STEP 16

Set Your Pricing Framework

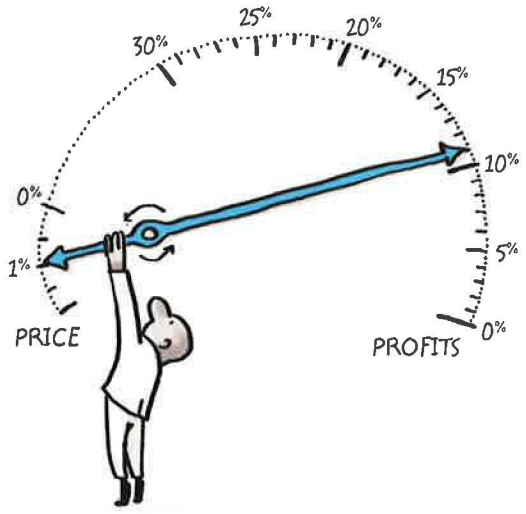
WHAT IS STEP 16, SET YOUR PRICING FRAMEWORK?

Determine a framework to test pricing for your new product, and make a decision on what the initial price will be.

WHY DO WE DO THIS STEP, AND WHY DO WE DO IT NOW?

Small changes in pricing can have dramatic impact on your profitability, so there is great incentive to get this right. It should also be a price that is acceptable to you and your customer so that you have a sustainable business. You are able to do this step now because you have made your initial decision on business model, and the pricing framework flows from the decisions you made in your business model.

By the Book: See pages 173–179 of *Disciplined Entrepreneurship* for basic knowledge on this step. See page 179 of *Disciplined Entrepreneurship* for an example of how a company addressed this step.



Even though it is impossible to know the right pricing for your new product just yet, you will do some analysis now and make some decisions to get started, but also build a framework to address the pricing decision as you move forward.

PROCESS GUIDE

It is virtually impossible to know your optimal price for your new product until you are able to offer it at scale and see how customers *actually* respond, as opposed to what they tell you they would hypothetically do. However, pricing is extremely important as even small pricing changes yield large direct effects on your profitability. As such, it is important to spend some good time on pricing now, but not too much, because it is foolhardy to think you can come up with accurate, detailed pricing at this early stage. Like with many other steps, this first pass on pricing is just a good educated guess to keep the process moving so you can continue learning; you will update and refine this step later.

In this step, you will come up with a reasonable pricing range aligned with the business model(s) you chose in Step 15, Design a Business Model. This framework will then be used to estimate the Lifetime Value (LTV) of a new average customer to your startup, and will be the starting point for later market testing (specifically, some form of A/B testing).

There are six major criteria to consider when making the decision, some of which also factored into your decision on business model:

1. **Value Creation**

   You will base your pricing on the value you create for your customer, and not your costs. While it greatly depends on the strength of your Core, think of 20 percent of the value created as a good starting point for what you can fairly capture.

2. **Customer Acquisition Analysis**

   - Revisit Step 12, Determine the Customer's Decision-Making Unit (DMU), and Step 13, Map the Process to Acquire a Paying Customer. What is the DMU and the process? What does that analysis tell you?
   - Understand what authorization limits exist for the person who pays you, and try to stay below them so you decrease friction in the sales process. If your economic buyer, who clearly

understands your value proposition, can't make a purchase of $1,000 without running it by a vice president who is removed from the purchase process and will need persuading, then seriously consider pricing at $999 or lower.

3. **Nature of the Customer**

   Understand how the *elasticity of demand*, or willingness to pay, depends on the type of customer. Using Geoffrey Moore's guide from *Crossing the Chasm*, customers typically fall into one of five groups, each of whom will respond differently to different prices:

   - Technological enthusiast (this type buys based on technology coolness and as such is price inelastic and buys in low volume)
   - Early adopter (this type buys based on ego because he or she wants to be first and show off and as such is price inelastic and buys in low volume)
   - Early majority (this type buys based on compelling return on investment [ROI] and as such is willing to take risk if reward is high enough and will buy in relatively large volume and be influential)
   - Late majority (this type buys based on ROI but is willing to take less risk, will buy a good volume, and as such is influenced by success of early majority customers, which de-risked the product for the late majority; when this type finally buys, it will buy in relatively large volume)
   - Laggard (this type buys based on defensive position because to not buy is now risky because everyone else is buying, and seeks to avoid risk above all else; as such, when this type finally buys—which will be late—it will buy in relatively medium volume)

4. **Strength of Your Core**

   Your Core will be critically important in your ability to command a premium price. As it grows over time, so will your power to command higher prices and give out fewer discounts.

5. **Competition**

   Awareness of competitive options (from the eyes of the customer, not you) is an important data point to consider in this process.

