			
P = FC + (M′)FC	20%	$336	$336
Incremental-Cost Pricing			
P = (L + M) + M′(L + M)	40%	336	280
Conversion-Cost Pricing			
P = (L + O) + M′(L + O)	180%	336	560

conversion cost may vary and how these costs affect product line prices. Exhibit 15-3 shows the procedure followed for setting target-return pricing.

Competition

Exhibit 15-4 shows the competitive information needed to formulate a pricing strategy. The information may be analyzed with reference to these competitive characteristics: number of firms in the industry, relative size of different members of the industry, product differentiation, and ease of entry.

EXHIBIT 15-3
Computation of Target-Return Pricing

Manufacturing capacity	200,000
Standard volume (80%)	160,000
Standard full cost before profit	$100/unit
Target profit	
Investment	$20,000,000
ROI target	20%
ROI target	$4,000,000
Profit per unit at standard ($4,000,000 ÷ 160,000)	$25/unit
Price	$125/unit

EXHIBIT 15-4
Competitive Information Needed for Pricing Strategy

1. Published competitive price lists and advertising
2. Competitive reaction to price moves in the past
3. Timing of competitors' price changes and initiating factors
4. Information on competitors' special campaigns
5. Competitive product line comparison
6. Assumptions about competitors' pricing/marketing objectives
7. Competitors' reported financial performance
8. Estimates of competitors' costs—fixed and variable
9. Expected pricing retaliation
10. Analysis of competitors' capacity to retaliate
11. Financial viability of engaging in price war
12. Strategic posture of competitors
13. Overall competitive aggressiveness

In an industry where there is only one firm, there is no competitive activity. The firm is free to set any price, subject to constraints imposed by law. As an Illinois Bell executive said about pricing (before the AT&T split): "All we had to do was determine our costs, and then we would go to the commission—the Illinois Commerce Commission, and they would give us the allowable rate of return."[2] Conversely, in an industry comprising a large number of active firms, competition is fierce. Fierce competition limits the discretion of a firm in setting price. Where there are a few firms manufacturing an undifferentiated product (such as in the steel industry), only the industry leader may have the discretion to change prices. Other industry members will tend to follow the leader in setting price.

The firm with a large market share is in a position to initiate price changes without worrying about competitors' reactions. Presumably, a competitor with a large market share has the lowest costs. The firm can, therefore, keep its prices low, thus discouraging other members of the industry from adding capacity, and further its cost advantage in a growing market.

If a firm operates in an industry that has opportunities for product differentiation, it can exert some control over pricing even if the firm is small and competitors are many. This latitude concerning price may occur if customers perceive one brand to be different from competing brands: whether the difference is real or imaginary, customers do not object to paying a higher price for preferred brands. To establish product differentiation of a brand in the minds of consumers, companies spend heavily for promotion. Product differentiation, however, offers an opportunity to control prices only within a certain range.

In an industry that is easy to enter, the price setter has less discretion in establishing prices; if there are barriers to market entry, however, a firm already in the industry has greater control over prices. Barriers to entry may take any of the following forms:

1. Capital investment.
2. Technological requirements.
3. Nonavailability of essential materials.
4. Economies of scale that existing firms enjoy and that would be difficult for a newcomer to achieve.
5. Control over natural resources by existing firms.
6. Marketing expertise.

In an industry where barriers to entry are relatively easy to surmount, a new entrant will follow what can be called *keep-away pricing*. This pricing strategy is necessarily on the lower side of the pricing spectrum.

Demand

Exhibit 15-5 contains the information required for analyzing demand. Demand is based on a variety of considerations, of which price is just one. Some of these considerations are

1. Ability of customers to buy.
2. Willingness of customers to buy.
3. Place of the product in the customer's lifestyle (whether a status symbol or a product used daily).
4. Benefits that the product provides to customers.
5. Prices of substitute products.
6. Potential market for the product (is demand unfulfilled or is the market saturated?).

EXHIBIT 15-5
Customer Information Needed for Pricing Strategy

1. The customer's value analysis of the product: performance, utility, profit-rendering potential, quality, etc.
2. Market acceptance level: the price level of acceptance in each major market, including the influence of substitutes.
3. The price the market expects and the differences in different markets.
4. Price stability.
5. The product's S curve and its present position on it.
6. Seasonal and cyclical characteristics of the industry.
7. The economic conditions now and during the next few periods.
8. The anticipated effect of recessions; the effect of price change on demand in a declining market (e.g., very little with luxury items).
9. Customer relations.
10. Channel relations and channel costs to figure in calculations.
11. The markup at each channel level (company versus intermediary costs).
12. Advertising and promotion requirements and costs.
13. Trade-in, replacement parts, service, delivery, installation, maintenance, preorder and postorder engineering, inventory, obsolescence, and spoilage problems and costs.
14. The product differentiation that is necessary.
15. Existing industry customs and reaction of the industry.
16. Stockholder, government, labor, employee, and community relations.

7. Nature of nonprice competition.
8. Customer behavior in general.
9. Segments in the market.

All these factors are interdependent, and it may not be easy to estimate their relationship to each other precisely.

Demand analysis involves predicting the relationship between price level and demand while considering the effects of other variables on demand. The relationship between price and demand is called elasticity of demand or sensitivity of price. E**lasticity of demand** refers to the number of units of a product that would be demanded at different prices. Price sensitivity should be considered at two different levels: total industry price sensitivity and price sensitivity for a particular firm.

Industry demand for a product is considered to be elastic if, by lowering prices, demand can be substantially increased. If lowering price has little effect on demand, demand is considered inelastic. The environmental factors previously mentioned have a definite influence on demand elasticity. Let us illustrate with a few examples. During the energy crisis, the price of gasoline went up, leading consumers to reduce gasoline usage. By the same token, since gasoline prices have gone down, people have again started using gas more freely. Thus, demand for gasoline can be considered somewhat elastic.

A case of inelastic demand is provided by salt. No matter how much the price fluctuates, people are not going to change the amount of salt that they consume. Similarly, the demand for luxury goods, yachts, for example, is inelastic because only a small proportion of the total population can afford to buy yachts.

Sometimes the market for a product is segmented so that demand elasticity in each segment must be studied. The demand for certain types of beverages by senior citizens might be inelastic, though demand for the same products among a younger audience may be especially elastic. If the price of a product goes up, customers have the option of switching to another product. Thus, availability of substitute products is another factor that should be considered.

When the total demand of an industry is highly elastic, the industry leader may take the initiative to lower prices. The loss in revenue due to decreased prices will be more than compensated for by the additional demand expected to be generated; therefore, the total dollar market expands. Such a strategy is highly attractive in an industry where economies of scale are achievable. Where demand is inelastic and there are no conceivable substitutes, price may be increased, at least in the short run. In the long run, however, the government may impose controls, or substitutes may be developed.

The demand for the products of an individual firm derives from total industry demand. An individual firm is interested in finding out how much market share it can command by changing its own prices. In the case of undifferentiated standardized products, lower prices should help a firm increase its market share as long as competitors do not retaliate by matching the firm's prices. Similarly, when business is sought through bidding prices, lower prices should help achieve the firm's objectives. In the case of differentiated products, however, market share can be improved even when higher prices are maintained (within a certain range). Products may be differentiated in various real and imaginary ways. For example, by providing adequate guarantees and after-sale service, an appliance manufacturer may maintain higher prices and still increase market share. Brand name, an image of prestige, and the perception of high quality are other factors that may help to differentiate a product in the marketplace and thus create an opportunity for the firm to increase prices and not lose market share. Of course, other elements of the marketing mix should reinforce the product's image suggested by its price. In brief, a firm's best opportunity lies in differentiating the product and then communicating this fact to the customer. A differentiated product offers more opportunity for increasing earnings through price increases.

