

10 Pricing Principles



A marketing master class from



10

Pricing Principles

A marketing master class from CMO Zen

How confident are you that your pricing is right?

**After this master class,
you'll never need to wonder again.**



Back Story

Several years ago, I was the CMO of a SaaS startup wrestling with pricing decisions.

We needed an effective **pricing policy**, so I went on a deep dive to get smart about pricing and to parse fact from fiction.

These ten pricing principles are what I learned.

— Chad Jardine

Founding Partner, CMO Zen

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Pricing Canvas: 10



1. Pricing Objectives

For revenue-based objectives, which lever is right?



1a. Increase Ticket Size



1c. Increase Frequency



1b. Increase New Sales



2. Pricing Components

3. Pricing Strategy

4. Pricing Method

5. Pricing Structure

6. Price Positioning

Key

1-2 Orientation
3-6 Strategic
Components
7-10 Tactical
Optimizations

1	3		8
	4	7	9
2	5		10
	6		



3. Pricing Strategy



3a. Skimming



3c. Value Maximization



3b. Penetration



4. Pricing Method



4a. Cost-Based:
Asset | Market | Income

WTP

4b. Value-Based



5. Pricing Structure

+1

5a. Linear



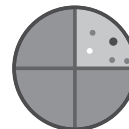
5c. Tiers, Bundling & Discounts



5b. Partial Tariffs



6. Price Positioning



6a. Classic STP

Ps

6c. Marketing Mix



6b. Unit of Sale/Value

0 Pricing Principles



7. Pricing Psychology

7a. Customer Type



7b. Buyer's Journey (GTM)



Sales-Led



Self-Directed
(Incl. PLG)

7c. Psychology/Cognitive Biases



First



Friends



Reactions



References

WTP Research Methods

Demand Curve
Van Westendorp
Gabor Granger
Conjoint Analysis



8. Pricing Optimization



8a. Split Testing



8c. Dynamic Pricing



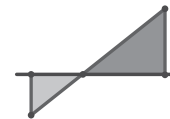
9. Pricing in Practice



9a. Unit Economics



9b. Price Leaks



9c. LTV/CAC



10. Price Changes

10a. Decide



10b. Communicate



10c. Execute



Value



Timing



Grandfather

Introduction

Pricing can be tough.

Pricing policy decisions are often made by *intuition* more than data or science.

Despite the reliance on intuition, it seems like everyone's heard of a *counterintuitive* pricing strategy that made all the difference.

Like the classic sale of ugly cats for \$100 in Denver (Beckwith, 2000) or one shop's accidental doubling of the price of turquoise jewelry (Cialdini, 1984/2021), both of which caused an uptick in sales.

I set out to understand objective pricing principles. Given a set of circumstances, what works every time?

What I learned is that pricing is understandable.

Getting smart about pricing is do-able, and it's probably easier than you think.

Of course I can't tell you what your particular pricing should be in a guide. I can, however, show you how to find it.

This master class will equip you with the tools to discover the right pricing strategy for your business and execute it.

The chapters are organized as follows:

- **Chapters 1-2** will orient you around pricing concepts.
- **Chapters 3-6** are the core pricing policy components.
- **Chapters 7-10** contain factors to optimize and influence those core components.

By understanding these principles you'll know how to find what customers truly value and that you aren't leaving money on the table.

And you'll never enter a pricing conversation naïvely again.

1. Pricing Objectives



Alternative Objectives | Revenue Growth Levers

What's your pricing goal?

What's the *objective*?

The objective is typically some type of revenue growth. That's the default and most of the time it's right.

But pricing is a versatile tool that can achieve a variety of business objectives and it gets interesting if your pricing goal is something else.

Alternative Objectives

Alternates can represent a short-term sacrifice for a long-term gain.

You may optimize for profit over revenue, or sales volume. You may deploy a loss-leader or try to encourage trials for a new product.

Common Pricing Objectives

Appear “fair” to customers & prospects
Avoid regulatory interference
Company growth
Create excitement about a product
Create interest in a product
Desensitize customers to price
Discourage competitor discounts
Discourage new market entrants
Encourage the exit of marginal firms
Encourage trial or switching
Enhance the brand perception
Focus on nonprice competition
Improve retention
Increase awareness or visibility
Increase contract length
Increase market share

Increase number of sales
Increase top-line revenue
Maintain or establish price leadership
Match competitor prices
Maximize long-term profit
Maximize short-term profit
Obtain a target return on sales
obtain or maintain supply chain loyalty
Obtain target ROI
Prepare the business for sale
Promotion/special offer
Signal quality
Social, ethical, or ideological objectives
Stabilization of margin
Stabilize market or market price
Survival

Sources: Wikipedia, Profitwell, Hubspot

You may try to stabilize prices, position differently against the competition, or influence perceptions about the product or your brand.

Pricing objectives can be pretty nuanced. This list (next page) can help you explore what some objectives might be and nail down yours so you're ready for what comes next.

If it turns out you don't have an alternate goal and you're really all about increasing revenue, then you can use the **Revenue Growth Levers** below to increase it.

Revenue Growth Levers

In *3 Frameworks for Boosting Revenue*, I share the **three revenue growth levers**. They are:

- 1a. Increase average ticket size
- 1b. Increase new sales/customers
- 1c. Increase frequency/repeat purchases.

That's it.

If you want more revenue, you've got to move the needle on one or more of these three things.

And pricing affects them all.

It gets better.

Since *frequency* is really just an optimization strategy, you only need to consider the two **new purchase** levers.

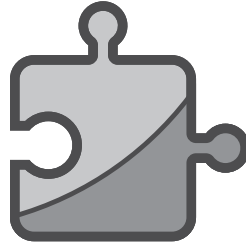
Keep *ticket size* and *new sales* in mind as you read how they affect pricing strategy and particularly bottom-of-funnel conversions.

Additional Reading:

The Demand Waterfall: A Modular System to End Chaos, Flaherty, T., 2018.



2. Pricing Components



Strategy | Method | Structure | Positioning

There are both strategic and tactical elements to pricing.

I love the framework of **Pricing Components** listed by Tomasz Tunguz in his article, *Ten Year's Worth of Learnings About Pricing*, for Redpoint Ventures. They are:

3. Pricing Strategy
4. Pricing Method
5. Pricing Structure
6. Price Positioning.

There's a lot of strategic value packed into each one. They're numbered to correspond to the companion **Pricing Canvas** and the next four chapters.

3. Strategy

There are three **pricing strategies** to choose from based on where your customers fall on the **demand curve** (more on demand curves later). It's very important that you understand and commit to the right one.

Method

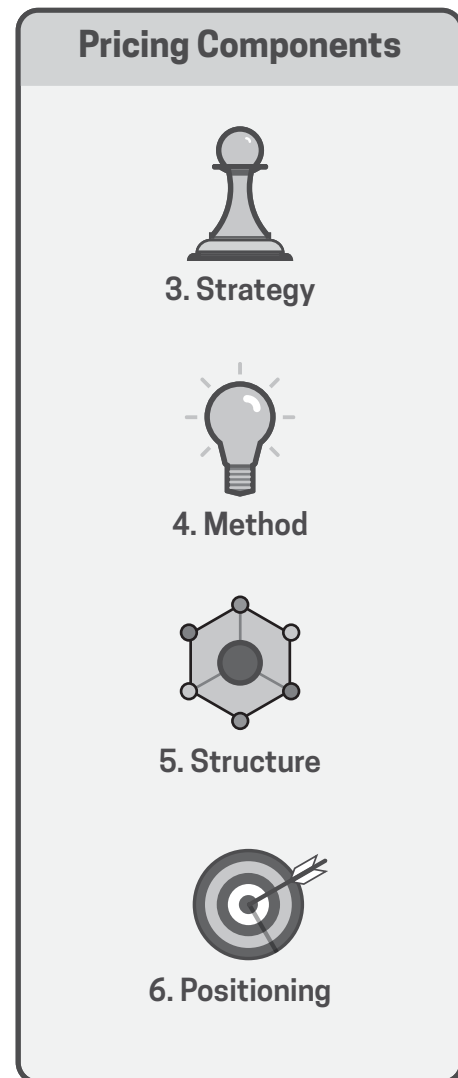
Tunguz calls this Pricing Philosophy. Is it easy to tell how customers value your product based on contextual clues? Or are you introducing something brand new and need to use tools to discover the value in the customer's mind?

Structure

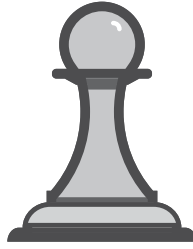
Are you using tariffs, bundling, or discounts to maximize the perceived value of your product? Should you?

Positioning

What does price communicate about how you relate to other products in the market? Does your purchase process, unit of sale, etc. align with what your customers care about?



3. Pricing Strategy



Value | Demand Curves | Skimming | Penetration | Value Maximization

There are three (and only three) pricing strategies:

- 3a. Skimming
- 3b. Penetration
- 3c. Value Maximization

Understanding which to choose requires an unpacking of the concept of Value.

Value

Value is rooted in exchange.

Since the first cavemen traded rocks, humans have been making decisions about exchanges based on what they *value*.

Today we use money for exchanges. And *price* is how we quantify value in these exchanges.

From there things get a little tricky.

If the value of a thing was part of its nature we would have an indisputable objective price for everything.

Theorems like *Rational Choice Theory* (that people always use rational decisionmaking to achieve rational outcomes) and the *Efficient Market Hypothesis* (all available information is reflected in the price) combined with a **Price Performance Analysis** (the amount of goods or functional performance I get for the price) would let us calculate a number.

If the value of goods and services was **intrinsic** and **objective**, pricing would be easy—there would only be one price which reflected the true value of any product.

But these theories haven't proven very useful for pricing decisions because value is **subjective** and **extrinsic**.

It's not inherent in the product at all. Instead it lives *in the mind* of each customer.

That means a product could theoretically have an infinite number of values. This is called the *Pricing Uncertainty Principle*—which says that all prices are *arbitrary* and *malleable*.

Now we're getting closer to something we can use to make pricing decisions.

In theory the Pricing Uncertainty Principle would tell us that an infinite number of prices might be possible. But even if that's true, **not all possibilities are equally likely**.

In practice, we don't see a smooth spectrum from zero to infinity. Instead we see lumpy clusters where buyers form groups or segments that place a similar value on any product.

Marketing researchers quantify these customers in terms of *demand*.

Demand is how we see what customers value.

Demand Curves

You've probably seen these charts before.

They represent change in demand at various prices.

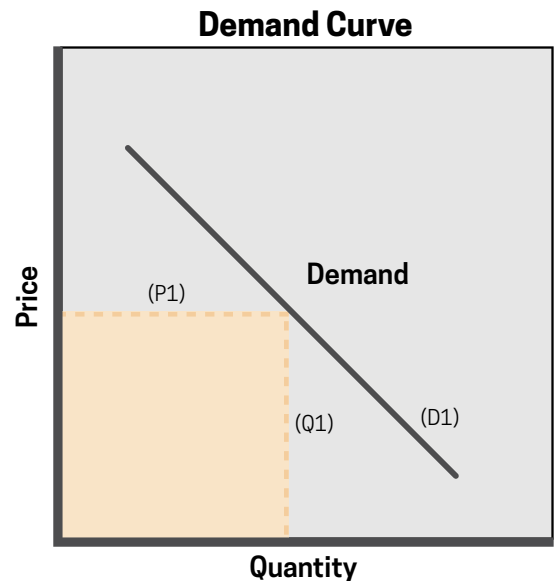
Given constant demand, increasing the price generally reduces the number of buyers who are **willing to pay**.

Notice that phrase, *willingness-to-pay* (WTP). Demand is often referred to as WTP. In fact:

Value = Demand = WTP.

These three terms are practically interchangeable—they all describe the motivation for someone to open their wallet and make a purchase.

The exact correlation between price and demand varies depending on the product.



Changing the price on some products causes a big swing in demand. For other products, price changes have a much smaller effect.

