A Pricing Framework for Product Managers

Brainmates White Paper #5
April 30, 2013

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Contents

Introduction

Is price a major influencing factor in the customer purchasing decision?

Yes and no.

Product Marketing traditionally views price as one of several tools available in the Product Manager's kitbag. But price or, more specifically transparency of price in an increasingly commoditised world of products purchased by connected and consumer-savvy clientele, has now become a determining factor in the purchase decision.

Nick Coster, Co-founder and Head of Training Services at Brainmates, provides five rules to consider when arriving at the price of a product:

- the price needs to be higher than the cost
- the benefits need to be higher than the price
- price is driven by supply and demand
- the business needs to be clear on its pricing goals
- pricing is a strategic activity not to be confused with short term offers

This whitepaper helps to improve pricing success by providing Product Managers with a pricing framework aimed at delivering results in the market.

Should We Forget About The Price Tag?

'Ain't about the cha-ching, cha-ching,
Ain't about the ba-bling, ba-bling.
Wanna make the world dance.
Forget about the price tag'

Jessie J popularized these lyrics in her song about a romantic notion that the love of music can potentially overcome materialism. As Product Managers unfortunately we cannot afford to ignore the price tag as this represents customer perception of product value. So, if you've got "20 dollars in your pocket and are gonna pop some tags" then it's the value of the product that is going to be one of the main attractions.

Pricing and Positioning

‘The art of marketing is the art of brand building. If you are not a brand then you are a commodity. Then price is everything and the low cost producer is the only winner’ Phil Kotler

In 1967 Philip Kotler wrote ‘Principles of Marketing’ in which he talks about the importance of pricing theory and practice. He acknowledges that there is a different level of emphasis on price as part of the overall marketing mix and this can depend on where the product is in its lifecycle. This advice still rings true today and often as a product matures, and the market becomes crowded with multiple entrants, it becomes commoditised. Price and, more importantly cost to serve, becomes tantamount to that product’s success.

Many customer purchasing decisions are made against a number of competing offers vying for share of wallet. A large target market segment is represented by customer aggressively seeking value for money and most industries have shining examples of businesses that thrive in this market segment. Examples include TPG Internet, Aldi Supermarket, Jetstar Airlines. The trick here is to position the brand as offering better value that its competitors. This is achieved by offering just the key features, stripping out under-valued frills, and making the customer believe they are getting a reasonable quality product that eats into less of their wallet.

In contrast luxury brands use a premium pricing strategy to position their product. The price needs to be reassuringly expensive enough tto appeal to those that are willing to pay more for the product.

A useful analogy for the power of price positioning is ‘The law of three’. It is an old retailer trick of displaying a budget version, a high end version, and a mid -range model at point of sale. The strategy to focus buying behaviour on the mid-range model. Customers are skeptical of the cheap model’s price but are attracted to the cost savings offered by the mid-range model compared to its more expensive counterpart.

‘Previously the customer was King. Now he’s a Dictator demanding a price structure built around his needs’

Customer Experience

When pricing a product it is essential to ask ‘How will this price impact the customer experience?’ i.e. does the customer clearly understand why they are paying this price and what they will receive in return for this price. If the answer is yes then the customer experience is likely to be enhanced as they will actually be happier about the price paid to enjoy that product. Sub-optimal customer experience around pricing is largely the result of a lack of transparency. If left unchecked this may even lead to government intervention and significant constraints placed on pricing within a sector.

EXAMPLE - Banks

During the 80's the banks were perceived as the 'bad boys' of pricing. Establishment, account keeping, ATM transaction, cheque book, phone banking, overdraw, redraw, discharge (not to mention record interest rates against borrowings) formed an impenetrable fortress of fees that long suffering customers fought to understand.

At the peak of escalating bank fees and charges, contrasting sharply against billion dollar profits, the government regulators and consumer groups stepped in. As a result of public scrutiny and negative media publicity the industry became intensely regulated. All financial products sold in the banking and superannuation industry must now have an associated Product Disclosure Statement detailing benefits, risks, fees and charges. Regulated comparison rate formulas were introduced allowing customers to perform an apples-for-apples view of prevailing lender rates.

Banks now realise the benefits of price simplification and have introduced capped monthly charges or annual package fees that consist of a single flat fee covering all transactions performed via savings account, current account, credit card, ATMs, cheque and so on.