The sensitivity of price can be measured by taking into account historical data, consumer surveys, and experimentation. Historical data can either be studied intuitively or analyzed through quantitative tools, such as regression, to see how demand goes up or down based on price. A consumer survey to study the sensitivity of prices is no different from any other market research study. Experiments to judge what level of price generates what level of demand can be conducted either in a laboratory situation or in the real world. For example, a company interested in studying the sensitivity of prices may introduce a newly developed grocery product in a few selected markets for a short period at different prices. Information obtained from this experiment should provide insights into the elasticity of demand for the product. In one study, the prices of 17 food products were varied in 30 food stores. It was found that the product sales generally followed the law of demand: when prices were raised 10 percent, sales decreased about 25 percent; a price increase of 5 percent led to a decrease in sales of about 13 percent; a lowering of prices by 5 percent increased sales by 12 percent; and a 10 percent decrease in price improved sales by 26 percent. In another study, a new deodorant that was priced at 63 cents and at 85 cents in different markets resulted in the same volume of sales. Thus, price elasticity was found to be absent, and the manufacturer set the product price at 85 cents.[3]

A recent study of the top 500 brands in the United Kingdom showed that a 10% price cut produced an 18.5% increase in sales. This excludes a small group of mainly luxury brands with a positive price elasticity whose sales increase when their price goes up. The study found wide variation across brands and categories. The household cleaning products were much less price-sensitive than, say dairy and bakery products.[4]

To conclude this discussion on pricing factors, it would not be out of place to say that, while everybody thinks businesses go about setting prices scientifically, very often the process is incredibly arbitrary. Packaged goods companies for example, have long recognized that pricing is a key lever in managing brands for profitability. Yet it is so neglected at present that improving price management can raise margins substantially. Companies seeking to capture this potential must make efforts to understand the behavior of consumers and find ways to apply this understanding to the thousands of frontline pricing decisions they make every year. Although businesses of all types devote a great deal of time and study to determine the prices to put on their products, pricing is often more art than science. In some cases, setting prices does involve the use of a straightforward equation: material and labor costs + overhead and other expenses + profit = price. But in many other cases, the equation includes psychological and other such subtle subjective factors that the pricing decision may essentially rest on gut feeling. Exhibit 15-6 suggests one way of combining information on different pricing factors to make an objective pricing decision in industrial marketing. For example, price sensitivity, visibility to competition, and strength of supplier relationships are used to rank various customers, allowing a different pricing strategy to be adopted for each customer to effectively achieve profit, share, and communication objectives.

The following eight steps deal with the essentials of setting the right price and then monitoring that decision so that the benefits are sustainable.[5]

1. Assess what value your customers place on a product or service.
2. Look for variations in the way customers value the product
3. Assess customers' price sensitivity.
4. Identify an optimal pricing structure.
5. Consider competitors' reactions.
6. Monitor prices realized at the transaction level.
7. Assess customers' emotional response.
8. Analyze whether the returns are worth the cost to serve.

The above eight steps assess the factors affecting price. Companies need to assess their customers to discover how a product or service is valued. Variations in the way customers value the same product may be turned to a company's benefit through clever pricing.

EXHIBIT 15-6
Pricing Guide

<table>
<tr><th rowspan="2">Company Relationship with Customer (Leverage)</th><th rowspan="2">Visibility of Price to Competition (Knowledge)</th><th colspan="2">Customer's Price Sensitivity</th></tr>
<tr><th>Low</th><th>High</th></tr>
<tr><td rowspan="2">Strong</td><td>High</td><td>To gain profit and communicate high price</td><td rowspan="2">To maintain share and communicate willingness to fight</td></tr>
<tr><td>Low</td><td>To gain profit</td></tr>
<tr><td rowspan="2">Weak</td><td>High</td><td colspan="2">To communicate high price</td></tr>
<tr><td>Low</td><td colspan="2">To gain share</td></tr>
</table>

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PRICING STRATEGY FOR NEW PRODUCTS

The pricing strategy for a new product should be developed so that the desired impact on the market is achieved while the emergence of competition is discouraged. Two basic strategies that may be used in pricing a new product are skimming pricing and penetration pricing.

Skimming Pricing

Skimming pricing is the strategy of establishing a high initial price for a product with a view to "skimming the cream off the market" at the upper end of the demand curve. It is accompanied by heavy expenditure on promotion. A skimming strategy may be recommended when the nature of demand is uncertain, when a company has expended large sums of money on research and development for a new product, when the competition is expected to develop and market a similar product in the near future, or when the product is so innovative that the market is expected to mature very slowly. Under these circumstances, a skimming strategy has several advantages. At the top of the demand curve, price elasticity is low. Besides, in the absence of any close substitute, cross-elasticity is also low. These factors, along with heavy emphasis on promotion, tend to help the product make significant inroads into the market. The high price also helps segment the market. Only nonprice-conscious customers will buy a new product during its initial stage. Later on, the mass market can be tapped by lowering the price.

If there are doubts about the shape of the demand curve for a given product and the initial price is found to be too high, price may be slashed. However, it is very difficult to start low and then raise the price. Raising a low price may annoy potential customers, and anticipated drops in price may retard demand at a particular price. For a financially weak company, a skimming strategy may provide immediate relief. This model depends on selling enough units at the higher price to cover promotion and development costs. If price elasticity is higher than anticipated, a lower price will be more profitable and "relief giving."

Modern patented drugs provide a good example of skimming pricing. At the time of its introduction in 1978, Smithkline Beecham's anti-ulcer drug, Tagamet, was priced as high as $10 per unit. By 1990, the price came down to less than $2; it was sold for about 60 cents in 1994. (Tagamet was to lose patent protection in the United States in 1995, unleashing a flood of cheaper generics onto the American market.)[6] Many new products are priced following this policy. Videocassette recorders (VCRs), frozen foods, and instant coffee were all priced very high at the time of their initial appearance in the market. But different versions of these products are now available at prices ranging from very high to very low. No conclusive research has yet been done to indicate how high an initial price should be in relation to cost. As a rule of thumb, the final price to the consumer should be at least three or four times the factory door cost.

The decision about how high a skimming price should be depends on two factors: (a) the probability of competitors entering the market and (b) price elasticity at the upper end of the demand curve. If competitors are expected to introduce their own brands quickly, it may be safe to price rather high. On the other hand, if competitors are years behind in product development and a low rate of return to the firm would slow the pace of research at competing firms, a low skimming price can be useful. However, price skimming in the face of impending competition may not be wise if a larger market share makes entry more difficult. If limiting the sale of a new product to a few selected individuals produces sufficient sales, a very high price may be desirable.

Determining the duration of time for keeping prices high depends entirely on the competition's activities. In the absence of patent protection, skimming prices may be forced down as soon as competitors join the race. However, in the case of products that are protected through patents (e.g., drugs), the manufacturer slowly brings down the price as the patent period draws near an end; then, a year or so before the expiration of the patent period, the manufacturer saturates the market with a very low price. This strategy establishes a foothold for the manufacturer in the mass market before competitors enter it, thereby frustrating their expectations.

So far, skimming prices have been discussed as high prices in the initial stage of a product's life. Premium and umbrella prices are two other forms of price skimming. Some products carry premium prices (high prices) permanently and build an image of superiority for themselves. When a mass market cannot be developed and upper-end demand seems adequate, manufacturers will not risk tarnishing the prestigious image of their products by lowering prices, thereby offering the product to everybody. Estee Lauder cosmetics, Olga intimate apparel, Rolex watches, Waterford Crystal, Armani suits, and Hermes scarves are products that fall into this category.

Sometimes, higher prices are maintained in order to provide an umbrella for small high-cost competitors. Umbrella prices have been aided by limitation laws that specify minimum prices for a variety of products, such as milk.

Du Pont provides an interesting example of skimming pricing. The company tends to focus on high-margin specialty products. Initially, it prices its products high; it then gradually lowers price as the market builds and as competition grows. Polaroid also pursues a skimming pricing strategy. The company introduces an expensive model of a new camera and follows up the introduction with simpler lower-priced versions to attract new segments.

Penetration Pricing

Penetration pricing is the strategy of entering the market with a low initial price so that a greater share of the market can be captured. The penetration strategy is used when an elite market does not exist and demand seems to be elastic over the entire demand curve, even during early stages of product introduction. High price elasticity of demand is probably the most important reason for adopting a penetration strategy. The penetration strategy is also used to discourage competitors from entering the market. When competitors seem to be encroaching on a market, an attempt is made to lure them away by means of penetration pricing, which yields lower margins. A competitor's costs play a decisive role in this pricing strategy because a cost advantage over the existing manufacturer might persuade another firm to enter the market, regardless of how low the margin of the former may be.

One may also turn to a penetration strategy with a view to achieving economies of scale. Savings in production costs alone may not be an important factor in setting low prices because, in the absence of price elasticity, it is difficult to generate sufficient sales. Finally, before adopting penetration pricing, one must make sure that the product fits the lifestyles of the mass market. For example, although it might not be difficult for people to accept imitation milk, cereals made from petroleum products would probably have difficulty in becoming popular.

How low the penetration price should be differs from case to case. There are several different types of prices used in penetration strategies: restrained prices, elimination prices, promotional prices, and keep-out prices. Restraint is applied so that prices can be maintained at a certain point during inflationary periods. In this case, environmental circumstances serve as a guide to what the price level should be. Elimination prices are fixed at a point that threatens the survival of a competitor. A large, multiproduct company can lower prices to a level where a smaller competitor might be wiped out of the market. The pricing of suits at factory outlets illustrates promotional prices. Factory outlets constantly stress low prices for comparable department-store-quality suits. Keep-out prices are fixed at a level that prevents competitors from entering the market. Here the objective is to keep the market to oneself at the highest chargeable price.

