Instructor's Note

Don't Leave Your Pricing Strategy Hanging: The Elevate Hammock Company

Abstract

Greyson Junggren had an entrepreneurial spirit and started Elevate Hammock Company (EHC) while he was still in college. His mission was to produce high-quality, durable hammocks that were made for the outdoors.

Not knowing a lot about how to set the price for his hammocks when he first started his business, Greyson used a cost-plus/competitive approach. But after some time, he noticed that much of the market he had hoped to capture was staying with his higher priced competitors. While still generating and growing sales figures, EHC was not capturing as much business from rival hammock companies in retail stores that Greyson expected and wanted. Greyson started to understand there was probably a real problem with his price when a very successful retailer in Taos, New Mexico ignored Greyson's suggested retail price of $55.00 and instead raised the price to $65.00; and this resulted in an increase in the demand for Greyson's hammocks.

After two years in business, Greyson wondered if he should change his pricing strategy and/or his distribution model. What pricing strategy should he change to? And what other business strategies should he change or continue with if he did change his pricing strategy?

Case Use

This case and the instructor's manual have been written with the expectation that the case will be used in an undergraduate junior/senior level entrepreneurship or pricing strategies class or in sections on pricing or marketing channels in junior/senior level marketing classes. The case discusses how a business in a growth industry might defend against competitors and grow market share by developing a more profitable pricing strategy.

Learning Objectives

1. To identify the pros and cons of Greyson using a cost-plus/competitive pricing strategy for his entrepreneurial start-up.
2. To be able to evaluate value based pricing as an alternative pricing strategy appropriate for Elevate Hammock Company's situation.
3. To be able to evaluate pricing strategies as they relate to different marketing channels.

Linkages to Concepts and Theories in the Academic Literature

Concepts: Cost-Plus and Competitive Pricing –

It is important for students to understand the difficulties faced by entrepreneurs in deciding how to price their products when they start their business. Both cost-plus pricing and competitive pricing are popular ways to determine a price when a business first starts selling its product because they are easy to calculate. However, there are both pros and cons to these strategies that entrepreneurs like Greyson should be made aware of.

Citations:

Bouter, E. (2013). *Pricing: the third business skill*. The Netherlands: FirstPrice, B.V., 12-16.

Caldwell, L. (2012). *The psychology of price: how to use price to increase demand, profit and customer satisfaction*. Great Britain: Crimson Publishing Ltd., 17-22.

Vohra, R. V. & Krishnamurthi, L. (2013). *Principles of pricing: an analytical approach*. New York, NY: Cambridge University Press, 57-60.

Concepts: Alternative Pricing Strategy: Value Based Pricing - Many entrepreneurs use cost-plus and competitive pricing but forget about the value that consumers will place on their good or service. Value Based Pricing adds that important dimension to the pricing decision.

Citations:

Agyekum, C. K., Haifeng, H. & Agyeiwaa, A. (2015). Consumer perception of product quality. *Microeconomics and Macroeconomics, 3*(2), 25-29.

Baker, R. J. (2011). *Implementing value pricing: a radical business model for professional firms*. Hoboken, NJ: John Wiley & Sons.

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Vohra, R. V. & Krishnamurthi, L. (2013). *Principles of pricing: an analytical approach*. New York, NY: Cambridge University Press, 15-35.

Concept: Channel Pricing – Students should become familiar with how pricing strategies differ depending upon the channel or channels that are being used by a firm to sell its products.

Citations:

Anderson, E., Day, G. S. & Rangan, K. (1997). Strategic Channel Design. *Sloan Management*

Review, 38(4), 59-69.

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Davis, J. (2017, July 7). *Finding the sweet spot: What pricing strategy to use for distribution channels*. Retrieved from https://www.fastcasual.com/blogs/finding-the-sweet-spot-what-pricing-strategy-to-use-for-distribution-channels/

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Pearson, M. M. & Marshall, K. P. (2006). Pricing over Alternative Distribution channels: A Spreadsheet-Based Student Assignment and Classroom Exercise. *Journal of Marketing Channels*, 13(4), 69-85.

