

Start Up Business and Their Pricing Strategy

Helena Sidharta¹

Universitas Ciputra

Abstract

Start Up Business like a newborn baby, they try to be a sustainable business. They need to compete their competitor. Most of start up business has a focus on cheap price to win their customer. This research is focus on the problem of start up business to choose pricing strategy based on common theories. The problem is their pricing strategy does not fit with their capability. They can compete their competitor. They have a difficulty to cut their cost of product or service, to achieve their economic of scale and to be a cost leader in the market. That problem makes start up business can not focus on their price to compete with competitor

1. Background

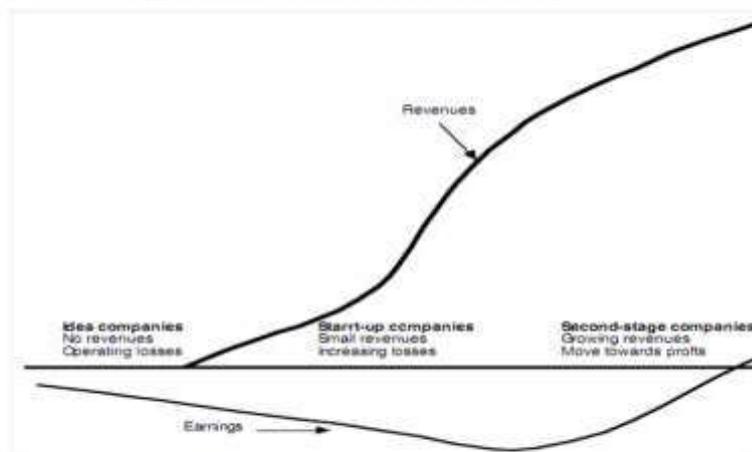
Pricing is one of the important parts when a company wants to win a market share. There are four major influences on pricing decision (Hilton, 2009): customer demand; political, legal and image issues; competitor and costs. Customer demand is important issues to considerate when company setting a price. Customer determines a product/service salable or not. Customer wants cheap price and best quality product/service, and when we ask about quality, it depends on their cost too. Logically higher cost higher quality, but in the market, customer wants cheap price, so if the competitor have cheaper price, customer choose the competitor product. It's why competitor must be considerate when the company set their product/service price. Political, legal and image issues is another issue to considerate. Sometimes government makes policies about price of product or service in which the company must be follow. Pricing strategy is not simple although for established company and more complicated for start up business. Furthermore, price is become competitive advantage between company in the market because customer usually wants cheap price with good quality of product or service.

Start up means if a business or other organization starts up, or if someone starts one up, it is created and starts to operate (Cambridge dictionary online, August 12, 2012). Start up business means business is created and starts to operate, in the other word start up business do not have a historical background to set their product or service price. The easy way to define their price is benchmark to established company with similar industry or background, but sometimes it is not a good decision because established company and start up business have a different character. Damodaran (2009) in his online paper revealed that start up

company have this six character: no history, small or no revenue may their operating is lost, dependent on private equity, many of them don't survive (only 44% business can survived at least 4 years and only 31% can survived trough the tenth years), multiple claim of equity, investment are illiquid. In the other hand, Established companies have historical background, continuously revenue, and public equity. They can generate cash quickly than start up business because they have clearly market. Because they know who are their costumer and they can quantify their market they can make a decision more accurate. Clearly and bigger market make established companies have an advantage from their economic of scale.

Established companies have advantage from their economic of scale which one of them is fixed cost. Total fixed cost remains constant but unit fixed cost declines (Hilton, 2009). That statement means when activity (volume of product/service) increases its cost will be decrease in unit cost. Volume of product/service increase because the company can sell more products or services and their production can be increase more than usual, so they have higher economic of scale. When established companies enjoy their advantage from huge market, start up business must create their own market. Damodaran (2009) have a life cycle view about young company (when the business started).

Figure 1. The Early Stages of the Life Cycle



Source: Damodaran (2009)

Figure 1.1 explained about why start up business maybe bankrupt. When a new entrepreneur decided to start a business, that business does not have revenue in the beginning. The owner of the business must be invested their money and that business have a negative cash flow. Because they do not generate revenue quickly they have limitation on money or resources. They can maintain their cost on efficient number, maybe they must buy some raw material or some resources with higher price than established company that make them must increase their price or can not compete with market price. This is similar to the observation result about

start up business in Surabaya, Indonesia. The observation aimed to young entrepreneur who doing their business in January 2010 until December 2011 divided to four semester include their problem.