6. **Maturity of Your Product**

   - Is your product new to the market, or is it a mature product that may have even been proven in other markets?
   - The former is high risk and hence harder to command a pricing premium; there is less risk in the latter, which affects not only list pricing but your ability to avoid having to discount.[1]
   - Flexibility early on, especially to get those key lighthouse customers or influential customers, is critical, and you should be willing to decrease your price in such scenarios. In such cases, customize the offering and include a confidentiality clause in the agreement with the customer with regard to the pricing so you don't set a dangerous precedent and have to provide discounts to other customers, too.
   - When you start going after follow-on markets, your success in other markets will allow you to price with fewer discounts than with your beachhead.

[1]Discounting is effectively decreasing the price, but it is less transparent to the market. This is in general a practice to be discouraged, but it can be a valuable tool to use in certain situations, especially early in the product's introduction to the market.

Remember it is easier to drop the price than to raise it, but that does not mean you should always start high and drop the price over time. In some cases, exactly the opposite is the better strategy, particularly with companies that have a short time window to achieve a Core of network effects.

There is also a tremendous amount of behavioral economics involved in pricing, especially for consumers. It is worth reading books and blogs on this topic. One of my favorites is *Predictably Irrational* by Dan Ariely. You should also learn more about A/B testing so that you have a fundamental skill needed to optimize pricing going forward.

After you complete your pricing analysis, you will probably be even less comfortable with the pricing decision than the business model decision. However, pricing is easier to change than business model, and you almost undoubtedly will change your pricing. Your goal for now is to make a first guess so you can analyze the unit economics for your product and see if they are viable to develop a scalable business. You'll start that analysis with the next step, Step 17, Estimate the Lifetime Value (LTV) of an Acquired Customer.

GENERAL EXERCISES TO UNDERSTAND CONCEPT

See the back of the book for answers to these questions.

1. **Responsibility for Setting Pricing:** While input should unquestionably come from all parties to analyze and ultimately determine prices, who should ultimately decide on pricing? Why and why not for the others?

   a. Sales

   b. Finance

   c. Product Management

   d. Engineering

2. **The Love of Nines:** Why do gas prices almost always end with as many 9's as possible?

3. **The Power of Pricing and Not Discounting:** If you increase your price by 1 percent, how much effect do you think that will have on your bottom-line profit?

WORKSHEET

Considerations in Setting an Initial Pricing Framework

CUSTOMER DMU/PROCESS TO ACQUIRE CUSTOMER

Looking at the DMU, what is important? _____

Process for acquiring a paying customer? _____

What spending limits are there? _____

Other considerations/Summary? _____

_____

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_____

NATURE OF CUSTOMER

What is the customer segment? Techie (tech) ___ Early adopter (ego) ___

Majority (ROI, some risk) _____ Late majority (ROI, low risk) _____

Laggard (avoid risk) ____. How do you know? _____

Often it is %s & then how will you ID each type in your customer sement?

_____

Other considerations? _____

_____

_____

VALUE CREATION

How much value do they get? _____

When? _____

How risky is it? _____

Other considerations/Summary? _____

_____

_____

_____

_____

COMPETITION

Who is the competition and what are their prices? _____

_____

Which is the best comparable? _____

What does that indicate your price range should be? _____

_____

Other considerations/Summary? _____

_____

_____

STRENGTH OF CORE

How strong is your Core today compared to the competition? _____

_____

Will it get stronger over time? If so, when? _____

Do you believe you will be able to raise prices in the future? If so why? ___

_____

Other considerations/Summary? _____

_____

_____

MATURITY OF YOUR PRODUCT

Has your product & value proposition been validated in the eyes of the customer? _____

Do they see your company as high risk? _____

What kind of flexibility can you do for your first customer to decrease the real risk & perceived risk in the market? _____

Operations & other considerations? _____

_____

_____

1. **Initial Decision and Rationale**
   a. What unit of product are you using for pricing (carried forward from Step 15, Design a Business Model)?

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   b. Based on your analysis, what is the price range that is most appropriate and why?

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   c. In the first year, what do you believe your initial listed price will be, and what will be the effective price to the market and why? (The effective price is the actual price your customer pays after discounts.)

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   d. Sanity Check: What is your expected estimated marginal cost (cost to produce a unit of product, excluding one-time setup costs)? Does your price per unit significantly exceed your estimated marginal cost in the long term?

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2. **Test to Validate**
   a. In setting your pricing framework, what hypotheses are you assuming to be true?

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   b. What experiments will you run to test your hypotheses?

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   c. What information will show that your hypotheses are valid or invalid?

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   d. How long will you give the experiments to run?