A low price acts as the sole selling point under penetration strategy, but the market should be broad enough to justify low prices. Thus, price elasticity of demand is probably the most important factor in determining how low prices can go. This point can be easily illustrated.[7] Convinced that shoppers would willingly sacrifice convenience for price savings, an entrepreneur in 1981 introduced a concentrated cleaner called 4 + 1. Unlike such higher-priced cleaners as Windex, Fantastik, and Formula 409, this product did not come in a spray bottle. It also needed to be diluted with water before use. The entrepreneur hoped for 10 percent of the $200 million market. But the product did not sell well. The product was not as price elastic as the entrepreneur had assumed. Though the consumer tends to talk a lot about economy, the lure of convenience is apparently stronger than the desire to save a few cents. Ultimately, 4 + 1 had to be withdrawn from most markets.

Unlike Du Pont, Dow Chemical Company stresses penetration pricing. It concentrates on lower-margin commodity products and low prices, builds a dominant market share, and holds on for the long haul. Texas Instruments also practices penetration pricing. Texas Instruments starts by building a large plant capacity. By setting the price as low as possible, it hopes to penetrate the market fast and gain a large market share.

Penetration pricing reflects a long-term perspective in which short-term profits are sacrificed in order to establish sustainable competitive advantage. Penetration policy usually leads to above-average long-run returns that fall in a relatively narrow range. Price skimming, on the other hand, yields a wider range of lower average returns.

PRICING STRATEGIES FOR ESTABLISHED PRODUCTS

Changes in the marketing environment may require a review of the prices of products already on the market. For example, an announcement by a large firm that it is going to lower its prices makes it necessary for other firms in the industry to examine their prices. In 1976, Texas Instruments announced that it would soon sell a digital watch for about $20. The announcement jolted the entire industry because only 15 months earlier the lowest-priced digital was selling for $125. It forced a change in everyone's strategy and gave some producers real problems. Fairchild Camera and Instrument Corporation reacted with its own version of a $20 plastic-cased digital watch. So did National Semiconductor Corporation. American Microsystems, however, decided to get completely out of the finished watch business.[8]

A review of pricing strategy may also become necessary because of shifts in demand. In the late 1960s, for example, it seemed that, with the popularity of miniskirts, the pantyhose market would continue to boom. But its growth slowed when the fashion emphasis shifted from skirts to pants. Pants hid runs, or tears, making it unnecessary to buy as many pairs of pantyhose. The popularity of pants also led to a preference for knee-high hose over pantyhose. Knee-high hose, which cost less, meant lower profits for manufacturers. Although the pantyhose market was dwindling, two new entrants, Bic Pen Corporation and Playtex Corporation, were readying their brands for introduction. Their participation made it necessary for the big three hosiery manufacturers—Hanes, Burlington, and Kayser-Roth—to review their prices and protect their market shares. An examination of existing prices may lead to one of three strategic alternatives: maintaining the price, reducing the price, or increasing the price.

Maintaining the Price

If the market segment from which the company derives a big portion of its sales is not affected by changes in the environment, the company may decide not to initiate any change in its pricing strategy. The gasoline shortage in the aftermath of the fall of the Shah of Iran did not affect the luxury car market because buyers of Cadillac, Mercedes-Benz, and Rolls-Royce were not concerned about higher gas prices. Thus, General Motors did not need to redesign the Cadillac to reduce its gas consumption or lower its price to make it attractive to the average customer.

The strategy of maintaining price is appropriate in circumstances where a price change may be desirable, but the magnitude of change is indeterminable. If the reaction of customers and competitors to a price change cannot be predicted, maintaining the present price level may be appropriate. Alternatively, a price change may have an impact on product image or sales of other products in a company's line that it is not practical to assess. Several years ago, when Magnavox and Sylvania cut the prices of their color television sets, Zenith maintained prices at current levels. Because the industry appeared to be in good shape, Zenith could not determine why its competitors adopted such a strategic posture. Zenith continued to maintain prices and earned higher profits.

Politics may be another reason for maintaining prices. During the year from 1978 to 1979, President Carter urged voluntary control of wages and prices. Many companies restrained themselves from seeking price changes in order to align themselves behind the government's efforts to control inflation.

Concern for the welfare of society may be another reason for maintaining prices at current levels. Even when supply is temporarily short of demand, some businesses may adopt a socially responsible posture and continue to charge current prices. For example, taxi drivers may choose not to hike fares when subway and bus service operators are on strike.

Reducing the Price

There are three main reasons for lowering prices. First, as a defensive strategy, prices may be cut in response to competition. For example, in October 1978, Congress authorized the deregulation of the airline industry. Deregulation gave airlines almost total freedom to set ticket prices. Thus, in spring of 1998, in response to Continental Airline's $298 round-trip fare on its New York–Los Angeles route, United Airlines acted to meet this competitive fare. United's regular round-trip coach fare at the time was about $750. Similarly, other carriers were forced to reduce their fares on different routes to match these prices. In addition, to successfully compete in mature industries, many companies reduce prices, following a strategy that is often called value pricing. For example, in light of slipping profit margins and lower customer counts, McDonald's cut prices under pressure from major rivals Burger King, Wendy's, and Taco Bell.[9]

A second reason for lowering prices is offensive in nature. Following the experience curve concept (see Chapter 12), costs across the board go down by a fixed percentage every time experience doubles. Consequently, a company with greater experience has lower costs than one whose experience is limited. Lower costs have a favorable impact on profits. Thus, as a matter of strategy, it behooves a company to shoot for higher market share and to secure as much experience as possible in order to gain a cost and, hence, a profit advantage. A company that successfully follows this strategy is Home Depot, the largest home repair chain in the country. The policy of everyday low prices has enabled the company to grow into a $4.0 billion chain of 150 stores, mostly in the sunbelt. Home Depot's goal is to go national with $10 billion in sales at more than 350 locations by the year 2000.[10]

Technological advances have made possible the low-cost production of high-quality electronics gear. Many companies have translated these advances into low retail prices to gain competitive leverage. For example, in 1978 a Sony clock radio, with no power backup and a face that showed nothing more than the current time, sold for $80. In 1988, a Sony clock radio priced at about $40 had auxiliary power and showed the time at which the alarm was set as well as the current time. In 1997, the same radio was available for less than $20.

Texas Instruments has followed the experience curve concept in achieving cost reductions in the manufacture of integrated circuits. This achievement is duly reflected in its strategy to slowly lower prices of such products as electronic calculators. Compaq Computer Corp. followed a similar strategy to make a dramatic comeback in the PC market. Even in other businesses where technological advances have a less critical role to play in the success of the business, a price reduction strategy may work out. Consider the case of Metpath, a clinical laboratory. In the late 1960s, at about the time Metpath was formed, the industry leader, Damon Corporation, was acquiring local labs all around the country; by the early 1970s, other large corporations in the business—Revlon, Bristol-Myers, Diamond Shamrock, and W.R. Grace—began doing the same. Metpath, however, adopted a price-cutting strategy. In order to implement this strategy, it took a variety of measures to achieve economies of scale. Figuring that there were not many economies of scale involved in simply putting together a chain of local labs that operated mostly as separate entities, to reduce costs, Metpath focused on centralizing its testing. A super lab that did have those economies of scale was created, along with a nationwide network to collect specimens and distribute test results. Metpath's strategy paid off well. It emerged as the industry leader in the clinical lab-testing field. Heavy price competition, much of it attributed to Metpath, led some of the big diversified companies, including W.R. Grace and Diamond Shamrock, to pull out of the business.[11]

The recession in the early 1990s caused consumers to tighten belts and to be more sensitive to prices. Sears, therefore, adopted a new pricing policy whereby prices on practically all products were permanently lowered. The company closed its 824 stores for two days to remark price tags and to implement its "everyday low pricing" strategy. A number of other companies, such as Wal-Mart, Toys "R" Us, and Circuit City, also pursue this strategy by keeping prices low year-round, avoiding the practice of marking them up and down. Consumers like year-round low prices because constantly changing sale prices makes it hard to recognize a fair deal.[12] Similarly, fast-food chains have started offering "value" menus of higher-priced items.

The third and final reason for price cutting may be a response to customer need. If low prices are a prerequisite for inducing the market to grow, customer need may then become the pivot of a marketing strategy, all other aspects of the marketing mix being developed accordingly.