This variance in WTP is called *elasticity*, or *price sensitivity*.

And that's where the choice of strategy comes in.



3a. Skimming

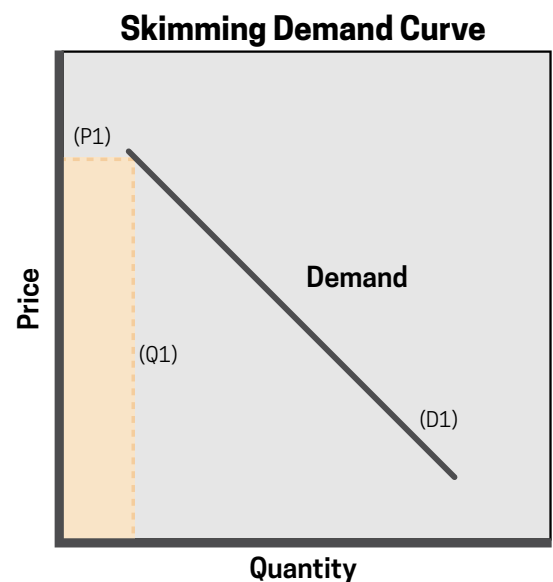
Skimming is charging a lot to a few.

You're skimming the cream, the topmost layer of WTP from the market.

Lamborghini, for example, isn't going for volume. In 2020, Lamborghini generated EUR 1.6B in sales on less than 7.5K cars per year.

By comparison, Tesla sold 500K cars, and Toyota sold 9.53M cars.

Skimming is often a strategy used for luxury goods like Lamborghini. It's effective



when people want the status of scarcity and high price.

When customers' purchase behaviors don't change much based on price, skimming is at its best.

Consider this. Would your purchase behavior change if I gave you a 10% off coupon for a Lamborghini?

Based on their sales numbers we can estimate that the average price is somewhere around \$215K. That coupon would be

worth **over \$20K**. But are you ready to rush out and buy one?

Not likely.

In fact, the discount might even tarnish your view of the purchase.

People prefer to pay as little as possible, with the exception of a countervailing social signal, as in the case of a **Veblen good**.

A Veblen good is a product that people actually value **MORE** because the price is high and sends a signal about their status.



We want what we can't have.

Human psychology comes with the FOMO app pre-installed. And scarcity (i.e., exclusivity or limited supply) drives up demand.

As a result, luxury cars and other Veblens are generally inelastic, i.e., NOT price sensitive.

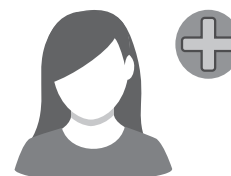
Real estate and fine art are like this. There's only one Mona Lisa and only one of any particular address on earth.

Today we can even create unlimited unique NFTs. (Kind of ironic that we can create something both unlimited and unique?)

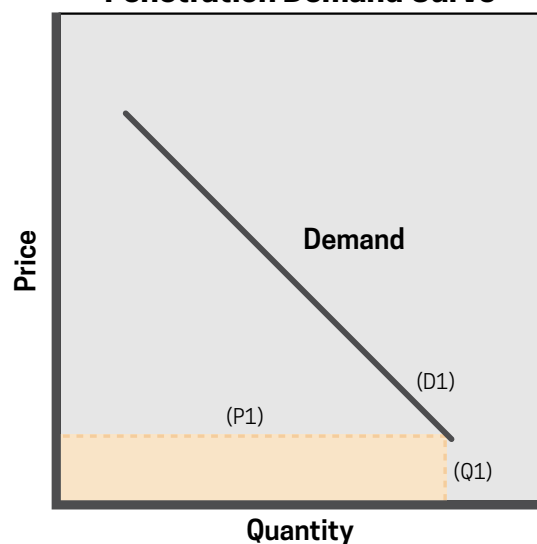
The bottom line:

This strategy is designed to capture the most revenue from each unit sold, not to sell the most units.

With a skimming strategy you're pulling the "ticket size" revenue lever.



Penetration Demand Curve



3b. Penetration

A penetration strategy on the other hand lowers price to reduce friction and achieve maximum volume.

It's all about capturing as many customers as you can.

In other words, you earn a small contribution margin from each sale while trying to box out competitors and own as much market share as possible.

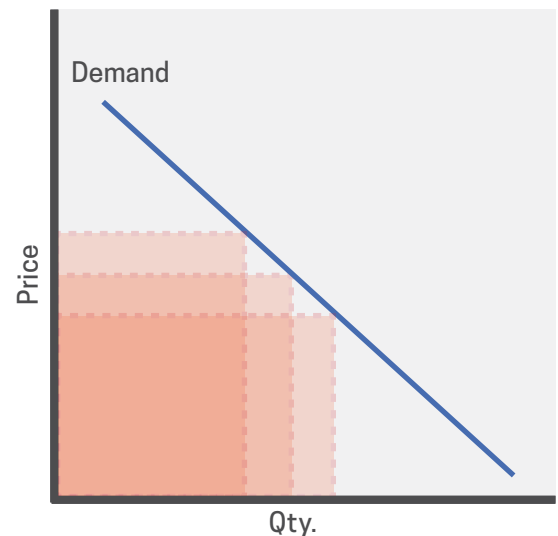
“Land and expand” approaches start with a penetration strategy, “freemium” and its product-led growth (PLG) successors being the extreme example.

Bottom-up approaches also start with a penetration strategy where you enter down- or mid-market and move upmarket to the enterprise.

A penetration strategy is about pulling the “new sales” revenue lever.



Value Maximization



3c. Value Maximization

The Value Maximization strategy is a balancing act between skimming (ticket size) and penetration (new sales).

Both skimming and penetration potentially leave money on the table.

The high skimming price certainly creates a barrier to otherwise willing buyers. And the low penetration price is less than what some buyers are willing to pay.

For companies that want to maximize growth, the value maximization approach strategy lets them pull both “ticket size” and “new sales” levers and try to extract every dollar of revenue the market is willing to pay.

For many, value maximization is the holy grail of pricing strategy.

Additional Reading:

[The Personal MBA by Josh Kaufman](#)

4. Pricing Method



*Cost-Based: Asset, Market, or Income | Value-Based: WTP | Markup v. Margin |
Surveys: Van Westendorp, Gabor-Granger, Conjoint Analysis*

Pricing is arbitrary.

The Pricing Uncertainty Principle tells us that. I mean, it's anyone's guess what a single person might be WTP, so why try?

But here's the deal.

Since value equals WTP, then **valuation methods** ought to tell us something quantifiable about broad-scale WTP.

And understanding the demand of a *crowd*—how entire markets value your product—is very useful.

The four valuation methods are:

1. **The Asset Approach**, a.k.a Replacement Cost
2. **The Market Comparison Approach**

3. **The Income Approach,**
a.k.a. Discounted Cash
Flows or Net Present
Value

4. **The Value-Comparison
Approach**

The first three methods are
“cost-based” approaches (the
fourth, as you’ll see, deserves
special treatment).

4a. Cost-Based Approaches

The Asset/Replacement Cost Approach

This method holds that a thing
is worth whatever it costs to
replace it.

Makes sense, right?

A historic building, for instance,
could be valued based on how
much it would cost to rebuild it
if it burned down.

Likewise, a company might
be valued as the sum of its

assets—equipment, real estate,
inventory, and IP.

Replacement cost is rational,
logical, and works... sometimes.

But then sometimes it doesn’t.

For example, [according to John Rowan](#), if you had to assemble
an entire automobile, buying
each component one at a time,
you’d end up paying as much
as ten times more for that
vehicle than buying one already
assembled off the lot.

Why?

Car manufacturers gain
efficiencies or **economies of
scale** by building vehicles in
large runs, not one at a time.
As a result, it doesn’t make
sense for cars to be priced using
Replacement Cost.

Also, in the last chapter we
covered the *intrinsic* nature of
value. Human beings can be
irrational, especially when it
comes to deciding what they
value.

One example of this is the **endowment effect**. People tend to value something they possess more than something they don't—a way of saying, *A bird in the hand is worth two in the bush*. (More about pricing psychology in Chapter 7.)

Because something cannot always be valued as the sum of its parts, we need other methods besides *Replacement Cost*.

Market Comparison Approach

This is the “look around” method.

The price of similar items is a signal for the market's WTP.

So, how similar do items need to be?

When there isn't much differentiation, those products are called **commodities** and the price is similar across the whole category.

In the public markets, the trading prices of commodities like gold or wheat move together. On a given day, the price of gold will be the same in Georgia or Seattle. The *Market Approach* tells us precisely what gold is worth.

Likewise **consumer packaged goods** (CPG) often exist in established and competitive markets. There might be some opportunity for differentiation based on quality, features, or brand strength—for example I might pay a little more for premium toothpaste or laundry detergent than the bargain option—but the prices aren't likely to be wildly different. As a rule, lots of competition puts downward pressure on margins and *commoditizes* prices.

What about products that are very dissimilar? How does the *Market Approach* work with something that's unique like a home, a business, or a software product?

Comparison is such a powerful signal that the *Market Approach* still works for differentiated products.

A home appraisal, for example, will include a list of **comparables**. None of the comparable homes is *exactly* like the appraised home, but each will be similar in size and features—close enough to justify the valuation.

Businesses are often valued using the *Market Approach* too.

The price to earnings (P/E) ratio for any public company reflects the confidence the market has that the company will earn profits in the future. P/E of 20 means the market values the company at 20 times its last year's profits.

By averaging P/E ratios across an entire category of companies, we get what's called an **industry-specific average multiple**.

How does this work?

Let's say a medical equipment company generates \$20M in annual profits and medical equipment companies have an industry average multiple of about 39 times earnings. That tells us the company in this example would be valued at roughly \$780M (\$20M x 39) using the *Market Approach*.

Income Approach/DCF & NPV

Some businesses or investments produce a stream of income.

The *Income Approach* uses that stream of cash flow and the **time/value of money** principle to determine value. The idea here is that *money in your pocket today is worth more than money in the future*—a lot like the “bird in the hand” idiom.

As a result, one hundred dollars today will be worth more than a contract for that C-note next year. This is due to historical

factors like inflation and general uncertainty.

To estimate a future cash value, we take today's value and apply a discount. Using a discount, we could estimate that next year's \$100 is only worth \$95 today.

Using a real life scenario, let's say you own an apartment building and your tenants pay rent. The rent payments every month create a stream of cash flows. Adjusting those future payments to reflect their value today, we apply an ever-

increasing discount the further they are in the future.

All future cash flows properly discounted give us a set of **discounted cash flows** (DCF). Then we can use [the formula](#) for calculating **net present value** (NPV) and *voila!* we have a value based on the *Income Approach*.

It's very interesting that over the past two decades, [software companies have largely transitioned](#) from the *Market Approach*, to the *Income Approach* by moving away from one-time desktop or on-premise



installations to **subscription-based** SaaS models.

Why would they do this?

Because the Income Approach, while more sophisticated and complex, establishes a basis for a much higher valuation.

4b. Value-Comparison Approach

The Value-Comparison Approach is different from the previous three.

Tomasz Tunguz describes Value-Based as a distinct **pricing philosophy** from cost-based approaches. And here's why.

The *Asset*, *Market*, and *Income Approaches* all attempt to objectively identify value, to peg the WTP for the entire market.

The *Value-Comparison Approach* acknowledges that a product may be worth more to one *group* of people than another. Rather than seek the global WTP

for the entire market or the granular WTP of individuals, the *Value-Comparison Approach* looks at a middle ground, the WTP for groups or *segments* of the market.

It relies on data about market segmentation and WTP for each segment. Then prices products accordingly.

Now you know what the four methods are, but how do you decide which is the right one to use?

How to choose the right pricing method

Pricing methods aren't a choice between equals.

Some methods will be just plain wrong for your business model. So, it's easy to start by ruling out any methods that don't fit.

Let's take them one by one.

