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Why startups lose money with their initial pricing

Have you ever wondered how startups get into that awful spiral of haemorrhaging cash by selling their product for less than it costs to make it? It’s on purpose. And there’s a good reason for it. But it all starts with their initial approach to pricing.

The science of setting a price for a product is not only sneaky difficult, it’s also surprisingly emotional. In a 20+ year career as an entrepreneur, I’ve gotten into straight-up confrontations with smart people over setting the price of a new product. Actually lost a relationship or two over it.

So not only can I impart to you what I did wrong, but I can tell you *why* I did it wrong.

Pricing requires vision, balance, and timing. When you get those things right, it doesn’t matter how wrong you were.

Why pricing a product is so difficult

In order to get pricing less wrong, let’s first understand why it’s never right.

Normally, when you have two equal and opposing forces, there’s going to be tension and difficulty that will eventually result in confrontation. Pricing is extra thorny because there are usually *three* sides to the pricing equation:

Your sales team will tell you that there is absolutely no way they can sell your full-featured product to your intended market for *more* than $X. Your customers, they'll rightfully defend, only have so much budget, and frankly, they're just not that interested in your product.

Your build team – engineering, manufacturing, service talent, etc. — will tell you that there is positively no way that they can deliver your full featured product for your intended market for *less* than $Y. Your customers, they'll rightfully declare, are too sophisticated to accept less than an exceptional offering, and honestly, your budget for product development just isn't where it needs to be.

And you — the owner, the inventor, the visionary — there's no chance in hell you're selling your baby for less than $Z. Just because.

Something's got to give here. Actually, all three of these forces have to give. Oh, and also satisfy the customer's demand and budget as well.

You're going to balance all this. So let's give you some weapons.

The price is wrong, Bob

Conventional fear will tell you that no matter what price you decide on, you're going to be wrong. But let's add a little conventional wisdom to that fear:

If you're taking wild guesses at the initial price of your product, you're screwed.

When you guess like that, you not only have the fear of pricing too low to get the margins you need or pricing too high to get market traction, you also pile on the possibility of attracting customers for the wrong reasons, cutting off any possibility of long-term success.

But remember what I said about losing money on purpose?

The truth is that startups usually lose money with their initial pricing structure because they're not pricing for today, they're pricing for tomorrow. As every part of your company gets better at what it does, costs decrease, value increases, technology advances, and new market segments develop.

Your sales team will figure out how to develop and address those new market segments and show those customers value faster. Your build team will figure out how to add more advanced features and stay within your budget.

As that happens, you need to remove that third part of the pricing equation. Take emotion out of it, lose any kind of imposter syndrome fear, and change your role from owner to arbiter, leading sales and build to meet somewhere in the middle.

Address the market first. Minimise costs, maximise value. That’s where you find your price. Here’s how.

Your costs are usually your high price target

When you start with the market and focus on margins, your costs will dictate the highest price target for your product. Factor in parts, labor, overhead, sales and marketing, all of those things that normally require spend to get to fulfilment. Don’t forget support and service too, your product isn’t indestructible or infallible.

Once you get this number down to a per unit basis, your next two factors are time and margin.

If your product has a time-based element, which is the case with most services or subscription models, you should not only calculate how long until you break even, but how much loss you’re taking on when you don’t.

Margin is next. Your target margin will vary based on your industry, your market, your product, and several other factors. But especially at the beginning, aim high. Ultimately, you want to be at the high end of whatever those factors dictate.

Just keep in mind that if you discover that the standard margin for a company like yours with a product like yours in a market like yours is around 10%, then 15% may be a good target, but 50% is not. Same on the other side. If everyone is surviving on 50% margins, you’re not going to undercut everybody by targeting a 10% margin. Your plan will fold like a house of cards.

When all is said and done, costs + margin (multiplied by time if necessary) becomes your high price target.

Your market price is usually your low price target

Your customers will tell you what your price should be, but they’re usually wrong too. Here’s why:

> Unless your startup is just copycatting another established business, you’re asking your customers how much they’d pay for something they’re not

familiar with. They know even less than you do about how valuable your product is. Much less, in fact.

You haven't even begun to properly communicate the true value of your product yet.

Hypotheticals always have a huge margin of error.

Also, there's a component of "right now" that you have to take at face value. In the beginning of a product's life, no one can see past "right now," because no one has a crystal ball. But anyone tasked with the responsibility of selling that product will be especially bad at seeing the future, because their success is inextricably tied to the price "right now."

I'm not saying don't listen to your sales team. I'm definitely not saying don't listen to your customers. In fact, get as much information as you can out of them.

I'm just saying this is your low price target.

How wrong should you be?

One you have your astronomically high cost target and your criminally low market target, you have your pricing dartboard. Time to throw the darts. That said, you're not going to be throwing them blindfolded.

On the build side —The first thing you're considering are the savings you're going to get in mass production. Cheaper materials, known quantities, economies of scale, and even distribution of fixed costs are all going to work together to bring the per unit cost down.

However, don't make the rookie mistake of overestimating the impact of these savings. Scale brings about almost as many inefficiencies as efficiencies, and there's going to be a learning curve.

Then consider advancement. There are two ways this will drive down costs.

1. The team that builds the product is going to get better at it. They'll have better knowledge about how their talent impacts the product which impacts the market. This results in reductions in waste and increases in value.
2. Technological advancements — regardless of the industry or the product — will lead to better and cheaper components, more automation, and even efficiencies in fulfilment and support.

On the sales side — As you approach product-market fit, you're going to change your target market to go broader is some aspects and narrower in other aspects. Regardless of how this plays out, you'll spend less time at each phase of the sales funnel, resulting in lower costs per sale.

In other words, as your sales team gets better, your customers are going to get better too.

In addition to this new customer being easier to sell to, as they find more value more quickly, they'll be willing to pay more for your product.

I like to use this example. Most people, including me, won't pay $100 for a bottle of wine. But people who know wine will pay $100 for a $500 bottle of wine. In a heartbeat.

You're counting on the understanding of you value proposition increasing over time. Like I said before, no one can effectively communicate the value of your product this early. As time goes by, everyone in the company, including the sales team, will find the right words.

So do this math and plan for tomorrow's price today, taking into account growth and scale. You might still be wrong, maybe even very wrong, but at least you've got levers to pull to get you over the initial hump to long term success.

This article was originally published on Medium by Joe Procopio

Joe Procopio is a multi-exit, multi-failure entrepreneur. In 2015, he sold Automated Insights to Vista Equity Partners. In 2013, he sold ExitEvent to Capitol Broadcasting. Before that, he built Intrepid Media, the first social network for writers. You can read more and sign up for his newsletter at www.joeprocopio.com

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