Spacey, J. (2017, Oct. 5). *5 Examples of Channel Pricing*. Retrieved from https://simplicable.com/new/channel-pricing

Research Methodology

This is a field research case and all names, places, and figures are factual. Primary research included personal interviews with the founder and owner of Elevate Hammock Company. Secondary research included industry reports and articles on the hammock industry and books and academic journal articles on pricing strategies. One author is involved in the organization the case discusses. No disguises have been imposed. There is no relationship between this case and any other cases or articles published about this organization by the authors.

Student Discussion Questions

Question One: Analyze Greyson's current pricing strategy. What are the pros and cons of his cost-plus/competitive strategy?

Question Two: Would customer value based pricing be appropriate for Elevate Hammock Company? How might Greyson analyze cost-plus pricing, competitive pricing, and value-based pricing to determine his selling price?

Question Three: Greyson's distribution channels included his website, retail stores, Amazon, and events. However, he eventually found that selling on Amazon and at events was too costly. He also had problems selling to four retail stores in one small town. Given these issues, what should Greyson's channel strategy be and why?

Question Four: Using the information in the case, should Greyson use different pricing tactics for each channel he is using to sell his hammocks? Why or why not?

Possible Answers to the Student Discussion Questions

Question One: Analyze Greyson's current pricing strategy. What are the pros and cons of his cost-plus/competitive strategy?

Possible Answer:

The instructor should explain what cost-plus and competitive pricing strategies entail before discussing the pros and cons of each strategy. Then the instructor should explain the pros and cons of using these strategies before looking at other pricing strategies Greyson might try.

Cost-plus pricing is a pricing strategy that theoretically guarantees that product costs are covered while at the same time delivering a minimum acceptable rate of profit for the entrepreneur.

The calculation for cost-plus pricing is:

Selling price = average cost x (1 + % profit mark-up)

Where, average cost = total cost/sales volume – which is an estimate or forecast.

An example:
If the company decides on a 50% profit mark-up, total cost = $2,000, and sales volume forecast is 100.
Average cost = $2,000/100 = $20
Selling price = $20 x (1 +% profit mark-up)
Mark-up = .50 x $20 = $10,
The selling price = $20 + $10 **= $30.00.**

The instructor should consult the following references: Bouter, 2013, pp.12-16 and Vohra and Krishnamurthi, 2013, pp. 57-60. The pros of cost-plus pricing include simplicity (the calculation appears simple) and costs are covered in the price. However, there are several assumptions involved in the cost-plus calculation. For example, what costs are included?

A major problem with cost-plus pricing, however, is that the calculation is simple if the sales volume forecast is correct. However, sales volume, market circumstances, competitiveness, mark-up, and pricing are all linked. They are not mutually exclusive.

What if the price is influences the sales volume? This calculation does not consider that. In other words, the market's supply and demand forces behind the sales forecast and profit mark-up variables are ignored. The bottom line is that cost-plus pricing does not consider what prices consumers are *willing* to pay, or which product features really matter to customers and drive them to choose the product over a competitor's product. ***The value that the product brings to consumers is ignored.*** Furthermore, the profit mark-up is a subjective choice. How should this be chosen? And how are the cost numbers determined? Where do they come from? Average cost is also a *subjective factor* in the cost-plus calculation. Why? Because calculating average cost requires assumptions about total costs and sales volume. They depend upon, among other things, considerations of value, production capacity, and tax implications, to name a few. Furthermore, sales volume is an estimate of the future – what if that turns out to be incorrect?

And finally, the source of the data used is also chosen subjectively. These data are obtained either from accounts based on the past (actual costing), or from the budget or business plan based on a forecast (cost estimate).

Another term used for a competitive price is a market price. When using competitive pricing, the firm chooses its selling price by looking at and following the prices competitors charge. This does not mean that the price always equals competitor prices – but that it is chosen based on those prices (or price).

The idea behind competitive pricing is that the market price should be a good indicator of what consumers are willing and able to pay for the product but also an indicator of a profitable price. In other words, a price where, at least in theory, market demand is equal to market supply. Use the price that others are using instead of going through the process of trial and error that existing firms already embarked on to find the market price.