Table 1. The Result Data from Start Up Business

| | 1 st Semester 2010 | 2 nd Semester 2010 | 1 st Semester 2011 | 2 nd Semester 2011 |
|---------------------------------------|--|-------------------------------------|---|-------------------------------------|
| New Start Up Business | 29 | 21 | 44 | 51 |
| Establish Business from last semester | 0 | 20 | 25 | 37 |
| Business Fail | 10 | 16 | 32 | 12 |
| Problem | - Team work, can't compete, operating lost | | - Operating lost, problem with supplier | |

Source: Process data

Most of that business has a problem with their cost that has an effect to their price and their market. From the beginning their cash just out from their business because of their expenses for rent a business place, transport, employee, utility etc. Finally, the owner cannot maintain their investment in their business. For the early observation, they have negative cash flow because they can sell their product to the market with the much number to achieve break event point in revenue. Most of them use market method based on competitor price so they have small margin or they cannot compete with their competitor, when their price lower than their cost they used cost plus pricing method to set their price, unfortunately their price higher than their competitor and they cannot compete with them. The question is why the two established method can not help them? Ho about the other method? What is the problem?

2. Start Up Business Owner Mindset vs Pricing Theory

Hilton (2009) reveal that pricing is one of the most important decisions and also most difficult because of it's due to number and variety of factors that must be considered. Setting price appears in all types of organization: manufacture, merchandising company, service even nonprofit organization. Hilton defined there

are four major influence to set price: customer demand, actions of competitor, cost and political, legal, and image-related issues. Mahet et al (2006) reveal the major influence on pricing is customer, competitor, and cost of product.

All of the pricing method using cost as a based computation. Commonly company must understand their cost of product, service even operating cost before they decided their pricing method. Garrison (2006); Reeve and Warren (2008) explained that cost behavior can be divided in three patterns: variable cost, fixed cost and mixed cost. Variable cost is constant per unit but varies in total depend on their activity level. Fixed cost is reverse of variable cost, fixed cost remain constant in total amount trough wide ranges of activity and varies per unit. Fixed cost can be minimized if the company can achieved economic of scale. Mixed cost includes fixed and variable cost elements, this cost usually known as semi variable cost too.

Based on the manufacturing, cost can divide into manufacturing cost: direct material, direct labor, overhead cost; and non manufacturing costs include selling and administrative costs (Hilton, 2009; Hilton et al, 2008). Non manufacturing costs means that cost are not used to produce products but that costs are really important to support the company operation activity. Reeve and Warren (2008) explained that direct material, direct labor, sales commissions is the examples of variable cost. Fixed cost example is likely depreciation expense, property taxes, insurance expense and officer salaries. Hilton (2009) also explained about direct and indirect cost. Direct cost is cost that easy to traceable to that cost object. Variable cost is direct cost because variable cost likes direct material easy to divide to product. Indirect cost difficult to traceable to the object. All fixed cost is indirect cost.

Established business can traced their cost of product so they understand their cost behavior. Start up business in the other hand have a difficulty to divided their cost on variable, fixed or mixed cost. Sometimes they do not know where is direct cost, indirect cost or how to calculated their cost per product, especially if their owner become a businessman before they understand about cost and pricing, for example start up business with two product maybe give the same price without calculate cost of each product correctly. The owner can divided the cost because they focus on the product and does not understand how to divided them. Because they don't know, for simplicity they divided their cost average for their product. For the result, one product has higher value than the other.

Commonly start up business followed their competitor to set their price or they just mark up their cost. Usually if they just follow the competitor price they make product with lower quality and market didn't like their product. If they are mark up their cost to set their price, price of their product maybe higher than market expectation. Even they used other pricing method they have difficulty to win their customer heart.