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EXAMPLE - Telcos

During the 90's the bad boy baton was passed from the banks to the telephone companies. Customers were referred to as subscribers and the price of a phone call could vary significantly depending on call type, mobile monthly fixed access charge, time of day, day of week, the network originated from and terminated to, flagfall, the per second, 30 second or minute rate, usage cap, fair use policy and the product used to make the call (eg. fixed, domestic mobile, international roaming, satellite, calling card and so on). The phone companies finished first place in a race started by the banks a decade earlier and were crowned the champions of convoluted charging.

The Telecommunications Act 1997 and Telecommunications Consumer Protection Code have been put in place to protect customers from price bullying tactics. A Standard Form of Agreement detailing all pricing and conditions must now be provided for any contracted telecommunications service. Pricing offers must be summarised and easily comparable. For example, the cost of a 2 minute mobile call, cost of sending SMS, cost per MB, minimum/maximum monthly recurring charges and minimum contract terms have to be highlighted.

Phone companies are now actively bundling multiple services under all-you can-eat package pricing and deploying usage caps to make it simpler for the end customer to understand, and budget for, their telephony services.

The examples from these two industries teach a valuable lesson. Heavy regulation is undesirable and could have been avoided if only the banks and telcos had not lost sight of the fact that they were pricing for the end customer, and not for themselves.

Pricing Strategies

Good pricing strategy monetises the business strategy by helping build the story.

Launch

The introduction of new products or even entire retail concepts can often leverage a market penetration pricing approach that focuses on minimising mark-up. The goal is to “buy” market share, change consumer behavior and quickly grow a critical sales volume. Once target sales volume is reached the lower margins associated with this strategy are compensated by repeat purchase behavior and size of the overall sales volume. The fastest growing retail chains in America are smaller dollar stores who have taken Walmart’s pioneering lead in penetration pricing methods and applied them to sell consumer staples at bare-bones pricing.(1)

(1)*Marketing 4*, Carl D. McDaniel, February 2010

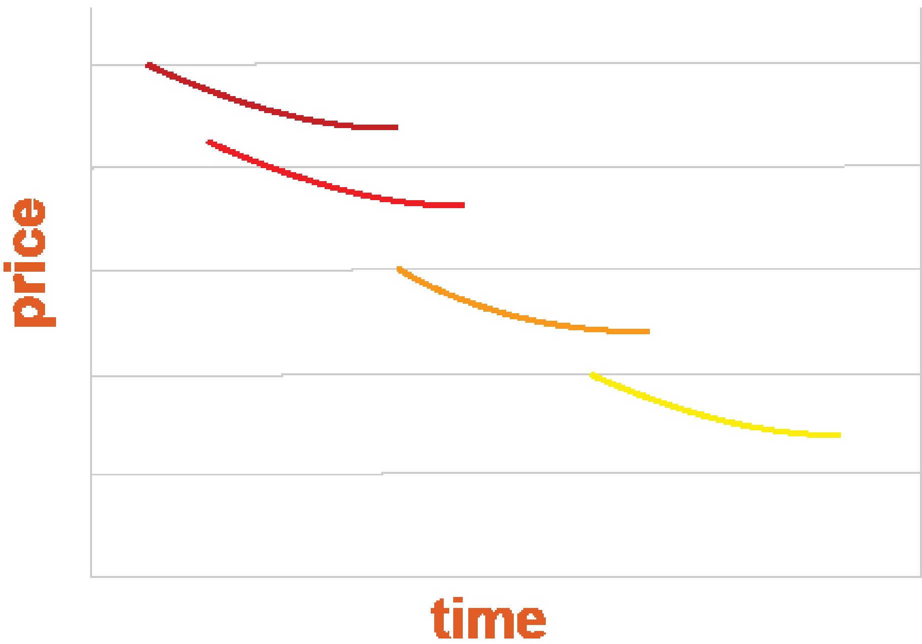
Cost Plus

One of the simplest pricing methodologies available is to take the cost of manufacture and add a mark up. This strategy works well in mass market situations exposed to considerable risk of inadvertently running low margin, commoditised products at a loss. The strategy emphasizes capturing all the costs, leading to lowering the cost of manufacture where possible, which in turn serves as a barrier to entry for new entrants.

A limitation of cost plus as a stand-alone strategy is that it does not address fluctuation in demand nor does it take perceived customer value into account. Peter Davanzo gives an example of a business creating a widget that allows a client's machine to double output. It may not cost a lot to produce such a widget and simple cost plus pricing would not therefore allow the business to share in the true value that the client gets by doubling their production output. (2)

Skimming

Sometimes the opposite pricing technique, known as skimming is used to launch high tech products. Skimming is where the price is set up deliberately high to target early adopters who are willing to pay for the latest technology. However once the competition, seeing the high margins available, enters the market the price can drop to attract the next level of more price sensitive customers.