Using competitive pricing makes sense – especially when a company has no history in the market. Competitive pricing is popular because it is relatively simple and it is a good starting place. Competitors that are already in the market should have some idea about what consumers will pay for similar products. However, price is not the only thing that differentiates a product from the competitors' products. Sometimes there is a possibility to improve selling prices through differentiation. Without recognizing this, a manager will lack insight into the specific needs of the customer and the actual weight of the price in customers' buying decisions.

Furthermore, competitive pricing could result in a failure to recognize competitor responses and supply factors. Defining the "market price" is not as easy as it seems. It requires thorough understanding of who the firm's immediate competitors are: their so-called "peer group" and it requires that the firm constantly keep track of competitors' prices.

Question Two: Would customer value-based pricing be appropriate for Elevate Hammock Company? How might Greyson analyze cost-plus pricing, competitive pricing, and value based pricing to determine his selling price?

Possible Answer: Would customer value-based pricing be appropriate for Elevate Hammock Company?

Customer value-based pricing is charging a price based on theory that a price should be a proxy of the value the consumer obtains from buying the product. The value then leads the customer to what he or she is willing to pay. However, this pricing theory also stipulates that a firm should not simply take customer value as given. Entrepreneurs should take the initiative in creating value by revealing to the customer just how much value they will obtain from the product.

Greyson basically asked: "how much will consumers pay for my hammocks?" Instead, he should have asked, "how can I show consumers how much value they will get from my hammocks?" Therefore, he was probably leaving profit on the table. EHC should not simply sell at whatever price the consumer is willing to pay, but rather it should raise customers' willingness-to-pay to a level that better reflects the product's true value.

One might ask, isn't the "true" value whatever the consumer decides it is? Yes, but consumers can change their minds about how valuable something is to them. This is especially true with new products. Customers don't know the value they will receive from the product until they have bought and used it (in most cases). It is up to Greyson to show consumers just how valuable his hammock can be to them (Nagle, Hogan and Zale, 2011 and Baker, 2011).

Instructors might also discuss the prestige effect of price. American Institutionalist economist Thorsten Veblen in *The Theory of the Leisure Class* (1898) maybe can be called the first behavioral pricing theorist. He talked about how people will buy expensive items because by doing so they signal to others how rich and important they are. He called this the "snob" effect (or "conspicuous consumption"). This explained why people who had money spent it on nice, expensive things – not so much to have those nice things – but to show other people that they could afford them. Therefore, the theory behind this pricing strategy is that the price itself becomes an indication for the quality and exclusivity of luxury products (Simon, 2015).

One experimental study conducted by Brucks, Zeithaml & Naylor (2000) found that consumers use price and brand name differently to judge the quality of a product. Consumers searched for price and brand name much more frequently when evaluating *prestige* than when evaluating any other quality dimension. (Simon, 2015).

Examples (in Simon, 2015):

Delvaux, a Belgian manufacturer of exclusive handbags, raised prices quite a lot in conjunction with a repositioning of the brand. Sales rose sharply, as consumers started to view the product as a viable alternative to Louis Vuitton handbags.

Sales of the famous whiskey brand Chivas Regal were in the doldrums in the 1970s. To reposition the brand, the company developed a label with a more high-end look and raised the price by 20%. The whiskey itself remained exactly the same. With the price increase, sales rose significantly.

Furthermore, there is some empirical evidence which suggests that consumers sometimes rely on price information to judge product quality. A higher price might increase the perception of quality and therefore induce the consumer to buy. See Rao & Monroe (1988) and Bornemann & Homburg (2011). According to one study by Agyekum, Haifeng and Agyeiwaa (2015), consumers "use price and brand name more than any other element or criteria on determining the quality of a product" (p. 29). A low price can cause consumers to forgo a purchase because the price increases concerns about the quality of the product. This might be a problem for EHC unless Greyson changes his pricing strategy. If there are enough customers using this "rule of thumb" - increasing a price can lead to more sales (Simon, 2015).