Is the Asset/Replacement Approach Right?

Cost-plus pricing is the most common form of the Asset Approach.

Ask yourself if it makes sense to price your product by adding a markup to your cost (essentially its replacement value).

To analyze cost-plus pricing, let's be clear about the definitions of price and cost:

Cost = wholesale cost

Price = retail price

Price minus cost (P-C) is our **gross margin**. To calculate **margin** and **markup** as a percentage use the following:

Margin (how much profit we make) = $P - C / P$

Markup (how much we add to our cost) = $P - C / C$

If your margin is low it may be appropriate to *keystone* your price based on your cost. If it's

high, however, you may find that cost-plus tends to lead you to undercharge and another method might be better.

Is the Market Approach Right?

The *Market Approach* is almost always at least an option.

In fact, in competitive markets, this may be your *only* choice.

The comparison to other products may simply be too influential with customers for you to break with trends.

Similarly, if you're valuing a startup company, it may have no assets or significant cash flows yet. The *Market Approach* could be the only one that doesn't unfairly discount the value of the company.

Is the Income Approach Right?

Many products don't produce repeat transactions or the stream of cash flows needed for the *Income Approach*.

In that case, the *Income Approach* isn't an option.

As a side note, if you're a SaaS company, I recommend spending extra time to really understand how the dynamics of this method impact you.

Is the Value-Comparison Approach Right?

The *Value-Comparison Approach* relies on precise information about your customer's WTP.

Without that information, this approach is useless to you.

Madhavan Ramanujam, author of *Monetizing Innovation*, goes so far as to say you should determine the price customers are WTP *before even developing* the product.

So how do you get WTP data?

There's always trial and error. You can present a price, then watch how many people buy. T&E is a classic method for discovering the unknown.

But what if we could do it with less... you know, error?

And expense.

If you've spent millions in product development and have a lot (including perhaps your job), riding on the success of a new product launch, can you really afford to just price randomly? Could a little research give you the confidence that you've nailed your pricing before you launch?

An effective marketing research tool for discovering WTP is to ask your customers via surveys.

Surveys

WTP surveys aren't a silver bullet.

There are limitations. For example, customers don't always *know* their WTP. If someone asked you to share your precise willingness to pay for something, would you be able to tell them?



Madhavan Ramanujam
Author, *Monetizing Innovation*



Patrick Campbell
Founder & CEO, ProfitWell

I probably wouldn't. At least not exactly.

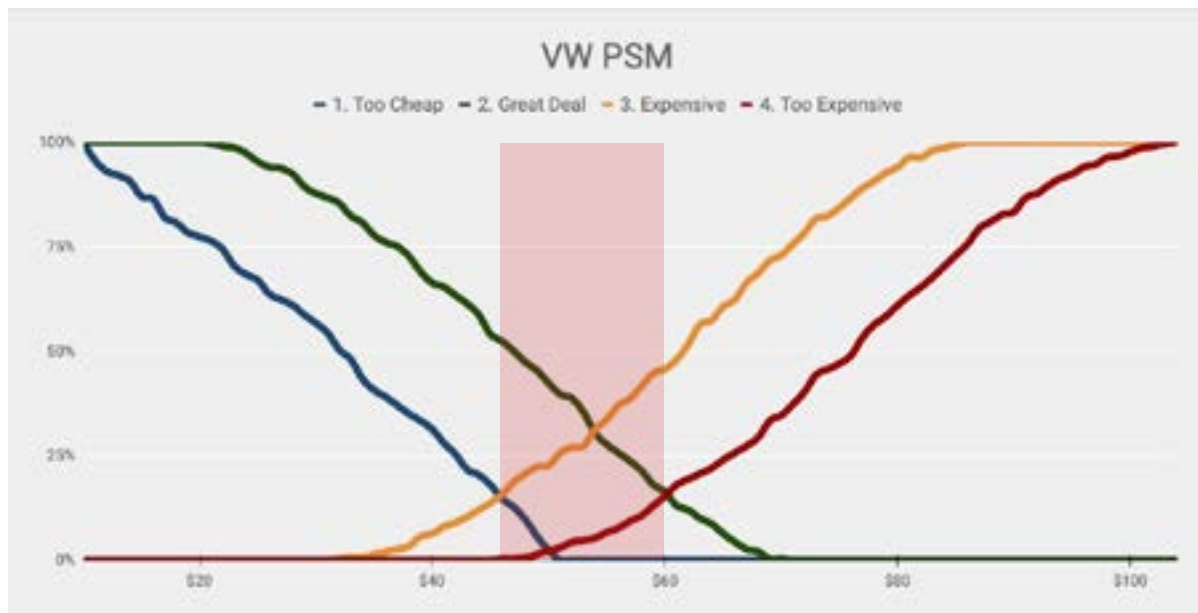
Furthermore some survey takers may think (perhaps correctly) that their responses will influence the final price. This might cause them to under report their WTP.

So surveys aren't perfect. But despite the limitations they're very useful.

When we got serious about our pricing conversations at GoReact, I read two articles

from *First Round Review*, *The Price is Right: Essential Tips for Nailing Your Pricing Strategy*, by Patrick Campbell, CEO of ProfitWell (formerly Price Intelligently) and *It's Price Before Product. Period.* By Madhavan Ramanujam of Simon-Kutcher.

Here you have two of today's best pricing experts both recommending something called a **Van Westendorp** survey.



Van Westendorp

In a *Van Westendorp* survey, respondents are asked four questions.

- What price is **TOO HIGH** you would never consider buying?
- What price is **GETTING EXPENSIVE**, but you would still consider it?
- What price is a **GREAT DEAL**, you would buy this right away?
- What price is **TOO LOW** that you would question the quality of what you were getting?

The resulting graph is called the *Van Westendorp Price Sensitivity Meter*, and typically looks something like the image above.

The intersecting lines create a characteristic diamond shape, which represents the *Zone of WTP*.

The Van Westendorp in Action

In 2017, GoReact (where I was CMO) was charging \$19.95 per user.

That price had held steady for two and a half years—a lifetime in SaaS. During this time the company had seen 700%

growth in revenue and a similar increase in customers.

We'd added significant features. We felt these features added real value but had not introduced any change in price.

Which is to say, we didn't really know how most of our customers valued the product. We had a gut feeling that we should raise our prices based on the lack of friction we saw with new sales, but we didn't *know*.

We were basically blind to WTP.

The team agreed that finding the sweet spot for value-based pricing, or the maximizing approach, is what we wanted. We chose to run a *Van Westendorp* survey with the following learning goals:

- Is WTP greater than our current price? If so, how much greater?
- Is WTP different from one customer persona to another? What is the

difference?

- Is there increased WTP attached to new features we intended to release later that year? If so, how much?

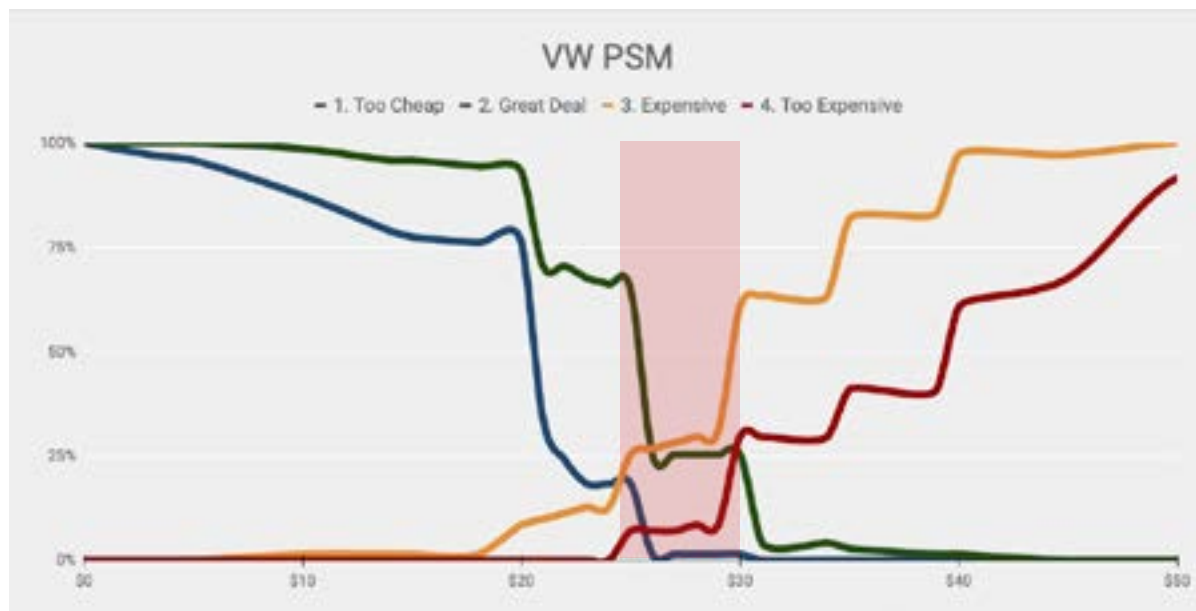
We surveyed two cohorts.

Prospects were surveyed about the price of GoReact in general. And we surveyed existing customers, asking them to rank the new features in order of importance. For the most important features, we asked the *Van Westendorp* questions.

We did our best to account for confirmation bias, potentially leading questions, and outliers.

The results of our survey are plotted on this chart (next page).

From this we learned several things: Our hunch that the current price did not reflect maximum WTP was confirmed. None of the respondents indicated the current price was



the max they were willing to pay.

We were priced at \$19.95, while the average WTP was \$27-30.

We learned that there was **WTP** for the new features we were adding to the product. And you can see from the chart on the following page, **WTP data manifested in clear bands**.

This gave us valuable insight into the price plateaus evident for our customers, indicating that we should probably evaluate multiple price points to maximize WTP.

Also, **WTP varied** between customer personas. Some personas were more likely than others to fall into a lower-price WTP band.

A significant number of comments (48%) showed **concern over changes to the price**. Even some who might be willing to pay more might lose enthusiasm and (we believed) evangelism for the brand. We risked losing some customers if we raised prices.

But perhaps most importantly, the data showed us the trade-offs. There was a WTP cliff at

\$30. At \$29 we might lose up to 30% of our customers BUT would gain 50% in revenue.

This was our revenue maximization sweet spot.

Other survey types

Van Westendorp isn't the only type of pricing survey.

Marketing Psychology pro **Nick Kolenda**, provides in-depth instructions and sample spreadsheets for three survey methodologies Van Westendorp, Gabor Granger, and Conjoint Analysis in his [online pricing course](#) (which I highly recommend).

All three aim to uncover the same thing. What is the WTP?

Gabor-Granger

Gabor-Granger and Conjoint Analysis both require a little more technical execution than Van Westendorp.

Price	3. Expensive	4. Too Expensive	Increase (3)
\$18	1%	0%	0%
\$20	8%	0%	7%
\$21	10%	0%	1%
\$22	11%	0%	1%
\$23	13%	0%	1%
\$24	13%	0%	0%
\$25	25%	7%	13%
\$26	27%	7%	1%
\$27	28%	7%	1%
\$28	30%	8%	1%
\$29	31%	8%	1%
\$30	61%	30%	30%
\$31	63%	30%	3%
\$34	63%	30%	0%
\$35	82%	41%	18%
\$39	83%	41%	1%
\$40	97%	61%	14%
\$45	97%	68%	0%
\$50	100%	92%	3%

Price	4. Too Expensive	Revenue	Likelihood
\$25	5	\$1,650	\$1,534
\$26	0	\$1,716	\$1,595
\$27	0	\$1,782	\$1,657
\$28	1	\$1,820	\$1,668
\$29	0	\$1,885	\$1,726
\$30	15	\$1,500	\$1,056
\$31	0	\$1,550	\$1,092
\$34	0	\$1,700	\$1,197
\$35	8	\$1,470	\$870

Gabor-Granger (named for its two inventors) surveys prospects by showing them a product and a corresponding price and asking if they would purchase.

