Pricing Strategies for A Unique Economic Climate

How Small Businesses Can Manage Inflationary and Recessionary Pressures

Table of Contents

Introduction

With Costs Rising and Sales Falling, Conversations Turn to Price

Pricing is always a tricky matter for small businesses (SMBs) — but it's gotten a whole lot more complicated in the past year. Verizon's 2022 State of Small Business Report found nearly four in five SMBs say their costs have gone up in the last 12 months. The most common business response: two-thirds say they've raised (or plan to raise) prices. Now, as recession anxieties slow spending, the report showed almost half of SMBs are already reporting a downturn in sales.

Caught between these inflationary and recessionary pressures, SMBs are bouncing between two critical questions:

COSTS ARE GOING UP. ***DO YOU RAISE PRICES?***	• By how much? • Will you lose customers if you go too high? • Will you lose all your margin if you don't go high enough?
SALES ARE GOING DOWN. ***DO YOU SLASH PRICES?***	• By how much? • Will you devalue your brand and destroy margins if you go too low? • Will you lose customers if you don't go low enough?

There is no one-size-fits-all answer to these tough questions. But this ebook will cover six pricing strategies that can help SMBs navigate the opposing pressures of this unique economic climate.

"I'm talking to a lot of businesses that are thinking about how to manage the ongoing volatility in the economy. Pricing is obviously always a major concern. It's important to make sure you're being competitive by balancing cost increases with what the market will bear."

- Russ Keithley, Chief Lending Officer at Coastal Community Bank

Why You Should Avoid Competing on Price

When costs go up, most businesses reluctantly increase prices. But when economic times get tough, the knee-jerk response is to cut prices to avoid alienating a customer base that may feel their own budgets tightening.

This is an intuitive reaction. But it turns out most companies greatly overestimate the price sensitivity of their customers. The research tells a different story: A study of more than 5,000 companies fared through the Great Recession found that if cost wasn't a "pure differentiator" before the recession, then cost was not an effective differentiator during the recession.

In other words, if price hasn't always been your primary selling point, then price isn't going to be the main factor driving your customers' buying decisions during an inflationary or recessionary period.

Most businesses will find that price increases will be better tolerated than they expect — and that cutting prices doesn't effectively correct declining sales volume. Here are two current examples that demonstrate this overestimated price sensitivity:

PRICING CASE STUDY #1

Restaurants Cutting Prices

Despite rising costs for labor and food, many restaurants across all categories (QSR to full-service) have responded to declining sales over the past year by decreasing prices — or not increasing them at the pace of cost inflation. But this strategy hasn't restored volume. Researchers say consumers may be slowing their spending. But they aren't choosing to eat at cheaper restaurants; they're simply choosing to eat out less. This strategy has only worsened the situation for these restaurants, as their low prices have eroded already-slim margins, without helping volume.

PRICING CASE STUDY #2

Airlines Raising Prices

Already lamented for high costs, airlines have been rightly concerned about how consumers would react to the price hikes needed to offset spiking fuel and labor costs. But pent-up demand for travel and experiences, along with the savings glut many amassed in the first 18 months of the pandemic, means that a large portion of consumers are actually willing to pay more for travel and experiences. Like the restaurant case, those most price-sensitive consumers aren't choosing lower-cost airline options; they just aren't flying at all. Airlines that took the leap in raising prices have successfully protected profitability, and it hasn't cost them volume.

6 Pricing Strategies to Meet the Economic Moment

1. DO YOUR RESEARCH
2. USE DISCOUNTS STRATEGICALLY
3. TAKE THE "*MORE FOR MORE*" APPROACH TO JUSTIFY PRICE INCREASES
4. UNBUNDLE SERVICES TO GIVE CUSTOMERS PRICING CONTROL
5. SEGMENT YOUR CUSTOMERS TO CREATE A TIERED OFFERING
6. SIMPLIFY PRICING STRUCTURE

So, how should SMBs be thinking about pricing right now? How can you use pricing strategies to deal with the inflationary and recessionary pressures facing your bottom line — and your customers' pocketbooks? Here are six pricing strategies to consider:

1 Do Your Research

We already mentioned that there's no one-size-fits-all pricing strategy. As with most strategic decisions, the right approach is entirely dependent on the specifics of your business. Doing your research is the critical first step to identifying and implementing the right pricing strategy for your business. These three areas of focus should guide your research phase:

KNOW YOUR MARKET

Macroeconomic pressures hit every business — but not equally. You know how rising costs are impacting your business, but you should understand how inflation is hitting the broader market or segment in which you operate. For example, if labor costs or a particular input cost is skyrocketing for every business in your market, that changes the price sensitivity of your customers. On the demand side of the market, you should understand the relative price elasticity (also called elasticity of demand) for your category of goods or services. For example, despite the constant focus on the price of fuel, higher prices don't impact demand that much, because fuel is a requirement for many consumers' everyday lives.

KNOW YOUR COMPETITION

Once you understand how inflationary and recessionary pressures impact your broader market, it's time to look closely at your competition: Who is competing on price, value, service, convenience, etc.? Are competitors changing their prices? Up or down? What is that doing to their sales, margins, and brand reputation? Businesses are often too quick with reactive pricing strategies — and that gives you the opportunity to see what's working, what not to do, and how your business might build a pricing strategy that stands out.

KNOW YOUR CUSTOMERS

Finally, zero in on what matters most for your business: your customers. If you haven't done so recently, now is a good time to do some form of customer research — whether that's a simple online survey, more in-depth surveys or focus groups, or just informal conversations with customers. The goal is two-fold: First, make sure you understand why customers ultimately choose your business and what they value most (i.e., price, value, products, service, convenience, location, etc.). This will likely align with what you view as your differentiator — but you may be surprised. Second, understand how inflation is impacting them and how they're thinking about a potential recession.

> **"When it comes to pricing, I always start by asking businesses what their competitors are doing. It's important to understand what your local market is doing — and how you're differentiated from your competitors. Then, you can focus in on your strengths to stand out in your market."**

- Russ Keithley, Chief Lending Officer at Coastal Community Bank

2 Use Discounts Strategically

When the economy is roaring, and spending is strong, discounting can be a great way to drive sales volume: using loss-leaders to bring in new customers and ultimately selling them other, more profitable goods. But both inflation and recession worries can change the way consumers respond to discounts. For example, discounts may only attract the most price-sensitive, deal-hunting segment of consumers. That type of customer is far less likely to make additional purchases of non-discounted offerings. Deal-hunters are also much less sticky — they move between brands as they follow the discounts.

Discounts can still work for your business, but you need to think carefully about how you can use discounts to incentivize and reward more profitable customer behaviors. Here are a few examples:

DISCOUNTS FOR FREQUENT PURCHASES

To encourage stickiness and reward your most loyal customers.

DISCOUNTS ON HIGHER-VOLUME OR BULK ORDERS

To drive operational efficiency and incentivize higher-margin sales.

DISCOUNTS FOR SHORTER PAYMENT TERMS

To improve cash flow and give a better cushion against rising operating costs and/or declining sales volume.

The above is far from a comprehensive list. Think about what types of sales/orders are most profitable to your business — and what other types of customer behaviors (like payment terms) are most beneficial to your business. Then, build a discounting strategy to incentivize it.

3 Take the "More for More" Approach to Justify Increases

With inflation rates consistently higher than we've seen in decades, many businesses simply cannot avoid raising prices to account for the spike in operating costs. One strategy is to be simple and transparent: Our costs have gone up, so our prices need to, as well. Consumers have heard and read about inflation ad nauseam over the last year. Most understand that businesses aren't charities.

But another strategy is to take the "more for more" approach to price increases. Rather than simply raising the price on a core product or service, create a new bundle of products and/or services that offers more value to your customer.

Value Offer Strategy #1

PRODUCT BUNDLES

Creating a bundle of products is an easy way to justify a higher price point. Look for opportunities to bundle complementary products, to add high-margin products, or to use bundling to move excess inventory, for example.

Value Offer Strategy #2

VALUE-ADDED SERVICES

Bundling services is another way to add value for your customer — without adding significant cost for your business. Try bundling value-added services like a free consultation or assessment, user training, optimization, extended warranties, a year of free maintenance, etc.

Value Offer Strategy #3

PARTNER BUNDLES

Partnering with another small business that can offer related, complementary services can be a powerful "more for more" strategy. A partner may be willing to give away services for free (or at a greatly reduced cost) in order to build brand awareness and generate solid leads. Done well, this strategy solves related customer needs and deepens loyalty.