As an example, in 1993 Philip Morris used price as an aggressive marketing tactic to seek growth for its Marlboro brand of cigarette. Its 40-cents-per-pack cut grabbed consumers' attention, narrowed the gap with discount brands, and squeezed competitors. In less than a year, Marlboro's share of the U.S. cigarette market increased from 20 percent to 25 percent, higher than it has been before.[13]

However, Philip Morris's move depressed the profits of the entire industry, since other cigarette manufacturers responded by reducing their own brands' prices. Philip Morris repeated the same strategy by cutting down prices about 20% on its Post and Nabisco ready-to-eat cereals. However, other cereal companies, such as Kellogg and General Mills, did not go along with Philip Morris's lead.[14]

In adopting a low-price strategy for an existing product, a variety of considerations must be taken into account. The long-term impact of a price cut against a major competitor is a factor to be reckoned with. For example, a regional pizza chain can cut prices to prevent Pizza Hut from gaining a foothold in its market only in the short run. Eventually, Pizza Hut will prevail over the local chain through price competition. Pizza Hut may lower prices to such an extent that the local chain may find it difficult even to recover its costs. Thus, competitive strength should be duly evaluated in opting for low-price strategy.

In a highly competitive situation, a product may command a higher price than other brands if it is marketed as a "different" product—for example, as one of deluxe quality. If the price of a deluxe product is reduced, the likely impact on its position should be looked into. Sony television sets have traditionally sold at premium prices because they have been promoted as quality products. Sony's higher-price strategy paid off: the Sony television rose to prominence as a quality product and captured a respectable share of the market. A few years later, however, consumer pressures led Sony dealers to reduce prices. This action not only hurt Sony's overall prestige, it made some retailers stop selling Sony because it had now become just one of the many brands they carried. In other words, the price cut, though partly initiated by its dealers, cost Sony its distinction. Even if its sales increased in the short run, the price cut did not prove to be a viable strategy in the long run because it went against the perception consumers had of Sony's being a distinctive brand. Ultimately, consumers may perceive Sony as just another brand, which will affect both sales and profits.

It is also necessary to examine thoroughly the impact of a price cut of one product on other products in the line.

Finally, the impact of a price cut on a product's financial performance must be reviewed before the strategy is implemented. If a company is so positioned financially that a price cut will weaken its profitability, it may decide not to lower the price even if lowering price may be in all other ways the best course to follow. For instance, a mere 1 percent price decrease for an average company might destroy over 11 percent of the company's operating profit dollars.[15]

Increasing the Price

An increase in price may be implemented for various reasons. First, in an inflationary economy, prices may need to be adjusted upward in order to maintain profitability. During periods of inflation, all types of costs go up, and to maintain adequate profits, an increase in price becomes necessary. How much the price should be increased is a matter of strategy that varies from case to case. Conceptually, however, price should be increased to such a level that the profits before and after inflation are approximately equal. An increase in price should also take into account any decline in revenue caused by shifts in demand due to price increases. Strategically, the decision to minimize the effects of inflationary pressures on the company through price increases should be based on the long-term implications of achieving a short-run vantage.

It must also be mentioned that it is not always necessary for a company to increase prices to offset inflationary pressures. A company can take nonprice measures as well to reduce the effects of inflation. For example, many fast-food chains expanded menus and seating capacity to partially offset rising costs. Similarly, a firm may substantially increase prices, much more than justified by inflation alone, by improving product quality or by raising the level of accompanying services. High quality should help keep prices and profits up because inflation-weary customers search for value in the marketplace. Improved product quality and additional services should provide such value.

Price may also be increased by downsizing (i.e., decreasing) package size while maintaining price. In a recession, downsizing helps hold the line on prices despite rising costs. Under inflationary conditions, downsizing provides a way of keeping prices from rising beyond psychological barriers. Downsizing is commonly practiced by packaged-goods companies. For example, recently Procter & Gamble cut the number of diapers in a package from 88 to 80 while leaving the price the same. In this example, downsizing effectively resulted in a price increase of 9.1 percent. Similarly, H. J. Heinz reduced the contents of its 6.5-ounce StarKist Seafood (tuna) can by three-eighths of an ounce. By keeping exactly the same price as before, the company gained an invisible 5.8 percent price increase.[16]

Prices may also be increased when a brand has a monopolistic control over the market segments it serves. In other words, when a brand has a differential advantage over competing brands in the market, it may take advantage of its unique position, increasing its price to maximize its benefits. Such a differential advantage may be real or may exist just in the mind of the consumer. In seeking a price increase in a monopolistic situation, the increase should be such that customers will absorb it and still remain loyal to the brand. If the price increase is abnormal, differential advantage may be lost, and the customer will choose a brand based on price.

The downside of increasing price may be illustrated with reference to coffee. Let us say that there is a segment of customers who ardently drink Maxwell House coffee. In their minds, Maxwell House has something special. If the price of Maxwell House goes up (assuming that the prices of other brands remain unchanged), these coffee drinkers may continue to purchase it because the brand has a virtual monopoly over their coffee-drinking behavior. There is a limit, however, to what these Maxwell House loyalists will pay for their favorite brand of coffee. Thus, if the price of Maxwell House is increased too much, these customers may shift their preference.

From the perspective of strategy, this example indicates that, in monopolistic situations, the price of a brand may be set high to increase revenues and profits. The extent of the increase, however, depends on many factors. Each competitor has a different optimum price level for a given end product for a given customer group. It is rare that such optimum prices are the same for any two competitors. Each competitor has different options based on different cost components, capacity constraints, financial structure, product mix, customer mix, logistics, culture, and growth rate. The competitor with the lowest optimum price has the option of setting the common price; all others must follow or retreat. However, the continued existence of competitors depends on each firm retreating from competition when it is at a disadvantage until each competes primarily in a “competitive segment,” a monopolistic situation where it has an advantage compared to all others. This unique combination of characteristics, matched with differentials in the competitive environment, enables each firm to coexist and prosper in its chosen area (i.e., where it has monopolistic control).

Sometimes prices must be increased to adhere to an industry situation. Of the few firms in an industry, one (usually the largest) emerges as a leader. If the leader raises its price, other members of the industry must follow suit, if only to maintain the balance of strength in the industry. If they refuse to do so, they are liable to be challenged by the leader. Usually, no firm likes to fight the industry leader because it has more at stake than the leader.

In the U.S. auto industry, there are three domestic firms: General Motors, Ford, and Chrysler. General Motors is the industry leader in terms of market share. If General Motors increases its prices, all other members of the industry increase prices. Thus, a firm may be compelled to increase price in response to a similar increase by the industry leader. The leader also sets a limit on price increases, with followers frequently setting their prices very close to those of the leader. Although an increase is forced on a firm in this situation, it is a good strategic move to set a price that, without being obviously different, is higher than the leader's price.

Prices may also be increased to segment the market. For example, a soft drink company may come out with a new brand and direct it toward busy executives/professionals. This brand may be differentiated as one that provides stamina and invigoration without adding calories. To substantiate the brand's worth and make it appear different, the price may be set at double the price of existing soft drinks. Similarly, the market may be segmented by geography, with varying prices serving different segments. For example, in New York City, a 6.4-ounce tube of Crest toothpaste may sell for $3.89 on Park Avenue, for $3.29 on the Upper East Side, and for $2.39 on the Lower East Side. Furthermore, companies with products that customers want and that are not easily matched by competitors may increase the price without any negative repercussions. For example, in 1998 when inflation was merely 2.1%, some industries, such as airlines, mutual-fund houses, sellers of mainframe software, and entertainment companies, boosted their prices far faster.[17]

Hewlett-Packard Company operates in the highly competitive pocket calculator industry, where the practice of price cutting is quite common. Nonetheless, Hewlett-Packard thrives by offering high-priced products to a select segment of the market. It seems to appeal to a market segment that is highly inelastic with respect to price but highly elastic with respect to quality. The company equips its calculators with special features and then offers them at a price that is much higher than the industry average. In other words, rather than running the business on the basis of overall volume, Hewlett-Packard realizes high prices by being a specialist that serves a narrow segment. In cosmetics or automobiles, for example, there may be a tenfold cost difference between mass market products and those designed, produced, packaged, distributed, and promoted for small high-quality niches. Up-market products are often produced by specialists, companies such as Daimler-Benz or BMW, that can compete successfully around much larger producers of standard products.

Many airlines have successfully used price structure to differentiate market segments and objectives based on customer price sensitivity. Business travelers are relatively price insensitive, whereas tourists are very sensitive to the price of tickets. In order to increase the volume of tourist traffic without forgoing bread-and-butter revenues from business customers, airlines have developed price structures based on characteristics that differentiate these two customer segments.