If the prospect says yes, the question repeats at a higher price. If they say no, it repeats at a lower price. This continues until the prospect is willing to buy at one price, but unwilling

to go any higher—and now we have their WTP.

Over multiple responses we can ascertain the likelihood that any group of respondents is WTP. By analyzing the percentage of those who would buy against the profitability of each price point, we can discover the profit-maximizing price.

An advantage over Van Westendorp is that prospects don't have to come up with the pricing number on their own. They are shown a number and only need to record their yes/no decision about whether they would buy.

The disadvantage is that presenting a number from the outset may bias the response.

Conjoint Analysis

This method is named for the technique used to analyze the data. Similar to Gabor-Granger, survey takers are presented with a product and a price. What's different is that this approach presents them in pairs.

Two products with different quality or features are presented at different price



points. Respondents are then asked which he or she prefers.

After each choice, a new combination is presented. Ultimately those data are analyzed using the Conjoint Analysis technique. This gives us not only data about WTP for a given product, but also how much certain features or quality attributes impact the purchase decision.

An advantage of Conjoint Analysis is that it offers insights into complex purchase decisions and quantifies the trade-offs buyers are making.

Another survey technique, MaxDiff Analysis presents features and asks prospects to rate their most preferred and least preferred options. This doesn't tie directly to WTP, but does underscore which features are the most relevant in the purchase decision.

Next, we'll take a look at how various ways of structuring or

presenting your prices may impact how much buyers are willing to pay.

Additional Reading:

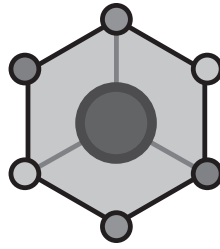
A wonderful treatment of Value-Comparison pricing is Malcolm Gladwell's 2004 TED talk [Choice and Happiness](#), which is all about... [Spaghetti Sauce](#).

[How To Price Your Product: A Guide To The Van Westendorp Pricing Model](#) - by Rebecca Sadwick Shaddix in [Forbes](#)

[25 Companies Show You Their Best SaaS Pricing Models](#), by P. S. Kullar

[Mastering SaaS Pricing: How to price your product from the seed stage through IPO](#), by Kyle Poyar of [OpenView Partners](#)

5. Pricing Structure



Linear | Partial Tariff | Tiers, Bundling & Discounts

How you structure pricing can impact value, perceptions, and WTP.

According to Madhavan Ramanujam, “*How you charge is often more important than what you charge.*”

Pricing structure helps create a match between both buyer and seller as they each seek to optimize the sale for themselves.

Buyers optimize for WTP, the quantity they need, and structures that match their perceptions of value. Sellers use structure to maximize **average revenue per user (ARPU)**, a transactional metric for measuring the value-maximization strategy from Chapter 3.

That’s not to say that pricing structures are always fair or equal for both sides, just that

they exist as a function of the interests of both.

5a. Linear (One-Part) Structure

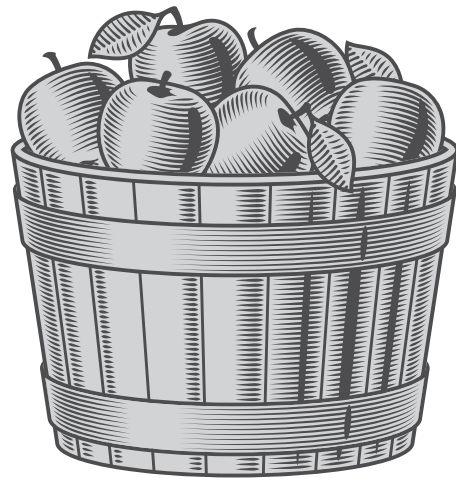
The simplest structure is linear.

When something increases proportionately with each additional unit, it's called **marginal**. Since linear pricing creates a one-to-one relationship between quantity and price, the entire structure is marginal.

In other words, if a grocery store sells apples for \$1 each, customers pay one dollar for every apple they buy. The price per unit never gets greater and never gets less.

Gasoline prices are also linear. The price itself changes often and the price is different for regular versus premium, but the structure is always linear, a set price per gallon.

Linear structure sometimes doesn't capture all of the advantages that best meet the needs of either buyer or seller.



Beyond linear there are multi-part structures, tiers, discounts, and bundling which offer more options for matching customer WTP.

5b. Partial Tariffs

Two-Part Tariff

In a two-part tariff system, customers pay a fixed price, plus a marginal price for each unit.

Since the fixed price is required in order to get the product units, it's viewed as a tax or a tariff on the transaction.

Using apples again, if the supermarket required each customer to purchase a basket for five dollars and then to pay \$1 for each apple they put in the basket, you'd have a two-part structure.

Similarly if a customer pays a flat fee to access a software platform, plus an additional fee per user, per transaction, or per

process? (Picking the right unit of sale is covered in the next chapter), that's also a two-part structure.

Three-Part Tariff

Three-part pricing requires the same flat fee tariff to unlock the purchase of marginal units *but* the flat fee includes some units.

Instead of buying just a basket for \$5, your basket purchase might include 5 “free” apples for \$8. Then each additional apple costs \$1. That's a three-part tariff structure. The three parts being the basket, the included allotment of apples, and the additional apples purchased.

In SaaS software, three-part pricing has proven to generate the highest revenues. See the research supporting this in Yong Chao's *Strategic Effects of Three-Part Tariffs Under Oligopoly*.

One reason customers prefer this is called the [Taxi-Meter Effect](#). Research suggests that

passengers in taxis experience anxiety from watching the meter tick up during their journey. By contrast the certainty of a fixed price is comforting to them. Purchasing in larger increments also reduces the cognitive load of making a purchase decision for every additional unit.

5c. Tiers, Discounts, and Bundling

The three structures are really just collections of tiers and discounts.

These constituent parts can be as simple or as complex as needed. (The tariff component is basically a minimum tier.)

In the GoReact example from Chapter 4, there were at least four clear bands of WTP—a great data-informed place to start evaluating pricing tiers.

Tiers may line up with WTP, which can map to certain sets of features. Other times tiers are tied to discounts.

Discounts for products with high elasticity are one of the most common and visible pricing policies.

Discounts can be permanent parts of a pricing program. For example discounts for volume, contract length, future commitments, or early payment may be standard practice.

Other discounts are temporary, seasonal, or promotional. Black Friday sales, Amazon Prime Day, back-to-school sales, holiday sales, product launches, and end-of-quarter incentives all fit this description.

And discounts come in many forms: percent off, dollars off, buy-one-get-one, buy-one-get-discount, free shipping, loyalty rewards and cash back, etc.

Choose your quantity

Quantity	Price per flyer	Pack price
50	\$0.78	\$39.00
100	\$0.66	\$66.00 \$78.00
250	\$0.44	\$109.00 \$145.00
500	\$0.27	\$135.00 \$240.00
1000	\$0.19	\$186.00 \$400.00
2500	\$0.14	\$353.00 \$1450.00
5000	\$0.12	\$598.00 \$3000.00

Consider a purchase of printed materials. Most printers charge a set-up fee and then a price per unit. Below is a pricing table from [Moo's website](#). Notice how the price per unit drops from \$0.78 for fifty flyers to \$0.19 for one thousand?

Where might this fit in the examples we've given?

It's not linear for sure. It has some attributes of two-part tariff pricing, but there's no flat

fee. This is discounting based on tiers.

It's also likely cost-plus because printing is fairly commoditized. Since it takes some work to set up a print run, but after that, the cost to create one more unit is proportionately tiny. Chances are the printer even runs a few extra for free and uses them as labels on the outside of the box.

Another way to use tiers is bundling.

Bundling like items is about volume (ever try buying just one egg?) Both the two- and three-part tariffs are a type of bundling.

Pizza and Breadsticks

You can also bundle complementary items like pizza and breadsticks. In the apples example, the basket is complementary to the apples. Likewise for software the software platform fee is complementary to the users or transactions made on the platform.

Madhavan Ramanujam has a pricing puzzle I love that uses pizza and breadsticks. I've often used it in my classes for MBA and MSF students at the University of Utah. Ramanujam reports that fewer than 10% of executives arrive at the most profitable approach.

Here's the punchline. In Ramanujam's scenario,

adjusting the bundling strategy has the potential to unlock 54% more revenue.

Same product. Same mix of WTP. Same number of potential customers. **54% more revenue!**

The *only* difference is the pricing approach.

Does that pique your interest?

Just think what you would be willing to do in order to raise revenue by 54 percent?

What would you do to raise ANY key metric by 54 percent?

That is what makes the headache of trying to uncover your customer's true WTP totally worth it.

Okay, what is the pizza and breadsticks scenario?

Imagine you own a world famous pizzeria that makes delicious pizza and cheese breadsticks. In an effort to decipher pricing, you study

Pizza & Breadsticks

What's the revenue-maximizing price?

Segment	Size	WTP Pizza			WTP Bread		
		Pizza	Bread	Bundle	Pizza \$8 Bread \$8.50	Bundle \$10.50	Mixed Bundling
A	100	\$9	\$1.50	\$10.50	\$800	\$1,050	\$900
B	100	\$8	\$5	\$13	\$800	\$1,050	\$1,300
C	100	\$4.50	\$8.50	\$13	\$850	\$1,050	\$1,300
D	100	\$2.50	\$9	\$11.50	\$850	\$1,050	\$900
Total Revenue					\$3,300	\$4,200	\$4,400

your customers and discover four segments.

Segment A loves pizza and will pay as much as \$9 for it but is not a big fan of breadsticks (they'll only pay \$1.50 for this).

Segment D loves breadsticks and will pay \$9 but doesn't love pizza (they will only pay \$2.50).

The other two segments, B and C, fall in between A and D in WTP.

There are 100 of each segment coming into your pizzeria each month.

For example, if you sell the pizza at \$4.50 and the breadsticks at \$5, you would make a total of \$2,850, since at \$4.50, segments A, B, and C will buy the pizza; at \$5 for the breadsticks, segments B, C, and D would buy it. Total revenue would equal $(\$4.50 \times 300) + (\$5 \times 300) = \$2,850$.

What is the maximum monthly revenue you can earn?

The most common answer I get from MBA students is to charge \$8 for pizza and \$8.50 for breadsticks. They quickly see that maximizing revenue is a balancing act between number of customers and revenue per customer.

This approach yields $(\$8.00 \times 200) + (\$8.50 \times 200) = \mathbf{\$3,300}$.

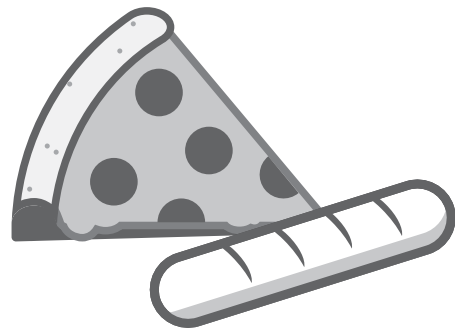
A nice bump from \$2,850.

But what if we priced based on combined WTP and bundled pizza and breadsticks together and sold the bundle for \$10.50? This price is below the combined WTP for ALL customers.

It yields $(\$10.50 \times 400) = \mathbf{\$4,200}$.

In this example, bundling clearly generates more revenue than an unbundled price.

But there's one more approach called mixed bundling. What if we offer either a bundle OR individual items from the menu? Could we capture more of the WTP?



If we bundle for \$13 we capture the combined WTP for Segments B and C. Then if we price pizza or breadsticks alone at \$9, we capture the WTP for pizza from Segment A and breadsticks from Segment D.

And the approach yields $(\$9 \times 200) + (\$13 \times 200) = .$

In this fictional scenario we went from \$2,850 to \$4,400 (a 54% increase) just by changing our pricing decisions.

Leader, Filler, Killer

What if the items you're bundling are more diverse?

In the pizza and breadsticks example, both items are treated as equivalent. But what if we're talking about a burger and fries? Would anyone place the same value on the fries as the burger?