Question Three: Greyson's distribution channels included his website, retail stores, Amazon, and events. However, he eventually found that selling on Amazon and at events was too costly. He also had problems selling to four retail stores in one small town. Given these issues, what should Greyson's channel strategy be and why?

Possible Answer:

Since Greyson's mark-up on his company website is very high (224%) and does not require a great deal of his time, he should continue using that channel. It not only explains his product but also his company's unique mission. The instructor might ask the students to list ways that Greyson could increase in company website sales. These might include: show off more customer testimonials, create a sense of urgency ("sale ends in 24 hours"), offer a money back guarantee and always follow through with it, reduce any problems that might be happening in his check out process, target lookalike audiences on Facebook, provide as many payment options as possible, use high-quality product images, implement tiered pricing to website customers (as he does with his retail buyers), and use follow-up emails. There are almost endless ways Greyson could try to increase his website sales. See Shewan (2018).

Since Greyson has found it difficult to sell to four retailers in the same small town, another option he should try is extending his wholesale sales to retailers outside of Durango, Colorado. After all, selling goods through a retail channel extends the geographical reach of a business. By utilizing existing retail networks, Greyson could expand his geographical sales.

Retailers hold stock of Greyson's products at their stores. This would also reduce his own holding costs. His only delivery costs would consist of delivering to the retailers.

By targeting sporting goods stores, Greyson could have immediate access to a group of customers and prospects who visit these types of retail outlets to buy hammocks. He might even consider trying to negotiate exclusive dealings contracts with some retailers. This way these retailers would stock only Greyson's hammock and not those of his competitors.

Another reason Greyson should continue selling his hammocks through existing retail stores is that the responsibility for selling his hammock is on the retailer. To encourage retailers to sell his hammock, he should think about providing product training for the retail sales team, together with a program of sales incentives and promotional support material. While selling through a retail channel provides Greyson with the equivalent of an additional sales team, he does not have direct control over the relationship with the final customer. He is dependent on the retailer to provide the right level of service to the customers so that they continue to buy his hammock. See Linton (2011).

Question Four: Using the information in the case, should Greyson use different pricing tactics for each channel he is using to sell his hammocks? Why or why not?

Possible Answer:

"Accelerating technological change, heightened marketplace demands, more aggressive global competition, and shifts in the workforce and population demographics are affecting distribution channels, forcing companies to reconsider fundamental assumptions about how they reach their markets" (Anderson, Day & Rangan, 1997, p. 59).

Differing distribution channels can mean reconsidering pricing strategies. Channel pricing is the use of distribution channels when deciding on a price. Examples include using price discrimination or utilizing a clearance channel (Spacey, 2017). It is common for firms to offer different prices depending which channel is being used to sell a product. This is because channels could have different price elasticities of demand, depending on customer differences – including even the time of day they are buying the product.

However, there are pros and cons to channel-specific pricing. Omni-channel pricing (having the same price for all products sold) is considered more customer-centric (Davis, 2017). This is because by charging different prices Greyson could risk alienating some customers. Even so, a recent study that compared prices from websites and physical stores of 56 large multi-channel retailers in 10 countries found that prices were identical about 72 percent of the time (Cavallo, 2017). If, for example, he sold a hammock to a customer at a music festival for a higher price than he offers on his web page, this might alienate event customers (although they probably do have a more inelastic demand due to the circumstances of buying – most particularly if Greyson is the only hammock seller at the event).

However, there are ways to deal with price inconsistencies across channels. For example, Greyson could implement a self-matching policy where he will match the lower prices he has on the internet when a customer complains (Nicaso, 2015). A customer service policy of some form needs to be developed when channel-specific pricing is used (Barry, n.d.).

In some cases, a combined solution might be the best strategy since channel-specific pricing risks alienating customers and omni-channel pricing can mean Greyson is leaving money on the table. A combined solution approach might consist of a base price across channels but using channel-specific promotions and personalized targeted offers (Davis, 2017). Greyson might offer the same price at the music festival as what is advertised on his web site but offer a "special festival discount" to those customers, for example.

To better understand when channel pricing should be used, the instructor might want to explain the following common examples of channel pricing: (See Davis, 2017).