(2) *How to Price* , SEOBook.com, June 2010

Value Based

If Cost Plus is bottoms up then Value Based would be considered a top down pricing strategy. Here the Product Manager leans over, produces a pen and asks “How much is this pen worth?” to which the answer is “Whatever the customer is willing to pay for it.” The margin could be negative in the case of a loss leader or exceedingly large in others.

A value based strategy works particularly well for brand leaders, and in markets where demand outstrips supply or infrequent consumer purchasing behaviour. An example of a market built on value based pricing is the gem and jewellery retail sector. Supply is tightly controlled through several large wholesalers who then heavily market the value of investing in diamond ownership. Retailers buy gems at wholesale prices and work up a large number of pieces which can then be displayed in store but the infrequent nature of jewellery sales means that a high margin needs to be built into each piece.

‘Their price may fluctuate but diamonds are forever’

List Price, Floor Price

In B2B environments buyers are cautious about committing to the first price offered, particularly in an environment with few vendors and large margins. The sales process is characterised by extensive price negotiation and, as a result, the list price is rarely the final price.

In such environments a financial authority matrix is called for. Such a matrix is designed to expediently solve the 80:20 rule of pricing where, for example, 80% of customers will purchase at a price discounted by between 0 and 20%.   A financial authority matrix for a 70% gross margin product/service might look like this:

DESIGNATION	DISCOUNT LIMIT OFF STANDARD BOOK PRICE
Sales Manager	Up to 10%
Product Manger	Up to 15%
Department Head	Up to 25%
CFO	Up to 50%

In this example the sales team are provided with the list price to communicate to prospective clients. However the floor price may be anything up to 50% off list price.   For the majority of deals the sales and marketing teams are pre-authorised to offer up to 25% off the standard price. For volume deals or strategic wins, a mini business case is used to justify CFO sign off on greater than 25%.

Price Reviews

Companies that regularly review price lists in order to remain competitive are less likely to be negotiated down at time of sale.

The trigger point for this review may be a quarterly price review or a customer re-contracting and highlighting disparity in the market place between competitors. Following the price review the product is normally aligned to the market and, at least for a brief period, the requests for discounting become less frequent.

Consideration needs to be given to customers who are presently within their minimum contract period. As these customers come out of term and are then recontracted in at lower rates, it will create revenue erosion unless there is upsell during time of recontract to offset the revenue reduction.

Where current pricing is clearly not winning business, and no extra product value can easily be added, the product manager may need to lower the price.

‘The four Ps of wholesale marketing are price, price, price ... and price.’

Other pricing strategies

Entire books have been written on this subject and detailing every price strategy is outside the scope of this white paper. However, a high level glossary of some of the other more popular pricing strategies include:

Loss leader – a strategy to entice the customer with a cheap price by subsidising a headline product that loses money with other more profitable products.

Extinction – variants include Predatory or Destroyer or Pre-emptive pricing and describe strategies of undercutting the competition with the intent of driving them out of the market entrants.

Discriminatory – similar product but different pricing eg. Student pricing for a train ticket or peak/of- peak rates for phone calls.

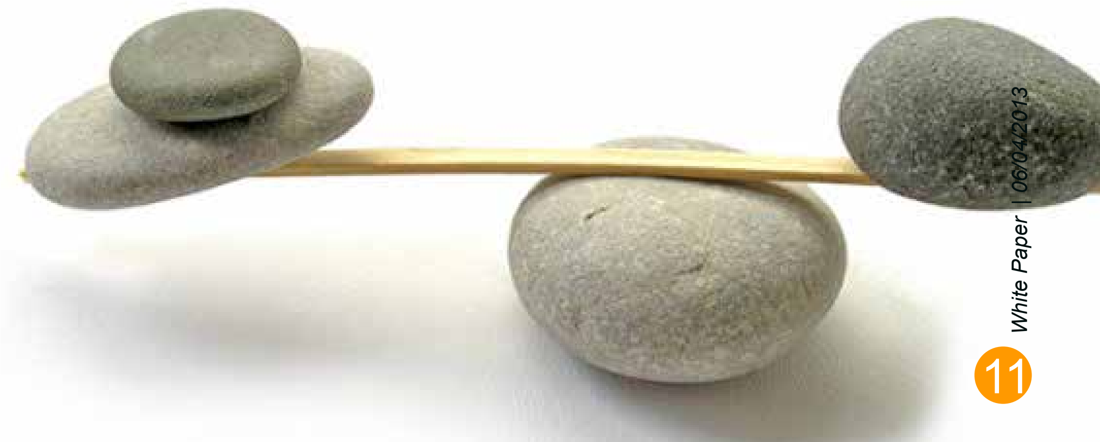
High Low – Normal high pricing but with limited promotional discounting to attract a more price sensitive client.