Target Costing on Start Up Business

Target costing is process to determine a price of product or service based on earlier market research (Hilton. 2009). The market research result given the company sales price that the customer wants and then they can make a product or service in the certain cost and acceptable profit. Target cost is the projected long run cost in which the company can enter the market and competed the competitor successfully. But, Garrison et al (2006) said that desired profit can depend on the company Return On Investment (ROI). For Start up Business, target costing make their cost too high because they does not have economic of scale. Some of start up business has limited capacity of production. If their production capacity is small, they can not minimize their cost for example cost of raw material. If their target costing is high, their price maybe higher than competitor, with that situation, hey can compete with their competitor.

Market Method on Start Up Business

Reeve and Warren (2008) explained that market methods usually based on demand or based on competition. Demand based methods set the price according to the product demand. Competition based methods set the price according to the competitor price. Carson and Bergstrom from University of Georgia have a conclusion that market price is the function of demand and supply.

Start up business, in early stage does not have market, they must educate people to buy their product even though their product is common product on market. Market will be anticipating and comparing the feature of product with the competitor or what is benefit of the product. If the owner of start up business used market method, their cost maybe does not fit with the price on market or they can find the suitable price for their product because they can find the similar product.

Cost Plus Methods on Start Up Business

Hilton (2009) explained that cost plus method means cost plus mark up. Depending on how cost is defined, the mark up percentage may differ. Company usually uses one of the four costs plus pricing based on variable manufacturing cost, absorption manufacturing cost, total cost and total variable cost. The percentage of mark up usually depend on target Return On Investment (ROI), this is same with target costing to decided the desired profit (Garrison et al. 2006). Reeve and Warren (2008) also explained that cost plus method is the additional amount added to the product cost. They divided cost plus method into three based: total cost concept, product cost concept and variable cost concept. Total cost concept combined all manufacturing cost include direct material, direct labor, overhead cost and all operating cost like selling and administrative expense. Product concept cost only using manufacturing cost to set the price. Product cost concept accordance Hilton (2009) divided to variable manufacturing cost method and absorption cost method. Variable cost divided cost to fixed cost and variable cost, and only variables cost influence the price setting.

This method is a common method that business used. This strategy has been applied on various companies in various type of industry. The problem with this strategy on start up business is similar with target costing, the start up business cost maybe higher than their competitor, the result is they have higher price and can not compete with the establish business. If they have new product, market maybe love their product but they do not want to pay because the price of the product is not match with their expectation.

Skimming Pricing and Penetration Pricing on Start Up Business

Hilton (2009) said that pricing new product is more difficult than establish product because the magnitude of uncertainty relate to new product. Established company usually use this two pricing strategy. One is skimming pricing. In skimming pricing, the company set the price high. This pricing is only used for unique product. The other pricing strategy is called penetration pricing. Penetration strategy is reverse from skimming pricing. In this method, price sets relatively low because company wants to penetrate the market quickly to acquire a large market share.

This two methods have been proven and tested by establish company. Establish company success used skimming pricing because they have name, they have loyal customer. Customer will be interest to buy their new product. Start up business does not yet have loyal customer, so they must be very careful to set their price. Skimming pricing can be success if they have a unique product with better benefit compare to establish product. Penetration pricing in other hand difficult to adopt by start up business because their cost maybe does not efficient (they does not yet have economic of scale).

If we learn the problem with start up business is they focus on their price is they can compete with establish business. Established business have a strong capital than start up business, they can achieved their efficient cost and have a power to distribute their product. Start up business can compete with them in cost or price. If start up business want to success and wins the market they can not be focus on cost or price because difficult for them to be cost leader like establish company except they have a lot of capital.

3. Conclusion

Pricing is important for a business when they want to sell their product on market. Established company have an advantage because they can be a market leader and their price can be lowest in market. Start up business in other hand can be competed with them. Start up business has a limitation, which is 1) start up business doesn't have enough capital compare with establish company. 2) Start up business still find their customer so they focus how to make people buy their product with lower cost. 3) Owner of start up business doesn't understand their cost and they failed to set their price.

Limitation of start up business makes them have a wrong price for their product. Some of them give their product over price so market cannot accept their

product. The other start up business have under value price for their product so they only have few profit for the result the owner can make their business growing.

Price is important for business but they must consider customer expectation, competitor, and substitute product when they set their price. For start up business, even price is important but price should not be their focus. They can compete with existing company through price, so they must compete in uniqueness of the product. This can be further research to support start up business become a successful business.

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