- Price Discrimination – The action of selling the same product at different prices to different buyers (when cost differences do not "justify" the price differences). This is typically used when there are different price elasticities of demand among buyers.

Example: A fancy boutique on a high-end shopping street is likely to attract customers who are willing to pay more than online shoppers.

- Clearance Channels: Using dedicated channels to clear excess inventory such as unpopular colors. Brands may take significant steps to keep clearance inventory out of sight of their regular customers.

Example: Firms might open outlet shops in rural or remote suburban locations.

- Costs: Using pricing to recoup the costs of expensive channels.

Example: A grocery store chain may operate both discount locations and full-service locations that charge higher prices but offer conveniences such as wide aisles and more checkout counters.

- Penetration Pricing: Charging less when the seller opens a new channel to gain market share.

Example: Using low prices to attract customers to an ecommerce presence to gain market share online (also a form of price discrimination).

- Unified Pricing: It is common for firms to make significant efforts to unify prices across channels for a region. Consistent and stable prices may be considered an important element of brand identity and customer experience.

Example: This may be done to maintain good relationships with channel partners such as distributors, retailers, dealers, and sales representatives who are impacted if you cut prices on a channel such as ecommerce.

Teaching Approach Recommendations

1. **Analysis of Cost-Plus Pricing, Competitive Pricing and Value Based Pricing – Which is Best?**

The instructor could break the class into small groups or ask each individual student to determine his/her answer on their own.

After the instructor has defined and discussed cost price, competitive and value pricing, he or she can ask students to decide which method should be used for a new product on the market and why. The instructor might ask the students to use Greyson's hammock as the new product being priced. Given the information presented in the case, the students should then determine a price based on the method they think should be used.

The instructor should allow some time for contemplation and encourage students to ask questions and engage in discussion.

Students will typically start to describe the strengths and weaknesses of each method. Eventually students usually select *one of the methods* and argue why they think it is the best method and determine a price based on the method they have chosen. After some time for discussion, the instructor should tell the students that they should have chosen to at least consider using *all three methods* in their decision process. The following explains why.

Explanation

It tends to be most unusual for all the three pricing methods to generate similar or disparate prices. Generally, two prices will be similar and one will be disparate.

Alternative Outcomes to Determine Pricing Method

Method	Similar ✓ or Disparate x				
Cost-Plus	✓	x	✓	✓	x
Competitive	✓	x	✓	x	✓
Customer Value	✓	x	x	✓	✓

Possible Outcomes

Similar ✓ or Disparate x: If all three of the pricing methods; cost plus, competitive, and customer value produce a similar or relatively close price then there is strong support that this price would be a good starting price to use when introducing the product or service to the marketplace. If all three methods result in entirely disparate prices, this suggests that there is something going on in the marketplace that is not well understood. This outcome will probably require some marketing research to investigate the situation.

Cost Plus & Competitive Similar and Customer Value Disparate: Sometimes the cost plus and competitive pricing methods will produce a similar price while the customer value method will result in a higher price This may indicate that the competitive and cost-plus methods are probably generating a price that is too low. The customers are willing to pay more than what is indicated by the cost plus and competitive methods. Therefore, the firm would be leaving money on the table. On the other hand, if the cost plus and competitive pricing methods produce a similar price while the customer value method results in a lower price, this indicates that customers might fail to value the product or service high enough to cover costs and/or obtain the desired mark-up. If there are very similar products already in the market, this begs the question as to why the competitive model indicates that a higher price should be charged. Are the competitors' goods or services valued higher by customers and if so, why?

Cost Plus & Customer Value Similar and Competitive Disparate: Another outcome that could take place is that the cost plus and customer value pricing methods give rise to a similar price while the competitive method shows that a higher price should be charged. This may indicate that the competition is charging too much for the product. On the other hand, if the cost plus and customer value pricing methods give rise to a similar price while the competitive method shows that a lower price should be charged, the competition might not be charging enough and is leaving money on the table.