For example, tourists generally spend a weekend at their destination; business travelers do not. By changing the structure from pricing flights to pricing itineraries, the airlines can discount itineraries that include a Saturday night stay. Most business customers cannot take advantage of such discounts without incurring substantial inconvenience. This enables the airline to increase tourist volume while maintaining high prices among the business customer segment. Such pricing policies have led to as much as 10 times the difference in fares paid for the same seat. Thus, a flexible pricing strategy permits a company to realize high prices from customers who are willing to pay them without sacrificing volume from customers who are not.[18]

Increase in price is seductive in nature. After all, improvements in price typically have three to four times the effect on profitability as proportionate increases in volume. But the increase should be considered for its effect on long-term profitability, demand elasticity, and competitive moves. Although a higher price may mean higher profits in the short run, the long-run effect of a price increase may be disastrous. The increase may encourage new entrants to flock to the industry and competition from substitutes. Thus, before a price increase strategy is implemented, its long-term effect should be thoroughly examined. Further, an increase in price may lead to shifts in demand that could be detrimental. Likewise, the increase may negatively affect market share if the competition decides not to seek similar increases in price. Thus, competitive posture must be studied and predicted. In addition, a company should review its own ability to live with higher prices. A price increase may mean a decline in revenues but an increase in profits. Whether such a situation will create any problem needs to be looked into. Will laying off people or reassigning sales territories be problematic? Is a limit to price increases called for as a matter of social responsibility? In 1979, President Carter asked businesses to adhere to 7 percent increases in prices and wages voluntarily. In a similar situation, should a company that otherwise finds a 10 percent increase in price strategically sound go ahead with it? Finally, the price increase should be duly reinforced by other factors in the marketing mix. A Chevy cannot be sold at a Cadillac price. A man's suit bearing a Kmart label cannot be sold on a par with one manufactured by Brooks Brothers. Chanel No. 5 cannot be promoted by placing an ad in *TV Guide*. The increased price must be evaluated before being finalized to see whether the posture of other market mix variables will substantiate it.

Finally, the timing of a price increase can be nearly as important as the increase itself. For example, a simple tactic of lagging competitors in announcing price increases can produce the perception among customers that you are the most customer-responsive supplier. The extent of the lag can also be important.

PRICE-FLEXIBILITY STRATEGY

A price-flexibility strategy usually consists of two alternatives: a one-price policy and a flexible-pricing policy. Influenced by a variety of changes in the environment, such as saturation of markets, slow growth, global competition, and the consumer movement, more and more companies have been adhering in recent years to flexibility in pricing of different forms. Pricing flexibility may consist of setting different prices in different markets based on geographic location, varying prices depending on the time of delivery, or customizing prices based on the complexity of the product desired.

One-Price Strategy

A one-price strategy means that the same price is set for all customers who purchase goods under essentially the same conditions and in the same quantities. The one-price strategy is fairly typical in situations where mass distribution and mass selling are employed. There are several advantages and disadvantages that may be attributed to a one-price strategy. One advantage of this pricing strategy is administrative convenience. It also makes the pricing process easier and contributes to the maintenance of goodwill among customers because no single customer receives special pricing favors over another.

A general disadvantage of a one-price strategy is that the firm usually ends up broadcasting its prices to competitors who may be capable of undercutting the price. Total inflexibility in pricing may undermine the product in the marketplace. Total inflexibility in pricing may also have highly adverse effects on corporate growth and profits in certain situations. It is very important that a company remain responsive to general trends in economic, social, technological, political/legal, and competitive environments. Realistically, then, a pricing strategy should be periodically reviewed to incorporate environmental changes as they become pronounced. Any review of this type would need to include a close look at a company's position relative to the actions of other firms operating within its industry. As an example, it is generally believed that one reason for the success of discount houses is that conventional retailers have rigidly held to traditional prices and margins.

Flexible-Pricing Strategy

A flexible-pricing strategy refers to situations where the same products or quantities are offered to different customers at different prices. A flexible-pricing strategy is more common in industrial markets than in consumer markets. An advantage of a flexible-pricing strategy is the freedom allowed to sales representatives to make adjustments for competitive conditions rather than refuse an order. Also, a firm is able to charge a higher price to customers who are willing to pay it and a lower price to those who are unwilling, although legal difficulties may be encountered if price discrimination becomes an issue. Besides, other customers may become upset upon learning that they have been charged more than their competitors. In addition, bargaining tends to increase the cost of selling, and some sales representatives may let price cutting become a habit.

Recently, many large U.S. companies have added new dimensions of flexibility to their pricing strategies. Although companies have always shown some willingness to adjust prices or profit margins on specific products when market conditions have varied, this kind of flexibility is now being carried to the state of high art. As a matter of fact, electronic commerce is further likely to accelerate the flexible-pricing trend. The Internet, corporate networks, and wireless setups are linking people, machines, and companies around the globe and connecting sellers and buyers as never before. This is enabling buyers to quickly and easily compare products and prices, putting them in a better bargaining position. At the same time, the technology allows sellers to know customers' buying habits, preferences, and spending limits, enabling them to tailor products and prices.[19] The concept of price flexibility can be implemented in four different ways: by market, by product, by timing, and by technology.

Price flexibility with reference to the market can be achieved either from one geographic area to another or from one segment to another. Both Ford and General Motors charge less for their compact cars marketed on the West Coast than for those marketed anywhere else in the country. Different segments make different uses of a product: many companies, therefore, consider customer usage in setting price. For example, a plastic sold to industry might command only 30 cents a pound; sold to a dentist, it might bring $25 a pound. Here again, the flexible-pricing strategy calls for different prices in the two segments.

Price flexibility with reference to the product is implemented by considering the value that a product provides to the customer. Careful analysis may show that some products are underpriced and can stand an upgrading in the marketplace. Others, competitively priced to begin with, may not support any additional margin because the matchup between value and cost would be lost.

Costs of all transactions from raw material to delivery may be analyzed, and if some costs are unnecessary in a particular case, adjustments may be made in pricing a product to sell to a particular customer. Such cost optimization is very effective from the customer's point of view because he or she does not pay for those costs for which no value is received.

Price flexibility can also be practiced by adding to the price an escalation clause based on cost fluctuations. Escalation clauses are especially relevant in situations where there is a substantial time gap between confirmation of an order and delivery of the finished product. In the case of products susceptible to technological obsolescence, price is set to recover all sunken costs within a reasonable period.

The flexible-pricing strategy has two main characteristics: an emphasis on profit or margins rather than simply on volume and a willingness to change price with reference to the existing climate. Caution is in order here. In many instances, building market share may be essential to cutting costs and, hence, to increasing profits. Thus, where the experience curve concept makes sense, companies may find it advantageous to reduce prices to hold or increase market share. However, a reduction in price simply as a reactionary measure to win a contract is discounted. Implementation of this strategy requires that the pricing decision be instituted by someone high up in the organization away from salespeople in the field. In some companies, the pricing executive may report directly to the CEO.

In addition, a systematic procedure for reviewing price at quarterly or semi-annual intervals must be established. Finally, an adequate information system is required to help the pricing executive examine different pricing factors.

PRODUCT LINE-PRICING STRATEGY

A modern business enterprise manufactures and markets a number of product items in a line with differences in quality, design, size, and style. Products in a line may be complementary to or competitive with each other. The relationships among products in a given product line influence the cross-elasticities of demand between competing products and the package-deal buying of products complementary to each other. For example, instant coffee prices must bear some relationship to the prices of a company's regular coffee because these items are substitutes for one another; therefore, this represents a case of cross-elasticity. Similarly, the price of a pesticide must be related to that of a fertilizer if customers are to use both. In other words, a multiproduct company cannot afford to price one product without giving due consideration to the effect its price produces on other products in its line.

The pricing strategy of a multiproduct firm should be developed to maximize the profits of the entire organization rather than the profitability of a single product. For products already in the line, pricing strategy may be formulated by classifying them according to their contribution as follows:

1. Products that contribute more than their pro rata share toward overhead after direct costs are covered.
2. Products that just cover their pro rata share.
3. Products that contribute more than incremental costs but do not cover their pro rata share.
4. Products that fail to cover the costs savable by their elimination.

With such a classification in mind, management is in a better position to study ways of strengthening the performance of its total product line. Pricing decisions on individual products in the four categories listed here are made in the light of demand and competitive conditions facing each product in the line. Consequently, some products (new products) may be priced to yield a very high margin of profit; others (highly competitive standard products) may need to show an actual loss. By retaining these marginal products to "keep the machines running" and to help absorb fixed overhead costs, management may be able to maximize total profit from all of its lines combined. A few items that make no contribution may need to be kept to round out the line offered.