The Leader, Filler, Killer framework (from Simon-Kutcher Partners) is this.

Leaders are must haves. These are the primary drivers of WTP.

Fillers are nice-to-haves. Customers like them, but probably wouldn't pay more for them.

Killers are detractors, actually reducing WTP.

The example Simon Kutcher gives is a burger meal combo. The burger is the Leader, the fries and drink are Fillers. If the meal included coffee or a dessert, that would be a killer because many people don't drink coffee or don't want a dessert with their lunch.

Kevin Cohn adds that using this framework for "good, better, best" pricing for SaaS products (where each upgrade includes everything below it) means that a feature's status as leader, filler, or killer changes depending on the bundle.

What is a leader for the "good" package, is by definition

filler for the “better” package (otherwise you could charge “better” package prices for “good” features). Likewise, the leader feature in the “best” bundle is a killer for the “good” and “better” bundles because it’s more than they need or are willing to pay for.

One last caution about bundling. Consumers tend to average the prices in a bundle. So it’s usually not a good idea to bundle a large ticket item with a small ticket one.

To arrive at the best structure, tiers and/or bundling just examine the approaches in this chapter for your own company and product(s).

Is linear, two-part tariff, or three-part tariff the right structure? What impact on ARPU would there be by introducing pricing tiers and volume or other discounts? Finally, is maximum WTP captured with unbundled,

bundled, or mixed bundle pricing?

Additional Reading:

[A Structural Pricing Competitive Advantage in SaaS - The Three Part Tariff](#) by Tomasz Tunguz

[Strategic Effects of Three-Part Tariffs under Oligopoly](#) by Yong Chao

[Clearbit: The Key to SaaS Pricing](#), by Kyle Poyar

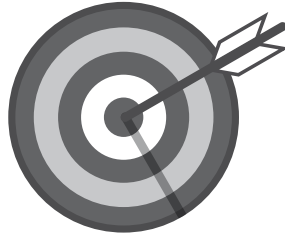
[Leaders, Fillers, and Killers: Creating Bundles That Work](#) by Kevin Cohn

[Insights from 100 SaaS Companies: Why It’s Time to Rethink Your Packaging Strategy](#) by Kyle Poyar

[Mastering SaaS Pricing, How to price your product from the seed stage through IPO](#) by Kyle Poyar

[An Introduction to the Theory of Mechanism Design](#) by Tilman Börgers:

6. Price Positioning



STP | Unit of Sale/Value | Marketing Mix

Positioning is about context.

To establish context it can be helpful to start from a global, zoomed-out perspective and then narrow the focus.

6a. Classic STP

An effective way to zoom in is to use the Segment-Target-Position (STP) method. Here's how.

Start by **segmenting** the market of potential buyers.

Segments might include demographic, geographic, psychographic, or behavioral criteria. Segments **MUST BE DISCRETE**, a person is either in or out of a segment.

For example, a demographic segmentation might be by age. A prospect is either over 18 or under, but not both.

With the market divided into segments, the next step is to **target** the segment that you best serve. This is your **ideal customer profile** (ICP)

Selecting a segment to target is making a choice that people with certain attributes are your potential customers, and others are not.

Now comes the tricky part because there are likely others already selling to that target, perhaps they are selling products with similar benefits.

Positioning is about how you intend to compete for a share of that target market. If there is a low-cost leader (using a penetration strategy), will you try to be cheaper? Will you try to capture the premium (skimming) spot or compete on quality (value)?

That puts us back to defining value, but positioning is defining value *in context*.

One of the ways innovative, novel, and category-defining companies can adapt to their particular context is to re-think the unit of sale.

6c. Defining Your Unit of Sale

A unit of sale is the variable axis that scales what the customer pays for.

Customers may pay for users (Salesforce.com), for files (Shutterstock), for transactions (Stripe), or purchase an all-you-can eat enterprise license agreement (ELA).

You probably have several options to choose from. They typically correspond to either what is the easiest thing for you as the company to sell, or what makes the most sense as a unit of value for the customer to buy.

Venture Capitalist and startup blogger [David Skok](#) was

interviewed on Jason Lemkin's [SaaStr podcast](#) and gave an excellent breakdown of [SaaS pricing](#) in particular (starting about 32:30) and discussed variable pricing axes.

The unit of sale question is deciding what unit you charge more for when it is consumed? In the GoReact case that was individual users. Skok actually makes a case for moving away from users and using the Hubspot model of leads/contacts, which is usage based. In fact, in their 2021 SaaS Pricing Guide, OpenView reported, "7 out of 9 recent software IPOs with the best net dollar retention have a usage-based pricing model."

The move to usage based is rooted in the key principle that your variable metric scales up or down in order to fully capture the customer's WTP.

6c. The Marketing Mix

An overlooked tool in positioning is the Marketing Mix. The Marketing Mix was originally developed as a messaging tool. It involves 5 Ps.

- Product
- Promotion
- Place
- People
- Price

Think of these as dimensions upon which you intend to differentiate, to "win" against the competition. Most products are trying to win on one. It's very difficult to win on two or more because to emphasize one, you must compromise on the others.

Here's an example from retail.

Target aims to win on **product**. Their buyers tend to sacrifice price in order to offer products that appeal to the upscale side of the mass market.

Kohls tries to win on **promotion**. They flood our mailboxes with coupons and Kohls Cash and the price marked on the rack is never what you pay at the register.

Amazon competes on **place**—the Internet and Prime shipping make it super convenient to do your shopping from home.

And what about Walmart? Of course they try to win on **price**. Their slogan, “*Save money. Live better.*” is all about price.

While these giants are fierce competitors, they have all survived because the market includes some customers who prioritize each of the various elements of the Marketing Mix.

You’ll notice that there is a pricing component to all of the Ps. Knowing for which P you’re trying to win versus the competition informs your price positioning strategy.

Established markets and categories can be a crowded place to differentiate. Savvy marketing coaches like Al Reis and Jack Trout, authors of *Positioning: the Battle for Your Mind* (1980) or newcomer authors of *Play Bigger: How Pirates, Dreamers, and Innovators Create and Dominate Markets* (2016) tackle the challenge of differentiation by avoiding competition altogether and instead reframe a company in a new category where it is the leader.

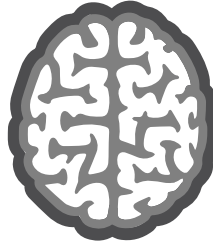
Creating a category solves a lot of problems that face competitors within an old category. And it influences, but doesn’t solve the question of pricing. Because even in a market where you’re the only player, the customer can opt-out and choose not to buy. You’re still positioning against the status quo, which might be choosing nobody.

Takeaways that may influence your pricing policy from this chapter include: have you done an STP exercise to understand who your market is and how you intend to differentiate yourself from others targeting the same buyer? Are you clear on which factor of the Marketing Mix is the one you intend to “win” on? Have you considered your options for unit of sale, and selected the unit(s) that offer your best opportunity to capture maximum WTP?

Additional Reading:

[How to Actually Use the 4 Ps of the Marketing Mix by Chad Jardine](#)

7. Pricing Psychology



*Customer Type: B2B/B2C | Buyer's Journey (GTM): Sales-Led v. Self-Directed
Psychology Effects & Cognitive Biases*

The human brain is **the most complex thing in the universe.**

One of its main jobs is making decisions. Research has uncovered certain norms that help predict what people are likely to choose, prefer, and do.

For six chapters we've looked at value, demand, and WTP as static facts in need of discovery.

But what if WTP isn't static? What if you can *change the customer's mind?*

Well, you can. Sometimes.

Knowing the research into understanding the psychology of pricing and purchase decisions gives you tools to influence WTP.

Maybe that sounds like a pile of manipulative mind-bending voodoo. But I

view it as every marketer's job to understand some basic truths about human nature, happiness, and satisfaction.

7a. Customer Types

B2B and B2C are more than just jargon.

Business-to-business (B2B) or business-to-consumer (B2C) describe distinct buyer-seller configurations with different psychology at work. Individual consumers buy differently than businesses.

Hang on, you say. There's still a person making the decision (a business is just a bunch of people, right?). So why are they so different?

It's the accountability. B2C purchase decisions begin and end with the buyer. As a result, B2C sales tend to be more emotional and impulse-driven.

"Peace of mind" or "getting a great deal" can be big drivers for B2C purchases.

My first sales job was selling real estate—big ticket B2C.

I was shocked that buyers often made such an expensive and important financial decision so emotionally. They didn't do deep analysis, call everyone they knew, or come through a home dozens of times.

They used what I imagine was the same decision process as a trip to the grocery store.

B2B purchases on the other hand tend to be more "considered" and the decision process tends to be long. Sometimes this is because there is a "buying committee" of stakeholders that need to reach consensus in order to purchase. It's also because the purchase decision can come under review.

IBM's old slogan, "Nobody ever got fired for choosing IBM" was aimed directly at the psychology of B2B sales. Buyers needed to be able to justify and defend their decision. As a result B2B sales tend to be more technical and feature-driven.

What about more nuanced categories like B2B2C, B2SMB, DTC, C2C and so on? ([Here's a breakdown by Tradly.](#))

DTC and C2C represent different seller configurations, but the buyer is still a consumer, so these behave like B2C. As a rule, SMB sales also behave a lot like B2C because the company is small and usually doesn't have the accountability infrastructure. The purchaser is often the founder or CEO who doesn't report to anyone upstream.

On the other hand B2B2C, such as selling to a restaurant, hospital, retailer, etc. can usually be lumped in with B2B.

7b. Buyer's Journey (GTM)

Self-directed (such as PLG) or sales-led go-to-market approaches have different implications for pricing. These are often called GTMs, but I've used "Buyer's Journey" here because how you take a product to market is less important than how a customer buys.

Product-led growth (PLG) software companies drive hard toward a self-directed sale, or at least a product usage-based qualification. But PLG isn't the only type of self-directed sale. Other examples include e-commerce, vending machines, and self-checkout.

Some products, however, require a salesperson to resolve concerns, select the right configuration, navigate internal stakeholders, or nudge buyers through the sales pipeline.

You might start down the product-led or sales-led path only to find you need to introduce the borrow from the other journey later on. Many companies that start PLG ultimately need to add a sales function to continue growing. Many early PLG companies discovered this as they matured.

Key to determining which approach fits you is your ticket size, or in the case of subscription sales the size of your annual contract value (ACV). If you need salespeople, your ACV needs to be large enough to support their commissions and compensation. If that isn't possible, you'll need to explore a self-directed go-to-market strategy.

Whatever the case, there's a lot of psychology at work and you've got to consider how the journey impacts both your cost and the buyer's perceptions

7c. Psychological Effects/Cognitive Biases

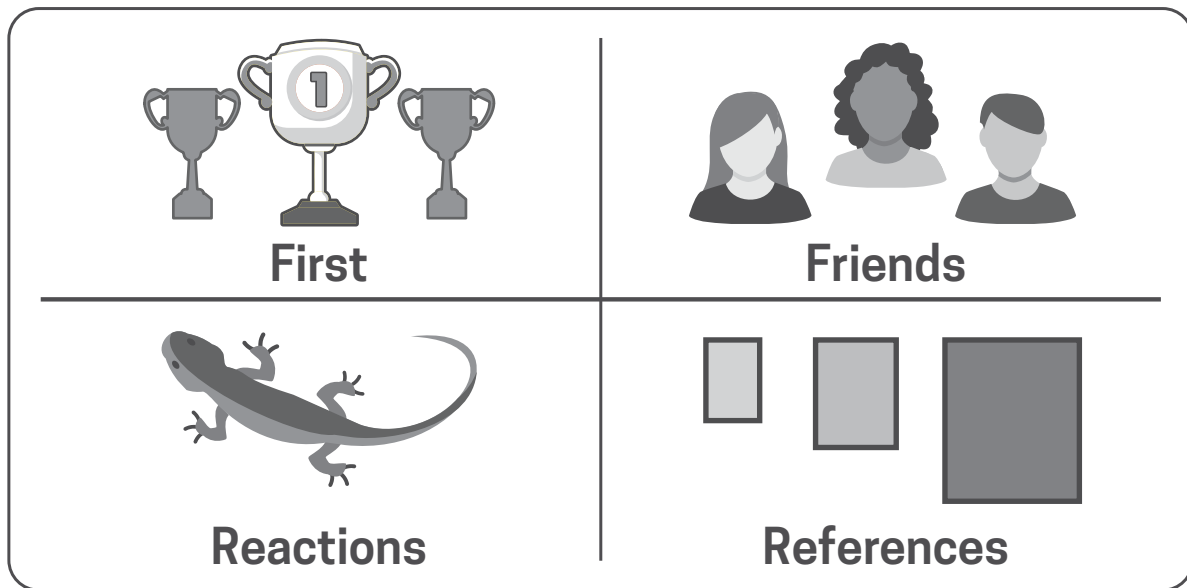
Research has produced an enormous list of psychological effects and cognitive biases.