Competitive & Customer Value Similar and Cost Plus Disparate: An outcome that could take place is that the competitive and customer value pricing methods produce approximately the same price while the cost-plus method shows that a higher price should be charged. This outcome may indicate that either the markup (the plus) is too high or that material, manufacturing, and/or other costs are too high relative to the value customers place on the final product or service. Possible solutions to this problem include: 1) reduce the percentage markup; or 2) endeavor to reduce manufacturing, materials, manufacturing, or other costs; or 3) reduce the markup and reduce the manufacturing costs. However, if the competitive and customer value pricing methods result in similar prices but the cost-plus method shows that a lower price should be charged, this may indicate that the markup (and profitability of the product or service) could be increased.

2. Quality Perception Exercise

Instructors might want to have the students develop a chart or diagram to try to determine if they think consumers will judge quality by the price when buying a hammock. Greyson felt that the quality of a hammock was determined by single vs triple stitching, weight capacity, type of carabineers, and the level of customization (is it wider than most other hammocks, are there more color options, is the logo visible and pleasing, as examples).

Consumers assess a product's quality primarily or solely on its price based on the following conditions: See for example Simon (2015).

a. There is uncertainty about the product quality and the price is the only information available:

- The product is new to them or the consumer rarely buys it.

Several researchers have concluded that when brand name, store reputation, or product information is available, consumers appear to rely on them rather than on price.

- Price appears to be used as an indicator of quality only when other indicators are absent or ambiguous.

b. When the absolute price of the product is not very high:

- This is also known as the "cost-plus mentality" because consumers might think that a low price means that manufacturer used "cheap" materials when making the product.
- On higher priced items, consumers are more likely to do more research about the good and are less likely to be as uncertain about the quality.
- If consumers have had good experience with high-priced items, they are more likely to judge a low-priced item as low quality.

c. When there is little transparency on prices for alternatives:

- Again, when there is more uncertainty about what the price "should be" in the consumer's mind, he or she is more likely to judge quality by price.

d. When consumers are under time pressure to make a buying decision:

- When consumers are in a hurry they don't have time to compare other characteristics of a product. Therefore, the price becomes the easiest comparison to make.

e. When product characteristics of quality are not easily ascertained by the customer:

- This is especially true when a good is an "experience good" – one that must be used before the quality can be known by the consumer. When this is the case, the consumer will often turn to the price to determine quality.

After explaining these conditions to the students, the instructor might ask the students which of these conditions, if any, would pertain to Greyson's hammock. Here is an example of how the students might look at this issue:

Quality Perception Diagram for Elevate Hammock Company

Reasons Buyers Will Use Price as Indicator of Quality	High Level of Uncertainty or Information Asymmetry Regarding Quality	Absolute Price is Low	Transparency on Prices for Alternatives	Consumers Under Time Pressure	Product Characteristics of Quality Not Easily Ascertained
	Moderate for First-time Buyers	Depends upon the income of the buyer. The question is: how long will the potential buyer search for quality characteristics before buying?	All competitors' prices are transparent to buyers with minimal search time.	Depends upon the individual consumer.	This depends upon the knowledge of the consumer regarding hammocks.

The students' analyses regarding their thoughts on the extent to which consumers of Greyson's hammocks see the price as an indicator of quality should lead to a good classroom discussion. If there is a consensus that the quality of EHC's hammocks is judged by the price charged, then perhaps Greyson should increase his price.

3. How Prices Effect Distribution Channels

If an instructor wants students to understand how prices might influence distribution channel strategies, they might look at the classroom exercise presented by Pearson and Marshall (2006). This exercise uses a spreadsheet approach to help students understand the influence of price on channel strategies. This teaches students the theory that it is not simply the channel that could influence the price chosen, but the other way around.

Epilogue

Greyson graduated from Fort Lewis College in April 2017 with a degree in economics. He did not sell his business before graduating. In July 2017 he found full-time employment. He continued to operate Elevate Hammock until March 2018, at which time he sold the business with the stipulation that he would consult with the new owner for one year. Although he wanted to try different pricing strategies, after finding full-time employment he just couldn't find the time to make changes to his company. He has recommended a price increase to the new owner and that has taken place (from $55 to $65 per hammock).

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