General Motors's pricing structure provides a good illustration of this procedure. To offset lower profit margins on lower-priced small cars, the company raises the prices of its large cars. The prices of its luxury cars are raised much more than those of its standard cars. For example, in 1998 a Cadillac Seville sold for more than $60,000, four times the price of the company's lowest-priced car. Ten years ago, the top of the line was three times as costly as the lowest-priced car. The gap is widening, however, because the growing market for small cars with low markups makes it necessary for the company to generate high profits on luxury cars to meet its profit goals. Thus, at the beginning of the next century, General Motors might sell a Cadillac for $80,000.

For a new product being considered for addition to the line, strategy development proceeds with an evaluation of the role assigned to it. The following questions could be asked:

1. What would the effect be on the company's competing products at different prices?
2. What would be the best new-product price (or range), considering its impact on the total company offerings as a whole? Should other prices be adjusted? What, therefore, would be the incremental gain or loss (volumes and profits of existing lines plus volumes and profits of the new line at different prices)?
3. Is the new product necessary for staying ahead of or catching up with the competition?
4. Can it enhance the corporate image, and if so, how much is the enhancement worth?

If product/market strategy has been adequately worked out, it will be obvious whether the new product can profitably cater to a particular segment. If so, the pricing decision will be considerably easier to make; costs, profit goals, marketing goals, experience, and external competition will be the factors around which price will be determined.

Where there is no specific product/market match, pricing strategy for a new product considered for the line will vary depending on whether the product is complementary or competitive vis-à-vis other products in the line. For the complementary product, examination of the industry price schedule, which is the primary guide for the bottom price, top price, and conventional spread between product prices in a given industry, may be necessary. There are three particularly significant factors in product line-pricing strategy. The lowest price in the market is always the most remembered and unquestionably generates the most interest, if not the most traffic; the top market price implies the ability to manufacture quality products; and a well-planned schedule structure (one that optimizes profit and, at the same time, is logical to customers) is usually carefully studied and eventually followed by the competition regardless of who initiated it. In addition, however, there can be a product in the line with the objective of pricing to obtain the principal profit from a product's supplies or supplementary components.

If the anticipated product is competitive, a start will need to be made with the following market analysis:

1. Knowledge of the industry's pricing history and characteristics regarding the line.
2. Comparison of company and competitor products and volumes, showing gaps and areas of popularity.
3. Volume and profit potentials of the company line as is.
4. Volume and profit potentials with the new internally competitive product.

5. Effect on company volume and profit if competition introduced the proposed product and the company did not.
6. Impact of a possible introduction delay or speedup.

With this information on hand, computations for cost-plus markup should be undertaken. Thereafter, the pricer has three alternatives to set price: (a) add a uniform or individual markup rate to the total cost of the product, (b) add a markup rate that covers all the constant costs of the line, and (c) add the rate necessary for achieving the profit goal. These three alternatives have different characteristics. The first one hides the contribution margin opportunities. The second alternative, although revealing the minimum feasible price, tends to spread constant-cost coverage in such a manner that the product absorbing the most overhead is made the most price attractive. The third alternative assigns the burden to the product with the highest material cost, an action that may be competitively necessary. No matter which alternative is pursued, however, the final price should be arrived at only after it has been duly examined with reference to the market and the competition.

LEASING STRATEGY

The major emphasis of a pricing strategy is on buying a product outright rather than leasing it. Except in housing, leasing is more common in the marketing of industrial goods than among consumer goods, though in recent years there has been a growing trend toward the leasing of consumer goods. For example, some people lease cars. Usually, by paying a specified sum of money every month, similar to a rental on an apartment, one can lease a new car. Again, as in the case of housing, a lease is binding for a minimum period, such as two years. Thus, the consumer can lease a new car every other year. Because repairs in the first two years of a car's life may not amount to much, one is saved the bother of such problems.

At the same time, overall the lease may cost slightly more than what a customer would pay by buying the car on loan. The net price of a fully equipped 1995 Ford Windstar with a sticker price of $23,650, after negotiations and a $1,000 manufacturer's rebate, would be $20,494. Payments on a two-year lease from Ford Motor Credit Co. would be $457.43 a month, or total payout of $10,520, assuming that the rebate is used for the first payment and a security deposit. At the end of the lease, the car would have a residual value—the value after depreciation—of $14,663. That is what the customer would have to pay if he/she decides to buy it, bringing the total cost to $25,183. On the other hand, monthly payments on a four-year loan at 9.9% would be $518.79. The total paid over the term of the loan would be $24,901, and the customer would have a vehicle valued at more than $7,000 at the end.[20]

Although there may be different alternatives for setting the lease price, the lessor usually likes to recover the investment within a few years. Thereafter, a very large portion of the lease price (or rent) is profit. A lessor may set the monthly rental on a car so that within a few months, say 30, the entire cost of the car can be recovered. For example, the monthly rental on a Toyota Corolla, based on its 1998 price (assuming no extras), may be about $239 a month (the sticker price is $15,985). With the term set at 36 months, the dealer gets all his or her money back in about 32 months. (It should be noted that a dealer gets a car at the wholesale price, not the sticker price, which is the suggested retail price.) The important thing is to set the monthly lease rate and the minimum period for which the lease is binding in such proportions that the total amount that the lessee pays for the duration of the lease is less than what he or she would pay in monthly installments on a new car. As a matter of fact, the lease rate must be substantially less than that in order for the buyer to opt to lease.

Automobile renting is transforming the market perspectives of the industry. One-fourth of all cars and trucks sold in 1998 went out under lease. By the year 2005, it is predicted, half of all cars and trucks will be leased. The reason for this shift in automobile buying is easy to understand. About 75 percent of car buyers need some sort of financing, and with interest on car loans no longer deductible, leasing's relatively low monthly payments are enticing. For the auto companies, leasing camouflages price increases, and restores brand loyalty. It offers companies an opportunity to strike up a relationship with the customers. Further, it attracts younger buyers to luxury brands and smoothes industry sales throughout the year.[21]

Leasing works out to be a viable strategy for other products as well. For example, furniture renting may be attractive to young adults, people of high mobility (e.g., executives, airline stewards), and senior citizens who may need appropriate furnishings only temporarily when their children's families come to visit. In addition, apartment owners may rent furniture to provide furnished units to tenants.

In industrial markets, the leasing strategy is employed by essentially all capital goods and equipment manufacturers. Traditionally, shoe machinery, postage meters, packaging machinery, textile machinery, and other heavy equipment have been leased. Recent applications of the strategy include the leasing of computers, copiers, cars, and trucks. As a matter of fact, just about any item of capital machinery and equipment can be leased. From the customer's point of view, the leasing strategy makes sense for a variety of reasons. First, it reduces the capital required to enter a business. Second, it protects the customer against technological obsolescence. Third, the entire lease price, or rental, may be written off as an expense for income tax purposes. This advantage, of course, may or may not be relevant depending on the source of funds the customer would have used for the outright purchase (i.e., his or her own money or borrowed funds). Finally, leasing gives the customer the freedom not to get stuck with a product that may later prove not to be useful.

From the viewpoint of the manufacturer, the leasing strategy is advantageous in many ways. First, income is smoothed out over a period of years, which is very helpful in the case of equipment of high unit value in a cyclical business. Second, market growth can be boosted because more customers can afford to lease a product than can afford to buy. Third, revenues are usually higher when a product is leased than when it is sold.

BUNDLING-PRICING STRATEGY

Bundling, also called **iceberg pricing**, refers to the inclusion of an extra margin (for support services) in the price over and above the price of the product as such. This type of pricing strategy has been popular with companies that lease rather than sell their products. Thus, the rental price, when using a bundling strategy, includes an extra charge to cover a variety of support functions and services needed to maintain the product throughout its useful life. Because unit profit increases sharply after a product completes its planned amortization, it is desirable for firms that lease their products to keep the product in good condition, thus enhancing its working life for high resale or re-leasing value. The bundling strategy permits a company to do so because a charge for upkeep, or iceberg, services is included in the price.

IBM once followed a bundling strategy, whereby it charged one fee for hardware, service, software, and consultancy. In 1969, however, the Justice Department charged IBM with monopolizing the computer market. Subsequently, the company unbundled its price and started selling computers, software, service, and technical input separately.

Under the bundling strategy, not only are costs of hardware and profits covered, anticipated expenses for extra technical sales assistance, design and engineering of the system concept, software and applications to be used on the system, training of personnel, and maintenance are also included. Although the bundling strategy can be criticized for tending to discourage competition, one must consider the complexities involved in delivering and maintaining a fault-free sophisticated system. Without the manufacturer taking the lead in adequately keeping the system in working condition, customers would have to deal with a variety of people to make use of such products as computers. At least in the initial stages of a technologically oriented product, a bundling strategy is highly useful from the customer's point of view.