4 Unbundle Services to Give Customers Pricing Control

Based on market and customer research, many businesses are recognizing that they need to offer lower-priced options for customers with tightening budgets. Just reducing prices is a dangerous plan. You risk devaluing your brand and starting a “race to the bottom” with your competitors.

The more strategic approach is the opposite of creating “more for more” bundles discussed in the previous strategy: Consider unbundling services that are currently wrapped into your offerings. This lets you offer key products and services at lower sticker prices — without devaluing the total package of your traditional offering. This approach also highlights the discrete value of the traditionally included services. Most importantly, it gives your most price-sensitive customers greater control: They can fine-tune their purchases based on their evolving needs and budgetary limitations.

Again, the most common examples are just the opposite of the common bundling tactics:

PRICING CONTROL STUDY #1

A La Carte Services

If you’re currently including value-added services in a bundle, create a separate, a la carte service menu. Customers can purchase the core offering at a lower price than the traditional bundle. Then, they can choose to pay for services like consultations and assessments, user training, optimization, or maintenance/updates for an additional cost.

PRICING CONTROL STUDY #2

Convenience at an Additional Cost

Many businesses have convenience built into their offerings — expedited shipping, guarantees, or warranties, for example. Separate these conveniences into their own discrete offerings. Customers can choose their shipping speed (and cost) based on their needs. They can choose to pay for the convenience of free returns or order cancellations — or skip it if they’re confident in their order. And they can pay for the insurance policy of a warranty — or take that risk on their own.

5 Segment Your Customers to Create a Tiered Offering

Many businesses will find that they have customers at both ends of the spectrum: some willing and able to pay more for more — and some that want lower-priced options. You can make use of both of the previously discussed strategies at the same time by creating a tiered structure to your offerings.

The first step is to identify those distinct segments of customers: those willing to pay more for more, those with heightened price sensitivity, and often a third group that is content with the status quo. Make sure each of these segments is large enough to justify a tiered approach.

Then, create the tiered structure for your products and/or services, focused on providing targeted offerings that allow you to simultaneously generate incremental revenue from each distinct customer segment:

TIER #1 - PREMIUM OFFERINGS

Your top-tier offering should follow the more-for-more approach: Core offerings bundled with complementary products and value-added services — with a higher price tag.

TIER #2 - STANDARD OFFERINGS

This is your status quo offering: What you provide today at (about) the same price. For example, if you offer a free consultation, free shipping or a warranty today, your standard tier will continue to include these features.

TIER #3 - ECONOMY | A LA CARTE OFFERING

Your lower-priced offering should follow the a la carte approach: Your core products and services offered on their own, at a lower price — with a menu of all your discrete value-added services and conveniences available for purchase separately.

6 Simplify Pricing Structure

Whether your customers are individual consumers or businesses — and whether those customers are confidently weathering the storm or anxiously pulling back — everyone is feeling greater pressure to rationalize spending right now. People are wary of inflation being used as a boogeyman for unnecessary price hikes. And everyone is thinking more carefully about planning their expenses to avoid any microeconomic surprises in the midst of macroeconomic uncertainty.

Complex pricing structures — with a web of contingent fees and variable rates, for example — make it much more difficult for customers to understand and plan their costs. So, whichever pricing strategy (or strategies) your business may choose to implement, you should make an overarching effort to make your pricing structure as simple to understand as possible.

MAKE COSTS TRANSPARENT — NO HIDDEN FEES

Whether bundling or unbundling offerings, make sure the price customers see is the price they'll pay. If there are additional contingent costs or fees, make sure those are clearly communicated upfront, so customers can make purchasing decisions with confidence.

MOVE TO FLAT RATES

When possible, consider moving away from variable rates and contingent fees and implementing flat rates or set prices. This makes it easier for customers to plan and allocate budget for your products and services.

CONSIDER SUBSCRIPTION MODELS

For both B2B and B2C customers, budget pressures can limit their ability to (or comfort with) making purchases with large upfront costs. From retail to software, we've seen rising adoption of subscription models as a way to give customers the ability to more comfortably spread costs over time.