When it comes to pricing, I group the most relevant ones into four groups: **First, Friends, Reactions, & References.**

First

The **first thing we encounter** or the **first thing we recall** has an outsized impact on how we perceive everything that follows.

Anchoring. Also known as **reference prices** describes how the price we know influences our perceptions of any subsequent price. Presenting a product as normally \$25, but currently on sale for \$12. We perceive \$12 as a discount. The opposite is also true if we



anchor at a lower price, we can make the same \$12 price feel expensive.

Primacy Bias. Related to Anchoring this is the phenomenon that in any list, we will give more weight to the first item on the list.

Recency Bias. Our memory fades, so things we saw recently are weighted more than things we saw in the past. In his book, *Thinking Fast, Thinking Slow*, Psychologist Daniel Kahneman said, “We give too much weight to information we’ve seen,

heard, read or experienced most recently.”

Availability Bias/Availability Heuristic. We overemphasize information that is available to us—things we know or can recall. In effect, “only” is another way to be “first.”

Frequency Bias. We learn through repetition. The decay of our memory can be mitigated by frequency. We are more likely to overemphasize things we have seen repeatedly. Being the first item someone

can recall is another way to be first.

Mere Exposure Effect. This simply states that we prefer things with which we are familiar.

In Robert Cialdini's 1984 classic, *Influence: The Psychology of Persuasion*, he tells the story of the Drubeck brothers as told by Leo Rosten.

Sid and Harry Drubeck were tailors. Sid would be helping a customer admiring a new suit in front of the mirror. Admitting to poor hearing, Sid would ask the customer to speak up as they chatted. Once the customer asked Sid for a price, he would call back to Harry and ask how much for the suit.

Harry would shout back, "That top-quality suit is \$42."

To which Sid would relay, "He says it's \$22."

The customer would rush to pay the \$22 before too much

discussion between the brothers might reveal the steep discount due to Sid's hearing problem. Of course, \$22 was a high price and exactly what Sid and Harry intended to sell for, but the customer was happier to pay it when they thought they were getting a discount.

A high-tech example comes from venture capitalist Mark Suster's interview on the SaaStr podcast. Suster talks about pricing strategy from his time at Salesforce.com and the then-novel pricing strategy of pricing at a premium and then liberally discounting.

If you can expose customers to any larger number first, it will influence their frame of reference.

The theme is that *sequence matters*. If you can expose customers to any larger number first, it will influence their frame of reference. To make your price appear lower,

introduce a higher price first, often, and soon relative to the time you want a customer to be exposed to the price you want him or her to pay.

Friends

Humans are herd animals in many ways. We take cues from others and we care about our relationships to those around us. Others also influence our WTP.

Social Proof

Nobody wants to be the first kid in the pool. But once one kid jumps in, peer pressure takes over and everyone follows.

That's because we are primed to see the behavior of others as a signal for what we should do and what is safe. Ratings, reviews, testimonials, and case studies all lower our guard and increase WTP.

Under the heading of Social Proof are several more nuanced effects.

The Bandwagon Effect. Also called **Conformity Bias**, is that we tend to adopt behaviors for no other reason than because others are doing it. We sometimes do this against our own beliefs.

The Belonging Effect. We derive emotional value from a sense of belonging to a group. Seth Godin's book *Tribes* explains how deeply our relationships with brands are affected by our perceptions that a brand shares our beliefs.

Community Bias. We tend to overvalue thoughts that are popular in our communities and undervalue thoughts from outside the community.

Likability Effect. Similarly, we tend to like those who are most similar to us, whether they are similar in the food they like, the sports teams they follow, or the brands they wear.

Mimicry Bias. We not only imitate the large actions of the

herd, but also small nuanced actions. We unconsciously imitate gestures, facial expressions, speech and movements of those we are with.

Authority Bias. We tend to trust figures of authority. We see this with influencers, experts, public speakers, and those with large followings.

Essentially Social Proof and its related effects show us that humans are wired to get and stay in sync with those around them.

If you can wrap your pricing in social proof, people will be more likely to buy.

More than just observable characteristics of others, sometimes we are motivated by how we perceive our relationships with others will be affected.

Gain or Loss

A number of biases are tied to our sense of investment, gain, or loss from our social relationships.

The Fear of Missing Out (FOMO). Also called the **Scarcity Effect** this is when we feel like others are having a positive experience, we want to have it with them. This is the psychological root behind the demand curve, where scarcity drives up prices.

Loss Aversion. Just like we fear losing opportunities, we fear other losses. This is the idea that because a loss hurts disproportionately more than the happiness we feel at a gain (losing \$100 is more significant than gaining \$200), we will do everything in our power to avoid it.

Reciprocity. Part of most cultures is the idea that when someone gives you something,

the appropriate response is to give something in return.

Things that appear as gifts: free add-ons, free samples, generous terms, etc. all motivate a sense of reciprocity.

Endowment Effect. We tend to overvalue things we own and feel they are worth more than we would pay for them new. This impacts how customers experience free trials. As trials expire, customers feel a fear of losing something they have gotten used to possessing.

Ikea Effect. When we invest time and effort and have a hand in creating something, we value it more than if we merely purchase it. Products that we invest in setting up or where we build on it during a trial, are more likely to convert at the end of their trials.

Momentum Effect. Also called the **Foot in the Door Effect**, if we can get a customer to take small steps toward

a purchase, they are more likely to take subsequent steps and complete the purchase. Pilots, introductory offers, and discounts followed by upsells all follow this principle.

Disposition Effect. Gains don't have to be realized to motivate purchase behavior. We often make purchase decisions based on perceived gains. We anticipate an outcome in the future, and make decisions as if we have already received it.

Before you write this off as foolish, most investing, insurance, putting money away for retirement, etc. are trading on the Disposition Effect.

In addition to a perceived future gain is the idea that the buyer will feel smart and prepared in the future.

Direct buyers to higher priced products by loading up the features at the top tier to dial up the perceived value.

Impact Bias. The nail in the coffin of loss is Impact Bias, which is that we overestimate the intensity of the way we will feel in the future. We think the loss will feel deeper and more intense than it actually will. The same psychology that keeps us in bad jobs and bad relationships also keeps us from canceling subscriptions.

Context

What surrounds an offer impacts our perception of it. This may be physically, visually, or metaphorically in time.

Framing. When we present offers in a desirable context or show a desirable outcome as a result of a purchase, we increase the customer's WTP.

The power of Framing is that customer behavior can change based solely on how the offer is framed. Nothing about the offer itself—terms, price, product features, etc.—needs to be different.

Products can be purchased outside the context in which they will be used. If I buy CRM software for instance, I make the purchase decision before the software is set up and long before I am extracting its full value. Putting the future benefit in context helps bridge this gap.

The downside is that this is also why we got the Marlboro Man and generations of beer commercials showing bars full of supermodels.

But there is an authentic and genuine version where we allow the customer to get a real sense of how a product solves a problem in their day to day life.

Reactions

The *First* and *Friends* categories are pretty understandable and rational.

Then there is a whole world of our psychology that is unconscious, that happens without our awareness for the

most part. This type of effect, I call Reactions because they just happen.

As a general rule, we seek comfort and clarity, avoid confusion and pain.

Deeper and more evolutionarily ancient are the emotions and decision making that stem from the more primitive parts of our brains.

The amygdala, or as it has become popularly known, *the lizard or crocodile brain*, is where we make gut reaction decisions.

Fluency. The idea that if things feel as expected, we scan a pricing page, or a product description and it feels familiar, then we are more likely to believe we understand it and be confident in our decision to purchase. We're familiar with Fluency in reading and likewise pricing information is most fluent when it's organized left-to-right (for Western cultures) and top-to-bottom.

Cognitive Dissonance. People look for evidence that purchase decisions were smart or correct. We all want to believe we are internally consistent. When onboarding and customer success teams reinforce our belief that a decision was good, it can be a key satisfaction driver and influence repeat purchases, DRR/NRR, and NPS.

Buyer's Remorse. The tendency to second-guess or doubt our purchase decisions.

Choice Supportive Bias. The opposite of Buyer's Remorse, the tendency to retroactively assign positive aspects to past decisions.

Purchase Satisfaction. Happiness with a purchase, NPS, consistency in our decision process.

Confirmation Bias. That we seek and remember information that supports our previously held beliefs.

Irrational Escalation. This is the idea that we make decisions based on previous rational decisions even when the scale has rendered them irrational. An example is a bidding war in an auction may prompt both bidders to offer more than they would be able to rationally justify.

Status Quo Bias. This is a preference for things as they are, an avoidance of change. Oftentimes the most significant competitor a company faces is not another company or product, it's simply making the choice to buy nothing at all.

Decoy Effect. What if you have two different products, and they aren't very different?

You can introduce a decoy. By listing another option whose only purpose is to give context or comparative strength to one of the original choices, you can disrupt a buyer's indecision.

For example, if the third option is priced much higher but does not include much more value the buyer will often see more value in the price/product combo we want them to select.

Paradox of Choice. Also called **Analysis Paralysis**, **Spoiled by Choice** and an **Embarrassment of Riches**. The *Paradox of Choice* is that more choices seems to paradoxically increase our anxiety and confusion and decrease our ability to make a choice.

This is the principle behind presenting product tiers as **good, better, and best**. In a [2016 study](#), this method was used by nearly 70% of the SaaS companies surveyed. Three levels is enough to compare, but not so much that the customer is flooded and overwhelmed.

More choices, more options configurations, or possibilities just makes choosing more difficult. (See Leader, Filler,

Killer in Chapter 5 for more on this.)

This seems to contradict the *Decoy Effect*, but seems to be related more to clarity than the precise number of choices.

Put simply, confused customers don't buy.

References

The fourth bucket of psychology is called *References* because our perception of these things refers to objects and attributes in the real world. Numbers are abstract and hard for the brain to accurately understand. Visual and linguistic cues can influence perception of numerical values and our brains will pick up on hints at relative scale.

Nick Kolenda is the best in-depth resource on this, but I'll include a digest.

Size. Generally speaking size is about things we want to appear

bigger and more prominent and those we want to appear smaller.

The demand curve tells us that smaller prices will increase demand. So we want to present our price in a way that makes it appear smaller. You may want to use smaller fonts for prices.

Amount. Our perceptions of amounts affect our perceptions of price. Typically we want to show a high amount of value for a low amount of price.

Weight. Heavier things may appear more substantial. Conversely, cookies placed high on a package may look lighter and imply that they will not increase the weight of the person who consumes them.

Placing prices higher on the page can make them appear "lighter."

Proximity. We tend to group things together. You may want to associate discounts, social proof, or payment security

information with prices by making them closer on the page.

If you need to place words near the price, use words that indicate smallness.

Language. Removing commas from numbers and using fewer syllables may make them appear simpler and less confusing.

Use alliteration, such as, “two T-shirts for \$25.”