For the company, this strategy (a) covers the anticipated expenses of providing services and maintaining the product, (b) provides revenues for supporting after-sales service personnel, (c) provides contingency funds to meet unanticipated happenings, and (d) ensures the proper care and maintenance of the leased products. The bundling strategy also permits an ongoing relationship with the customer. In this way the company gains firsthand knowledge of the customer's needs that may help to shift the customer to a new generation of the product. Needless to say, the very nature of the bundling strategy makes it most relevant to technologically sophisticated products, particularly those marked by rapid technological obsolescence.

On the negative side, the bundling strategy tends to inflate costs and distort prices and profitability. For this reason, during unfavorable economic conditions, it may not be an appropriate strategy to pursue. Grocery wholesalers, for instance, may pass through a straight invoice cost and then charge separately for delivery, packaging, and so on. A growing number of department stores now charge extra for home delivery, gift wrapping, and shopping bags. Thus, people who don't want a service need not pay for it.

PRICE-LEADERSHIP STRATEGY

The price-leadership strategy prevails in oligopolistic situations. One member of an industry, because of its size or command over the market, emerges as the leader of an entire industry. The leading firm then makes pricing moves that are duly acknowledged by other members of the industry. Thus, this strategy places the burden of making critical pricing decisions on the leading firm; others simply follow the leader. The leader is expected to be careful in making pricing decisions. A faulty decision could cost the firm its leadership because other members of the industry would then stop following in its footsteps. For example, if, in increasing prices, the leader is motivated only by self-interest, its price leadership will not be emulated. Ultimately the leader will be forced to withdraw the increase in price.

The price-leadership strategy is a static concept. In an environment where growth opportunities are adequate, companies would rather maintain stability than fight each other by means of price wars. Thus, the leadership concept works out well in this case. In the auto industry, General Motors is the leader, based on market share. The other two domestic members of the industry adjust their prices to come very close to any price increase by General Motors.

Usually, the leader is the company with the largest market share. The leadership strategy is designed to stave off price wars and "predatory" competition that tend to force down prices and hurt all parties. Companies that deviate from this form are chastised through discounting or shaving by the leaders. Price deviation is quickly disciplined.

Successful price leaders are characterized by the following:

1. Large share of the industry's production capacity.
2. Large market share.
3. Commitment to a particular product class or grade.
4. New cost-efficient plants.
5. Strong distribution system, perhaps including captive wholesale outlets.
6. Good customer relations, such as technical assistance for industrial buyers, programs directed at end users, and special attention to important customers during shortages.
7. An effective market information system that provides analysis of the realities of supply and demand.
8. Sensitivity to the price and profit needs of the rest of the industry.
9. A sense of timing to know when price changes should be made.
10. Sound management organization for pricing.
11. Effective product line financial controls, which are needed to make sound price-leadership decisions.
12. Attention to legal issues.[22]

In an unfavorable business environment, it may not be feasible to implement a leadership strategy because firms may be placed differently to interact with the environment. Thus, the leader hesitates to make decisions on behalf of an entire industry because other firms may not always find its decisions to their advantage. For this reason, the price leader/follower pattern may be violated.

In order to survive during unfavorable conditions, even smaller firms may take the initiative to undercut the price leader. For example, during 1988 when the list prices of steel were similar, companies freely discounted their prices. In the chemical industry, with increasing competition from overseas, the price-leadership strategy does not work. Companies thus plan a variety of temporary allowances to generate business. The following quote highlights the erosion of the leadership strategy in the glass container industry:

> Traditional patterns of price leadership also are breaking down in the glass container industry, with smaller companies moving to the fore in pricing. Last year, for example, Owens-Illinois, Inc.—which is larger than its next five competitors combined—increased its list prices by 4½ percent. Fearing that the increase would hurt sales to brewing companies that were just beginning to switch to glass bottles, the smaller companies broke ranks and offered huge discounts. The action not only negated O-I's increase but served notice that the smaller companies were after O-I's market share.[23]

An automatic response to a leader's price adjustment assumes that all firms are more or less similarly positioned vis-à-vis different price variables (i.e., cost, competition, and demand) and that different firms have common pricing objectives. Such an assumption, however, is far from being justified. The leadership strategy is an artificial way to enforce similar pricing responses throughout an industry. Strategically, it is a mistake for a company to price in a manner identical to that of its competitors. It should price either above or below the competition to set itself apart.

PRICING STRATEGY TO BUILD MARKET SHARE

Recent work in the area of marketing strategy has delineated the importance of market share as a key variable in strategy formulation. Although market share has been discussed earlier with reference to other matters, this section examines the impact of market share on pricing strategy.

Time and again it has been noted that higher market share and experience lead to lower costs. Thus, a new product should be priced to improve experience and market share. The combination of enhanced market share and experience gives a company such a cost advantage that it cannot ever profitably be overcome by any competitor of normal performance. Competitors are prevented from entering the market and must learn to live in a subordinate position.

Assuming the market is price sensitive, it is desirable to develop the market as early as possible. One way of achieving this is to reduce price. Unit costs are necessarily very high in the early stages of any product; if price is set to recover all costs, there may be no market for the product at its initial price in competition with existing alternatives. Following the impact of market share and experience on prices, it may be worthwhile to set price at a level that will move the product. During the early stages of a product introduction, operations may need to be conducted even at a loss. As volume is gained, costs go down, and even at an initial low price the company makes money, implying that future competitive cost differentials should be of greater concern than current profitability. Of course, such a strategic posture makes sense only in a competitive situation. In the absence of competition there is every reason to set prices as high as possible, to be lowered only when total revenue will not be affected by such an action.

The lower the initial price set by the first producer, the more rapidly that producer builds up volume and a differential cost advantage over succeeding competitors and the faster the market develops. In a sense, employing a pricing strategy that builds market share is a purchase of time advantage. However, the lower the initial price, the greater the investment required before the progressive reduction of cost results in a profit. This in turn means that the comparative investment resources of competitors can become a significant or even the critical determinant of competitive survival.

Two limitations, however, make the implementation of this type of strategy difficult. First, the resources required to institute this strategy are more than those normally available to a firm. Second, the price, once set, must not be raised and should be maintained until costs fall below price; therefore, the lower the price, the longer the time needed to realize any returns and the larger the investment required. When a future return is discounted to present value, there is obviously a limit.

It is these difficulties that lead many firms to set initial price to cover all costs. This policy is particularly likely to be adopted when there is no clear competitive threat. As volume builds and costs decline, visible profitability results, which in turn induces new competitors to enter the field. As competitors make their moves, the innovating firm has the problem of choosing between current profitability and market share. Strategically, however, the pricing of a new product, following the relationship between market share and cost, should be dictated by a product's projected future growth.

SUMMARY

Pricing strategy is of interest to the very highest management levels of a company. Yet few management decisions are more subject to intuition than pricing. There is a reason for this. Pricing decisions are primarily affected by factors, such as pricing objectives, cost, competition, and demand, that are difficult to articulate and analyze. For example, assumptions must be made about what a competitor will do under certain hypothetical circumstances. There is no way to know that for certain; hence the characteristic reliance on intuition.

This chapter reviewed the pricing factors mentioned above and examined important strategies that a pricer may pursue. The following strategies were discussed:

1. Pricing strategies for new products.
2. Pricing strategies for established products.
3. Price-flexibility strategy.
4. Product line-pricing strategy.
5. Leasing strategy.
6. Bundling-pricing strategy.
7. Price-leadership strategy.
8. Pricing strategy to build market share.

There are two principal pricing strategies for new products, skimming and penetration. Skimming is a high-price strategy; penetration strategy sets a low initial price to generate volume. Three strategies for established products were discussed: maintaining the price, reducing the price, and increasing the price. A flexible-pricing strategy provides leverage to the pricer in terms of duration of commitment both from market to market and from product to product. Product line-pricing strategy is directed toward maintaining a balance among different products offered by a company. The leasing strategy constitutes an alternative to outright sale of the product. The bundling strategy is concerned with packaging products and associated services together for the purposes of pricing. Price-leadership strategy is a characteristic of an oligopoly, where one firm in an industry emerges as a leader and sets the pricing strategy to build market share. Setting price to build market share emphasizes the strategic significance of setting an initially low price to gain volume and market share, thereby enabling the firm to achieve additional cost reductions in the future.

DISCUSSION QUESTIONS

1. Is the maintenance of a stable price a viable objective? Why?
2. Is there a conflict between profit and volume objectives? Doesn't one lead to the other? Discuss.
3. What are the advantages of using incremental costs instead of full costs for pricing? Are there any negative implications of using incremental costs that a pricing strategist needs to be aware of?
4. What assumptions need to be made about competitive behavior for formulating pricing strategy?
5. "Short-term price increases tend to depress industry profits in the long run by accelerating the introduction of new capacity and depressing market demand." Discuss.
6. Following the experience curve concept, the initial price of a new product should be set rather low; as a matter of fact, it may be set below cost. Taking into account the popularity of this thesis, discuss the relevance of the skimming strategy.
7. What factors are ascribed to the decline in popularity of the price-leadership strategy?

