Case study on pricing strategy

How Starbucks Uses Pricing Strategy for Profit Maximization

by Tucker Dawson

Last Thursday Starbucks raised their beverage prices by an average of 1% across the U.S, a move that represented the company's first significant price increase in 18 months. I failed to notice because the price change didn't affect grande or venti (medium and large) brewed coffees and I don't mess with smaller sizes, but anyone who purchases tall size (small) brews saw as much as a 10 cent increase.The company's third quarter net income rose 25% to $417.8 million from $333.1 million a year earlier, and green coffee prices have plummeted, so what gives?

Starbucks claims the price increase is due to rising labor and non-coffee commodity costs, but with the significantly lower coffee costs already improving their profit margins, it seems unlikely this justification is the true reason for the hike in prices. In addition, the price hike was applied to less than a third of their beverages and only targets certain regions. Implementing such a specific and minor price increase when the bottom line is already in great shape might seem like a greedy tactic, but the Starbucks approach to pricing is one we can all use to improve our margins. As we've said before, it only takes a 1% increase in prices to raise profits by an average of 11%.

Value Based Pricing Can Boost Margins

For the most part, Starbucks is a master of employing value based pricing to maximize profits, and they use research and customer analysis to formulate targeted price increases that capture the greatest amount consumers are willing to pay without driving them off. ***Profit maximization*** is the process by which a company determines the price and product output level that generates the most profit. While that may seem obvious to anyone involved in running a business, it's rare to see companies using a value based pricing approach to effectively uncover the maximum amount a customer base is willing to spend on their products. As such, let's take a look at how Starbucks introduces price hikes and see how you can use their approach to generate higher profits.

An Overview of the Starbucks Pricing Strategy

The Right Customers and the Right Market

While cutting prices is widely accepted as the best way to keep customers during tough times, the practice is rarely based on a deeper analysis or testing of an actual customer base. In Starbucks' case, price increases throughout the company's history have already deterred the most price sensitive customers, leaving a loyal, higher-income consumer base that perceives these coffee beverages as an affordable luxury. In order to compensate for the customers lost to cheaper alternatives like Dunkin Donuts, Starbucks raises prices to maximize profits from these price insensitive customers who now depend on their strong gourmet coffee.

Rather than trying to compete with cheaper chains like Dunkin, Starbucks uses price hikes to separate itself from the pack and reinforce the premium image of their brand and products. Since their loyal following isn't especially price sensitive, Starbucks coffee maintains a fairly inelastic demand curve, and a small price increase can have a huge positive impact on their margins without decreasing demand for beverages. In addition, only certain regions are targeted for each price increase, and prices vary across the U.S. depending on the current markets in those areas (the most recent hike affects the Northeast and Sunbelt regions, but Florida and California prices remain the same).

Product Versioning & Price Communication

They also apply price increases to specific drinks and sizes rather than the whole lot. By raising the price of the tall size brewed coffee exclusively, Starbucks is able to capture consumer surplus from the customers who find more value in upgrading to grande after witnessing the price of a small drip with tax climb over the $2 mark. By versioning the product in this way, the company can enjoy a slightly higher margin from these customers who were persuaded by the price hike to purchase larger sizes.

Starbucks also expertly communicates their price increases to manipulate consumer perception. The price hike might be based on an analysis of the customer's willingness to pay, but they associate the increase with what appears to be a fair reason. Using increased commodity costs to justify the price as well as statements that aim to make the hike look insignificant (less than a third of beverages will be affected, for example) help foster an attitude of acceptance.

What can Your Business Learn From Starbucks?

The profit maximizing tactics Starbucks implements in their pricing strategy are vital components of a process anyone can use. Here are some of the takeaways you can apply to your own business:

1. Study your customer personas. Starbucks understands that the majority of their customer base is fairly insensitive to price, and uses small price increases that everyday consumers barely notice to boost margins. Quantify your buyer personas and the demand for your product or service will help you choose a price that captures the maximum amount your customers are willing to pay.

2. Justify the exchange rate for your product. Communicating price increases effectively is crucial to a successful price hike, and managing customer perception is a key part of the Starbucks strategy. Support your price increases using changes in the market such as higher commodity costs and ease the pain on the consumer by finding an attractive way to publicize the new prices. Starbucks said their beverage prices were increasing by an average of 1%, but that low average probably stemmed from including all of their beverages in the equation, including ones that remained at the same prices.

3. Use product differentiation to put your company in the lead. You can justify maximizing your profits using the fairest of reasons, but if the customers don't value your service the way they value a delicious cup of coffee, then a decrease in demand is inevitable. Build a service or product that consumers can't live without, and you'll be able to implement price hikes without turning off your customers.

4. Don't increase the prices of the products with the highest margins. Raise the prices of the products surrounding them. As mentioned earlier, Starbucks raised the price of the tall size brew exclusively in order to persuade customers to purchase larger sizes (with slightly higher margins). Price hikes for your lower margin products can entice customers to upgrade to more expensive options, especially with respect to products and services that are tiered based on time usage and features. The goal is to use the price increases to guide the customer towards your most profitable product.