Price Leadership – A strategy to be associated as the product offering most value at the most competitive rates.

Freemium – Provision of a basic entry level product for free but then charging for premium value adds often used with PC software or mobile aps.

Pay what you want – a strategy used in commodity trading and auctions.

Flanking – a strategy to avoid a head-on pricing war with a competitor who has deeper pockets.

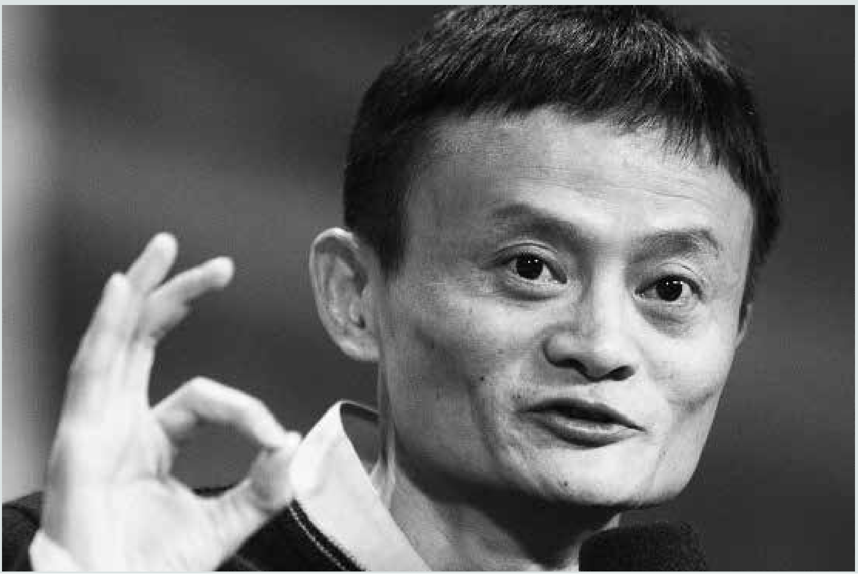


Case Study 1 – Taobao

Arguably the best example in recent times of a successful extinction pricing strategy is the case of TaoBao Vs eBay. In their quest for dominance in the C2C online auctioning business eBay and Paypal have acquired a number of smaller entities operating in their respective local markets. These include Gumtree and mobile ap developers such as Duff Research. In 2004 a reporter visiting Alibaba's Henzhon headquarters asked a staff member do you think eBay will acquire you? To which the reply was 'we will buy eBay'. (3)

The story began in 2003 when eBay acquired Eachnet for $180M. With 85% share of total transactions Eachnet was China's leading online market place. In response Alibaba launched it's own C2C auction site TaoBao (Chinese word which translates into "digging for treasure") to defend it's B2B market place portal from eBay . Unlike eBay's pricing which charged sellers for listing and a commission on each sale TaoBao was free. Founder Ma was using an aggressive pricing strategy to increase market share. It worked. By March, 2006 TaoBao had claimed 67% if the market and eBay EachNet retained only 29%.(4) In December 2006 eBay closed down the Eachnet website. Alibaba, a company with revenues of $170M PA had taken on a global online giant and won. TaoBao pricing did not rely on a rake in the same way as Facebook or Apple but their key revenue stream eventually came from advertising in much the same way as Google. Today the TaoBao website generates over $1Bn PA in advertising revenues. Their platform also receives revenue through the charge a 10% a technical service fee to enable the platform over which online retailers such as SNS Mogujie and Meilishuo operate

(3)Helen H Wang. *The Chinese Dream, The rise of the world's largest middle class*
(4) *Taobao Vs eBay,* Forbes magazine 12/09/2010



Jack Ma,
CEO,
Alibaba Group

Pricing Tools

Conjoint Analysis

Leaving money on the table can be a consequence of pricing that has been derived purely on a cost plus basis. For many products therefore additional tools need to be deployed that help derive value based pricing. Conjoint analysis is one such tool and takes a number of product attributes factored into the product construct, then assigns each attribute a score based on importance to the customer. Certain attributes can be demonstrated to be more important than others and therefore worth more from the perspective of pricing. For example, which of the two laptops, from the same manufacturer, is worth more?