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APPENDIX — *Perspectives of Pricing Strategies*

I. Price Strategies for New Products

A. Skimming Pricing

Definition: Setting a relatively high price during the initial stage of a product's life.

Objectives: (a) To serve customers who are not price conscious while the market is at the upper end of the demand curve and competition has not yet entered the market. (b) To recover a significant portion of promotional and research and development costs through a high margin.

Requirements: (a) Heavy promotional expenditure to introduce product, educate consumers, and induce early buying. (b) Relatively inelastic demand at the upper end of the demand curve. (c) Lack of direct competition and substitutes.

Expected Results: (a) Market segmented by price-conscious and not so price-conscious customers. (b) High margin on sales that will cover promotion and research and development costs. (c) Opportunity for the firm to lower its price and sell to the mass market before competition enters.

B. Penetration Pricing

Definition: Setting a relatively low price during the initial stages of a product's life.

Objective: To discourage competition from entering the market by quickly taking a large market share and by gaining a cost advantage through realizing economies of scale.

Requirements: (a) Product must appeal to a market large enough to support the cost advantage. (b) Demand must be highly elastic in order for the firm to guard its cost advantage.

Expected Results: (a) High sales volume and large market share. (b) Low margin on sales. (c) Lower unit costs relative to competition due to economies of scale.

II. Price Strategies for Established Products

A. Maintaining the Price

Objectives: (a) To maintain position in the marketplace (i.e., market share, profitability, etc.). (b) To enhance public image.

Requirements: (a) Firm's served market is not significantly affected by changes in the environment. (b) Uncertainty exists concerning the need for or result of a price change. (c) Firm's public image could be enhanced by responding to government requests or public opinion to maintain price.

Expected Results: (a) Status quo for the firm's market position. (b) Enhancement of the firm's public image.

B. Reducing the Price

Objectives: (a) To act defensively and cut price to meet the competition. (b) To act offensively and attempt to beat the competition. (c) To respond to a customer need created by a change in the environment.

Requirements: (a) Firm must be financially and competitively strong to fight in a price war if that becomes necessary. (b) Must have a good understanding of the demand function of its product.

Expected Results: Lower profit margins (assuming costs are held constant). Higher market share might be expected, but this will depend upon the price change relative to competitive prices and upon price elasticity.

C. Increasing the Price

Objectives: (a) To maintain profitability during an inflationary period. (b) To take advantage of product differences, real or perceived. (c) To segment the current served market.

Requirements: (a) Relatively low price elasticity but relatively high elasticity with respect to some other factor such as quality or distribution. (b) Reinforcement from other ingredients of the marketing mix; for example, if a firm decides to increase price and differentiate its product by quality, then promotion and distribution must address product quality.

Expected Results: (a) Higher sales margin. (b) Segmented market (price conscious, quality conscious, etc.). (c) Possibly higher unit sales, if differentiation is effective.

III. Price-Flexibility Strategy

A. One-Price Strategy

Definition: Charging the same price to all customers under similar conditions and for the same quantities.

Objectives: (a) To simplify pricing decisions. (b) To maintain goodwill among customers.

Requirements: (a) Detailed analysis of the firm's position and cost structure as compared with the rest of the industry. (b) Information concerning the cost variability of offering the same price to everyone. (c) Knowledge of the economies of scale available to the firm. (d) Information on competitive prices; information on the price that customers are ready to pay.

Expected Results: (a) Decreased administrative and selling costs. (b) Constant profit margins. (c) Favorable and fair image among customers. (d) Stable market.

B. Flexible-Pricing Strategy

Definition: Charging different prices to different customers for the same product and quantity.

Objective: To maximize short-term profits and build traffic by allowing upward and downward adjustments in price depending on competitive conditions and how much the customer is willing to pay for the product.

Requirements: Have the information needed to implement the strategy. Usually this strategy is implemented in one of four ways: (a) by market, (b) by product, (c) by timing, (d) by technology. Other requirements include (a) a customer-value analysis of the product, (b) an emphasis on profit margin rather than just volume, and (c) a record of competitive reactions to price moves in the past.

Expected Results: (a) Increased sales, leading to greater market share. (b) Increased short-term profits. (c) Increased selling and administrative costs. (d) Legal difficulties stemming from price discrimination.

IV. Product Line-Pricing Strategy

Definition: Pricing a product line according to each product's effect on and relationship with other products in that line, whether competitive or complementary.

Objective: To maximize profits from the whole line, not just certain members of it.

Requirements: (a) For a product already in the line, strategy is developed according to the product's contributions to its pro rata share of overhead and direct costs. (b) For a new product, a product/market analysis determines whether the product will be profitable. Pricing is then a function of costs, profit goals, experience, and external competition.

Expected Results: (a) Well-balanced and consistent pricing schedule across the product line. (b) Greater profits in the long term. (c) Better performance of the line as a whole.

V. Leasing Strategy

Definition: An agreement by which an owner (lessor) of an asset rents that asset to a second party (lessee). The lessee pays a specified sum of money, which includes principal and interest, each month as a rental payment.

Objectives: (a) To enhance market growth by attracting customers who cannot buy outright. (b) To realize greater long-term profits; once the production costs are fully amortized, the rental fee is mainly profit. (c) To increase cash flow. (d) To have a stable flow of earnings. (e) To have protection against losing revenue because of technological obsolescence.

Requirements: (a) Necessary financial resources to continue production of subsequent products for future sales or leases. (b) Adequate computation of lease rate and minimum period for which lease is binding such that the total amount the lessee pays for the duration of the lease is less than would be paid in monthly installments on an outright purchase. (c) Customers who are restrained by large capital requirements necessary for outright purchase or need write-offs for income tax purposes. (d) The capability to match competitors' product improvements that may make the lessor's product obsolete.

Expected Results: (a) Increased market share because customers include those who would have forgone purchase of product. (b) Consistent earnings over a period of years. (c) Greater cash flow due to lower income tax expense from depreciation write-offs. (d) Increased sales as customers exercise their purchase options.

VI. Bundling-Pricing Strategy

Definition: Inclusion of an extra margin in the price to cover a variety of support functions and services needed to sell and maintain the product throughout its useful life.

Objectives: (a) In a leasing arrangement, to have assurance that the asset will be properly maintained and kept in good working condition so that it can be resold or re-leased. (b) To generate extra revenues to cover the anticipated expenses of providing services and maintaining the product. (c) To generate revenues for supporting after-sales service personnel. (d) To establish a contingency fund for unanticipated happenings. (e) To develop an ongoing relationship with the customer. (f) To discourage competition with "free" after-sales support and service.

Requirements: This strategy is ideally suited for technologically sophisticated products that are susceptible to rapid technological obsolescence because these products are generally sold in systems and usually require the following: (a) extra technical sales assistance, (b) custom design and engineering concept for the customer, (c) peripheral equipment and applications, (d) training of the customer's personnel, and (e) a strong service/maintenance department offering prompt responses and solutions to customer problems.

Expected Results: (a) Asset is kept in an acceptable condition for resale or release. (b) Positive cash flow. (c) Instant information on changing customer needs. (d) Increased sales due to "total package" concept of selling because customers feel they are getting their money's worth.

VII. Price-Leadership Strategy

Definition: This strategy is used by the leading firm in an industry in making major pricing moves, which are followed by other firms in the industry.

Objective: To gain control of pricing decisions within an industry in order to support the leading firm's own marketing strategy (i.e., create barriers to entry, increase profit margin, etc.).

Requirements: (a) An oligopolistic situation. (b) An industry in which all firms are affected by the same price variables (i.e., cost, competition, demand). (c) An industry in which all firms have common pricing objectives. (d) Perfect knowledge of industry conditions; an error in pricing means losing control.

Expected Results: (a) Prevention of price wars, which are liable to hurt all parties involved. (b) Stable pricing moves. (c) Stable market share.

VIII. Pricing Strategy to Build Market Share

Definition: Setting the lowest price possible for a new product.

Objective: To seek such a cost advantage that it cannot ever be profitably overcome by any competitor.

Requirements: (a) Enough resources to withstand initial operating losses that will be recovered later through economies of scale. (b) Price-sensitive market. (c) Large market. (d) High elasticity of demand.

Expected Results: (a) Start-up losses to build market share. (b) Creation of a barrier to entry to the industry. (c) Ultimately, cost leadership within the industry.