Additional Best Practices

BEST PRACTICE #1

TEST PRICING

You don't have to simply hope for the best on which pricing strategy will work best for your business and your customers. You can take a more data-driven approach: Regularly test pricing changes by industry, region, or however you segment your offerings or customers. See if price reductions drive higher volume without eating into profitability. Test reactions to price increases to gauge price sensitivity. Begin offering an a la carte model in one market or one product line to see if most customers prefer to build customized packages, or if most simply select the traditional offerings.

BEST PRACTICE #2

USE PRICING TO SHOW VALUE

Whenever possible, connect the upfront price of an offering to the lifetime value or ROI it delivers for your customer. For example, if a service includes free maintenance for a year or free updates for life, calculate the true cost that the customer is saving with that freebie. Or, if a product generates an expected annual revenue or cost savings, demonstrate that the product pays for itself in X amount of time — and continues delivering value in perpetuity.

BEST PRACTICE #3

PLUG REVENUE LEAKS

We already mentioned using discounts to incentivize positive customer behaviors like larger orders or faster payment. But you should look closely at your business operations to identify and plug revenue leaks that eat into profitability. For example, setting minimum order quantities can ensure processing costs (or bundled conveniences like free shipping) don't consume all the margin of smaller orders. Improving accounting operations can help your business receive and process payments faster, directly boosting cash flow.

BEST PRACTICE #4

STREAMLINE YOUR PORTFOLIO

Along the same lines as plugging operational revenue leaks, now is also a good time to evaluate your business lines/product and service portfolio. In boom times, diversifying or expanding into new products and services can be an easy way to capture incremental revenue gains. But often, these peripheral business lines are loss leaders or have low margins. As economic conditions tighten and/or costs increase, it can be a smart time to pare down your portfolio to focus in on core business lines that drive consistent, substantial margins.

"I see a lot of businesses evaluating business lines right now. Instead of simply raising prices, they're streamlining and eliminating products or services that have low margins or are losing money."

- Russ Keithley, Chief Lending Officer at Coastal Community Bank

The Key Takeaway:

Amid Volatility, Be Strategic and Methodical — Not Reactive

We're in the midst of an unprecedented economic climate. Persistent, high inflation; disrupted global supply chains; low unemployment and broad labor shortages; and now rising rates and recession worries. No one is sure how these converging factors will play out in the coming years. Will there be a recession? Are we already in one? Will it be a quick dip or an extended slowdown? A deep dive or a "return to earth" after a few years of booming growth? And is there still hope for the much-lauded "soft landing?"

Amid all this uncertainty, the common mistake is for businesses to make rash, knee-jerk reactions: immediately raising prices when costs go up, or going straight to discounts when sales slow down.

But reactive strategies too often lead to overreaction. Instead, focus on your business' true differentiator(s). Don't panic and put all your focus on price reduction.

Start by knowing your market, your competition, and your customers. Then, build a pricing strategy that meets the needs of your core customer base — without compromising your core business value.

"Businesses that take a balanced approach to planning can not only respond to the current economic environment — they might be able to capitalize on it. The combination of a methodical approach to decision-making and understanding their business well enough to see potential opportunities serves all sizes of companies during a downturn."

- Russ Keithley, Chief Lending Officer at Coastal Community Bank

Leaning on a Local Business Banking Partner

It’s critical to be methodical about major changes in your business — whether that’s implementing a new pricing strategy or making investments to help your business survive and thrive amid economic volatility.

When you’re ready to make a change, strong, local commercial banking partners like Coastal Community Bank can provide tailored financial products and business banking solutions to help you deploy your strategy and realize your vision. This includes flexible business banking accounts and expert services to help you efficiently and effectively manage operating budgets, as well as a full range of commercial lending solutions to meet your needs — from SBA financing, equipment financing, and other traditional commercial term debt, to lines of credit, real estate investment financing, and other customized solutions.

Perhaps most importantly, a local commercial lending partner like Coastal can provide hyper-localized and relevant insights to help you understand how the local economy is impacting your customers, your competitors and your business. This focused, localized insight can help you home in on the right business strategies for your goals — and the financial products to help you get there.

To talk with a local business banker at Coastal Community Bank, call us at 425.257.9000.

To see our full range of business banking solutions, visit coastalbank.com.