Activations. Related to the First effects, seeing something activates that thing in our brain and primes us to think about it. Showing an apple, might create an association with the design and tech-forwardness of Apple Computers, for example.

Conclusion

Once you’ve set your core strategic pricing elements, review the psychological elements to present your prices in the most favorable way.

Additional Resources:

[Psychology of Pricing by Nick Kolenda \(Summary video\)](#)

[Pricing Course by Nick Kolenda](#)

[*Influence: The Psychology of Persuasion* by Robert Cialdini](#)

[*Monetizing Innovation: How Smart Companies Design the Product Around the Price* by Madhavan Ramanujam.](#)

[*The Art of Thinking Clearly* by Rolf Dobelli](#)

[*Pitch Anything: An Innovative Method for Presenting, Persuading, and Winning the Deal* by Oren Klaff](#)

[Psychological Triggers \[gated e-guide\] by Talia Wolf](#)

8. Pricing Optimization



Split Testing | Dynamic Pricing

We've been painting with a broad brush so far.

Big pricing decisions.

But what about minor tweaks?

I like to view pricing as a project that is always open. You can make the big decisions fairly quickly. Then most of the time is actually spent optimizing and making small adjustments to extract maximum value.

8a. Split-Testing

Minor changes are not usually made based on some pricing principle or best practice. They're made as a result of the scientific method in the form of testing.

The most basic test you can run is a **split test** or **A/B test**.

This isn't a sophisticated survey-style test like we used as our Conjoint Analysis example. It's just taking our website or store traffic and sampling a portion of it with an alternative.

Your A is your control. That's the status quo or the current option or configuration. B is what you think will perform better.

These tests aren't limited to just the price itself, but everything around the price. The context, the journey that led the buyer here, the UX, and the brand promise.

If you need ideas of what to test, go back to the previous chapter and look at Nick Kolenda's pricing psychology article.

Be careful. Step back from time to time so you don't test yourself into a website that looks like a giant [Belcher Button](#).

The results of well-run A/B tests are some of the most

convincing data you can have for getting buy-in to website, channel, or pricing changes.

8b. Dynamic Pricing

In Chapter 7 we looked at how we might influence WTP.

But what if WTP changes on its own as a function of time? There's a version of pricing optimization where prices change rapidly. Pricing that automatically changes to match perceptions of fluctuating WTP is called **dynamic pricing**.

One example of this is the price of stocks. Minute by minute the price changes to reflect the equilibrium of supply and demand for the publicly traded shares of any particular stock.

Another example is ridesharing. Uber and Lyft have surge rates influenced by the time of day, holidays, and special

events. During the surge, riders pay more because demand is growing against supply.

Airlines have annoyed many customers who pause their booking for some reason, only to return and find the price has changed.

I once flew from Salt Lake City, Utah to Dublin, Ireland for \$320 return. I booked in advance as part of a promotion and I felt like I got a pretty good deal. In New York a passenger joined the flight (that used to be a thing) and sat next to me. He boasted that he got his ticket at the last minute for only \$1,800.

Even though he paid *nearly six times as much* as I had, we were both happy with what we paid and the airline was capturing that variable WTP by pricing dynamically based on the circumstances when we purchased our tickets.

Dynamic pricing requires technology and an algorithm to

present prices based on timing and other factors. As with other types of personalization, you need to be careful because done wrong this delivers a horrible experience. But do it right and you are capturing the revenue available due to fluctuating WTP.

Additional Resources:

[How To Use Split Testing To Find The Perfect Product Pricing](#) by Anna Gotter of Shopify

[Zenrez: A Case Study in Dynamic Pricing](#) by Amy Bond

9. Pricing in Practice



Unit Economics | Price Waterfall | Price Leaks | LTV:CAC

Unit economics: Price waterfall per unit sold,
Look for leaks, abstract into annual profits
OR LTV:CAC

“Unit economics” is an academic phrase.

But it’s really cool and important. Here’s
what it means.

9a. Unit Economics

The “unit” is a way of defining the *zoom level*. Zoomed all the way out we can see the company as a whole. Zoom in a little and we could look at a division or department. Zoom in even further and we can view a single purchase.

“Economics” here means we’re looking at cash flow—the flow of money in (revenue) minus the flow of money out (expense). As one investor explained it to me, we add up

all the “goes-intas” and subtract all the “goes-outas.”

In principle the macro view is a sum of all the micro views.

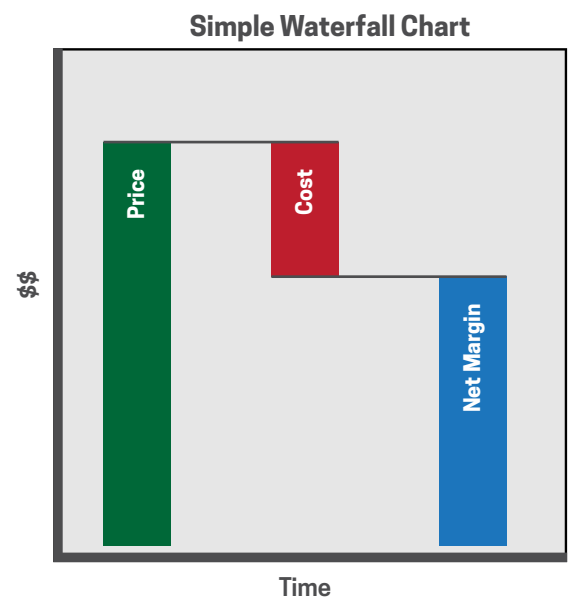
Company-level economics are shown on the Income Statement (where the sum of revenue minus expenses is the proverbial “bottom line.”) An Income Statement for a division or department is often called a Profit and Loss Statement or P&L. And all levels, including down to individual purchases can be analyzed using a price waterfall chart.

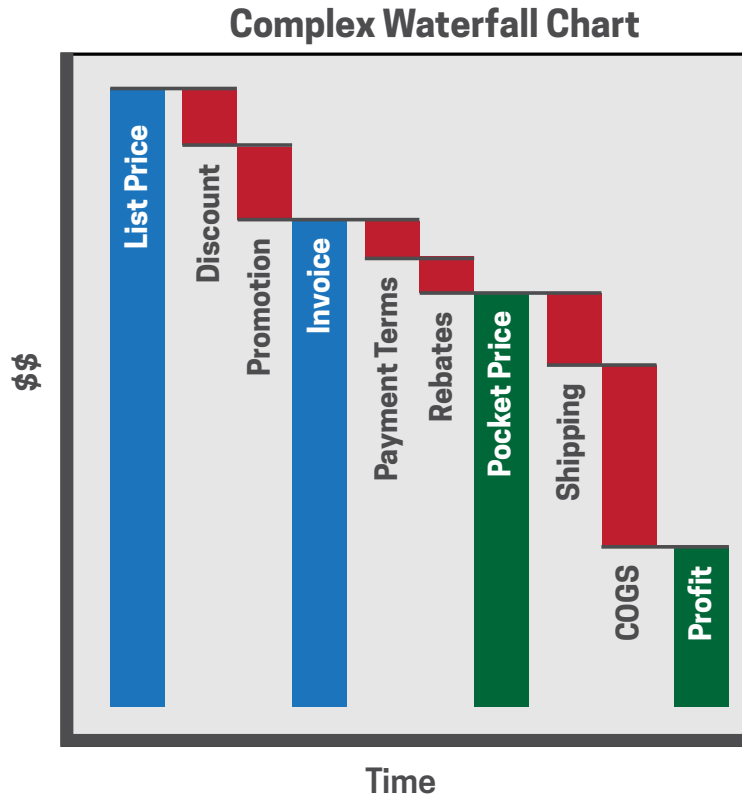
Zoomed in at this level, revenue is simply the unit price or value, i.e., what the customer pays. Expense is the single-unit cost of goods sold (COGS), or what the company pays to deliver the product. Adding these up shows us whether or not we are “unit profitable.”

The following chart shows unit economics for simple purchases.

The most granular “unit” might be your unit of sale from Chapter 4.

Simple purchases are easy. For example, if I buy a sandwich the seller





either made or lost money at the moment of purchase.

Many purchases, especially B2B, are more complex. There are lead times, discounts, shipping, ongoing customer support, returns, etc. Analyzing unit economics with all factors in mind can help ensure you are as profitable as you think.

Because they are so complex, McKinsey coined the term *Pocket Price* to help zero in on what the customer actually pays “out of pocket.”

9b. Price Leaks

A detailed waterfall chart can help identify **price leaks**.

Price leaks are like little profit thieves hiding in the complexity of your purchases. A price leak happens when you think you're charging one price, but discover the customer is actually paying less due to an unintended practice in the sales process.

According to Insight2Profit.com, three of the most common price leaks are,

1. Shipping/Freight
2. Payment Terms/Trade Credit
3. Exceptions: Order Minimums and Rush Delivery

Let's break those down.

Shipping

We live in a world where free shipping is common. But does it make sense for you? If your margins are thin, fluctuations

in freight cost may be stealing your profits. Or, your sales team may be throwing in free freight when they shouldn't be. Make sure your team is sticking to a policy that protects your profits.

Terms

Payment terms are better described as **trade credit** and they are a key part of your **cash conversion cycle**—the timeline between when you pay for raw materials and when you get paid for finished goods.

Note: Dell famously flipped this on its head in the 1990s by getting paid by customers before they had to pay for raw materials. Unfortunately that's not a model every business can imitate.

Terms might look something like 5% 10, Net 30, meaning customers who pay within 10 days get a 5% discount; customers who pay within 30 days pay the net price on the invoice.

When you give the customer time to pay, that's a financial transaction and you become a creditor. There is a cost as you wait for access to those funds. Are you factoring that cost appropriately into your pricing? Are your terms being abused?

Exceptions

Production is often most efficient in large batches and standard time frames. When you have to alter the process, efficiency goes down and cost goes up.

Are you adequately charging for small runs or rush delivery?

You can expand the waterfall chart to include these details.

Knowing your unit economics helps ensure that you have the makings of a profitable business—versus what a banker once sarcastically asked me, “I see you’re going to lose a little on every sale and make it up in volume?”

Unit Economics for SaaS

Software businesses look simple from a retail or manufacturing perspective. There's no inventory, no shipping, and very simple production once the code is written. Where software becomes very sophisticated is in how it's bought and sold.

A manufacturing company might wrestle over a 60-day lead time and whether or not to offer 30, 60, or 90 day terms. But a software company might need to look at trends over *multiple years* to know if it is profitable.

Often for software companies the question is, will the company *eventually* be profitable?

The J-Curve

One way of visualizing this dynamic is as a J-curve. In the beginning we spend money to acquire customers, so we start in the hole. Over time subsequent

payments bring us positive and into profitability.

Another way of breaking down these dynamics is using a “magic ratio,” LTV:CAC.

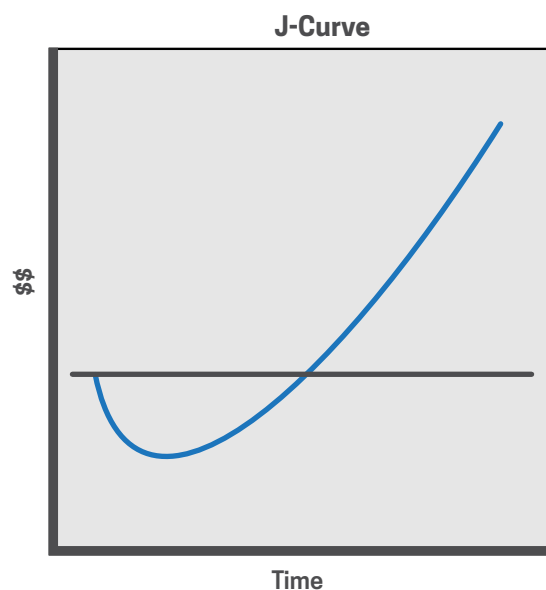
9c. LTV:CAC

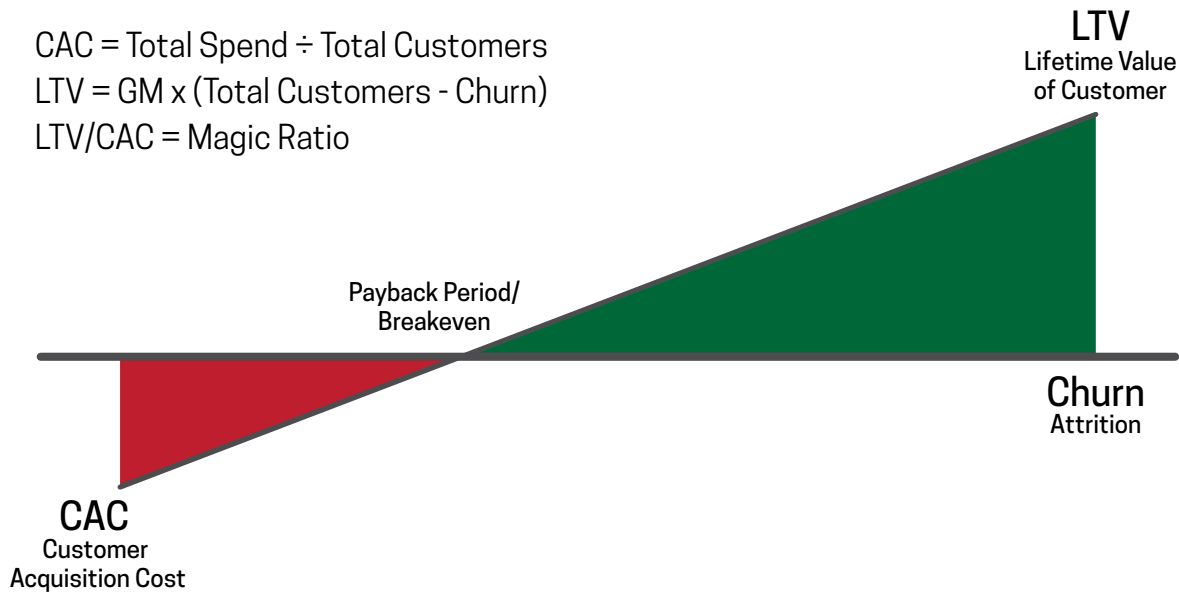
The magic ratio is the **lifetime value** of your customer divided by your **customer acquisition costs**.

LTV, or **lifetime value**, is used when the full value of a customer is not captured up front, but comes over time, like in a SaaS business.

Because of this, LTV/CAC is not useful without recurring purchases, nor is it useful if your payback period is less than one year.

LTV can be calculated on a single customer, but for LTV:CAC we want your *average* LTV across all customers. On average, how long does someone stay a customer and continue making payments? This is calculated as Gross Margin times Total Customers less Churned Customers





CAC stands for **customer acquisition cost**.
How much do you need to pay to get one more customer?

That average is calculated as total sales and marketing spend, divided by total new customers.

The amount of time it takes to break even on your CAC is called the **Payback Period**.
In SaaS you ideally want a payback period of 24-30 months. 18 months is considered very good.

Take note: LTV:CAC is not appropriate if your product doesn't generate recurring payments or if your payback period is *less than one year*.

And at some point you will lose customers to **churn**. These are the customers that don't renew. Ultimately you'll have an average lifespan of your customer. Once they churn out, they no longer contribute to LTV.

To make a profit, you must not pay more to acquire customers than they will ultimately pay you. LTV gives you the flexibility to see not just what you can spend to make one sale, but what you can spend to acquire the customer and still turn an eventual profit. LTV is the present value of all future profits that customer will generate.

In highly competitive, winner-takes-most markets, the strategic question might be, can I spend more to compete for customers today so I win tomorrow? This is often the motive for raising capital.

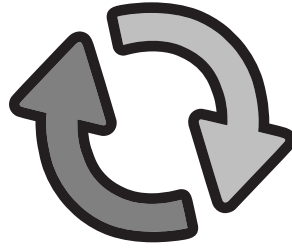
Additional Resources

[50+ Most Common Price Leaks from Insight2Profit](#)

[Price Waterfall: Fix Your Price To Gain More Revenue by Competera](#)

[What Are Unit Economics in SaaS? Definition & Explanation by Danette Acosta from ProfitWell](#)

10. Price Changes



Deciding | Communication Strategies | Execution: Add Value, Timing, & Grandfathering

Pricing policies aren't static.

Costs fluctuate, market conditions change, and our understanding of pricing evolves. Inevitably prices change.

And by change I mean increase.

Prices can go down. Dynamic pricing may even introduce questions for customers when that happens. But by and large, price drops don't trouble customers.

Increases are more complex.

The new price may cross over a customer's WTP threshold or trigger a new evaluation of competitors. And that's the main question we have when we're looking at executing an effective price increase.

Will customers churn?

Best practices tend to fall into three buckets:

10a. Deciding to Raise Prices

10b. Communicating Price Increases to Customers

10c. Executing Price Changes

10a. Deciding to Raise Prices

Raising your price may be as complex as choosing the price in the first place.

Start by gathering the data that's easy to get.

- Existing customer behavior—churn.
- Review notes from any previous price changes.
- Solicit experience and opinions from your executive team. Not every voice is equally credible, but it's just shortsighted not to capture these insights.

- Expand from your internal team and ask board members, investors, personal networks, and advisors.
- Speak with your Sales and Customer Success team. Are customers happy? Do they complain about pricing?
- Revisit Chapters 1–9 here.
- Consider the implications of the timing (frequency, current events, etc.).
- Consult any relevant market research you've done previously.

Then decide if you need to do some additional research to anticipate customer response.

Case Studies

In the oughts and early 2010s many well-known print newspapers and magazines were trying to understand what strategy to adopt to support their digital counterparts.

Back then there weren't a lot of examples to look to and it was anyone's guess exactly how consumers would react.

The Economist

In 2011, The Economist bundled its digital web-access edition with its print edition.

They generated revenue from two sources: advertising and subscriptions.

Ad revenue was going strong, but subscriptions actually lost money.

They contemplated raising their prices to get the subscription side revenue positive. But would customers go along?

Their research concluded:

Any increase produced SOME churn.

Churn rates were similar for any increase below 20 percent.

At 20 percent churn would wipe out revenue gains.

An Increased impact was felt over three years. Year 1 saw customer reaction. Year 2 saw revenue growth. Year 3 saw stabilization.

As a result, they settled on a strategy of significant (up to 20 percent) and infrequent (minimum three year gap) price increases.

By executing their price changes in an informed way, they were able to deliver consistent growth for years.

GoReact

In Chapter 4, I shared that we launched a survey at GoReact to help us decide if we should raise our price from \$19.95 to \$29.95 per user, a 50% increase.

Following the checklist above, the situation was this.

We had the occasional grumble from prospects about price, but it was more common for prospects to express surprise at how low our price was.

Our existing customer base had very low churn. NPS scores were high and anecdotal customer avidity was through the roof.

Our price change two-and-a-half years earlier had gone fairly smoothly. We only lost one or two small customers. At that time a few customers had told us this was their limit. Some of our team wondered, would another price increase go too far?

On the other hand, our customer base had grown *seven times* its size since then. With that kind of growth, was our past experience even relevant?

The senior team all had a sense that our current pricing wasn't right. Our pricing meetings were thoughtful, opinionated, but ultimately non-consensus. There were wildly divergent opinions about the response to a price increase.

Some were concerned a price increase would rock the boat and introduce dissatisfaction in an otherwise very contented customer base.

Others argued that we had clear evidence that our pricing was too low.

Almost all of our competitors charged more and (we felt) delivered less. Some charged differently. Did they know something we didn't?

Our category had no established leader and no norms we could view as reliable guides.

We started collecting wisdom wherever we could find it. We polled our personal networks, questioned investors and board advisors (who echoed what we had seen [from Andreessen Horowitz](#)—that they had rarely seen a company err by pricing too high), and scoured all the online resources we could.

Ultimately we admitted that our data was scant and we ran the Van Westendorp survey.

Our survey results indicated that that 80 percent plus of our customers were willing to pay more.

To make the arithmetic easy, let's say our annual revenue was \$1 million. If we lost 20 percent of our customers, the current price equivalent would drop to \$800K.

Factoring in the price increase meant the same 80 percent of our customers would generate \$1.2 million in revenue and we should come out ahead.

Plus we were growing fast and would capture the additional revenue from the increased price on all of our new business.

Ultimately we went ahead with the price change and this became an important chapter in the company's growth.

10b. Communicating Price Increases to Customers

Money and trust go hand in hand.

Introducing a change in the financial relationship with customers therefore automatically raises questions of trust.

Communication shows the customer that we value the relationship and creates an opportunity to retain their trust.

Communicate Internally First

Effective communication around price changes starts with a thorough briefing of your internal team before communicating to customers.

An informed team presents a united front to customers, so they will perceive your message clearly.

Sending your team out to talk to customers without all the information just sets them up for embarrassment and frustration and can be detrimental to your company culture.

Communicate Early and Often

Aim for no surprises. Surprises undermine trust.

Start telling customers what is coming as early as possible. In that communication you want to:

- Be direct, specific, and clear. Don't beat around the bush.
- Don't over-communicate and don't use euphemisms. Microsoft, YouTube, and Netflix have all made this mistake.

- Don't apologize. This sounds impolite but signaling that you don't have a good reason for your price increase will be confusing.
- Include a rationale and give them a reason for the change.
- Reinforce the value of your product or service.
- Communicate any added value.
- Offer a way for customers to voice questions and concerns.

10c. Executing Price Changes

When executing price changes, these three things help things go as smoothly as possible.

Add value

Carefully consider the timing

Judiciously apply grandfathering

Add value

A spoonful of sugar helps the medicine go down.

Where possible add more value when you raise prices. Added value can come via new features, free upgrades, more time, etc. Having something to offset the negative news of a price increase, defuses mistrust and knee-jerk churn.

Non-cash loyalty rewards can add value, as can promotions to position your company against competitors.

Timing

I have already mentioned communicating early and often as well as timing price increases to coincide with added value such as new feature releases.

Also think about the context at large. Inflation and times of upheaval can cause people to be more price sensitive or price aware (think about how much closer you pay attention to the

price of gas when prices are volatile).

If price changes are due to something affecting the whole market, say a raw material price increase, then consider if you can use time to your advantage.

For example, can you time things so your competitors introduce their price changes first?

You also have the option of a staged roll out. Only you can tell if it's right to "boil the frog" and go slow or "rip the band-aid off" and get the pain over all at once.

Staged roll-outs can be done over time or across only certain products, bundles or tiers. By reconfiguring your offering, you may be able to limit price increases to only where they are needed.

Grandfathering

The big key to grandfathering is whether or not you are growing. If you are in a rapid growth phase, it may cost you little to keep customers at the old price. They will soon be dwarfed by new customers who are paying the new price and know no difference.

If your customer base is large and fairly static, you may not have this option.

At GoReact, we used several of these techniques. We grandfathered certain customers for a year.

We also notified prospects that if they purchased their licenses before the increase went into effect, that they would get the old price for the coming year.

This served as both a timing incentive to soften the blow of the price increase for existing customers, and also a lever to

close more business as the price change approached.

The scarcity of “get the old price while you can” helped us motivate more purchases.

We strongly considered creating a new pricing tier (see tiers in Chapter 5), which would become our standard product offering while retaining a lower tier with some restricted features to appeal to those more budget-conscious and likely to churn (ultimately we chose not to do this and stayed with a single price)..

Conclusion

There’s more to say.

Pricing is bigger than just what I’ve included in these pages.

Yet, this is the guide I needed when I first encountered questions about pricing strategy.

Most of what I've encountered since fits within the framework I've outlined here and in my journey to provide the comfort and confidence that comes from understanding, this guide has become a go-to reference for me.

I sincerely hope that you find value here and that these learnings contribute to your success.

Namaste.