WHICH LAPTOP IS BEST PRICED TO SELL?	
Option 1	Option 2
4G RAM	4GB RAM
500 GB HDD	256 GB SDD
17.3 inch monitor	15.6 inch monitor
Plastic casing	Metal casing
Current operating system	One year old operating system
2.8 Kg	1.8 Kg
$950	$1050

A mainly desk bound individual does not value a lighter laptop and would likely not place significant value on Option 2 being lighter than Option 1. However a customer who does not require a lot of storage may prefer the portability benefits of a lighter PC. Given the different variables, and particularly in the case where both models sit side by side on a retailer counter competing for the consumer purchase decision, the pricing decision is tough.

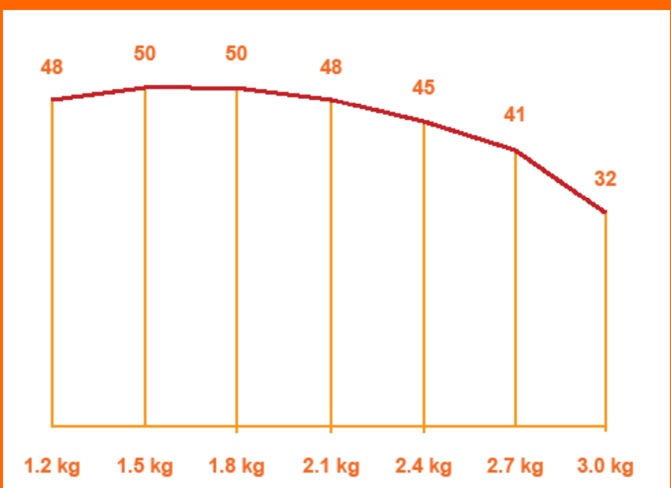
'Conjoint analysis breaks your product down to individual attributes and features'

Conjoint research conducted over a large sample size effectively averages out individual consumer preferences and would therefore help to formulate a winning price point by allocating score points against each attribute and might look like this.

Laptop 1	Points	Laptop 2	Points
4G RAM	50	4GB RAM	50
500GB HDD	75	256 GB SDD	50
17.3 inch monitor	60	15.6 inch monitor	55
Plastic casing	35	Metal casing	40
Current operating system	65	One year old operating system	40
2.9 Kg	32	1.8 Kg	50
$950	45	$1050	40
Total points	362	Total points	325

In this case the higher score for laptop 1 would indicate that overall sales for this model will likely outperform sales for laptop 2. The analysis also highlights that a product manager of laptop 2 wanting to improve sales should focus investigation on the economic feasibility for providing the latest version software or increased hard disk storage. The price point on laptop 2 could be reduced but, even if the price matches laptop 1 based on this conjoint analysis, it shall not have a major impact on sales.

Allocation of value points across a range of laptop weights indicates higher perceived value attributed to the 1.5-1.8kg range. At 1.2kg or less, the benefits of lightness are offset by perceived poorer quality of materials or shorter battery life etc…



Share of Voice Pricing

Share of voice (SOV) is a tool that helps measure the number of impressions being targeted by an advertisement and can be used by social media websites and search engines. It is calculated using the following formula:

$$\text{Share of voice} = \frac{\text{Client specific mentions}}{\text{Total mentions for competitive companies/brands}}$$

This formula is an alternative to charging a price per thousand impressions because it guarantees a minimum result and offers a fixed price against that result. The advertiser pays a fixed fee based on a minimum guaranteed number of mentions and the proportion of mentions that are received compared to the all the other advertisers.

Traditionally an advertiser may be willing to pay $10 per thousand impressions. So at the end of the month if they receive 30 thousand impressions the price works out at $300. However SOV allows the business to calculate the total number of impressions available and allocate pricing for a guaranteed share of those impressions.

EXAMPLE - Share of Voice

The online Arkansas Times in North America generates a total of 800,000 impressions per month and uses SOV pricing methodology by selling advertising space to a select 25 advertisers at a rate of $99 per week to run an ad that is guaranteed to receive 25,000 client specific mentions per month. Using this price methodology the Arkansas Times average cost per thousand works out at $17.16 which is considered higher than industry average. The small business paying for the ad also benefits as they know they are a member of a limited, select group of clients who pay to receive a guaranteed number of mentions.(5)

(5) ***Blinder Group*** **– Arkansas Times Study**

Case Study 2 – OneTel

‘There are no prizes for winning first place in a race to the bottom’

Why did OneTel collapse? OneTel’s collapse was certainly complicated and to this day the liquidators Ferrier Hodgson continue to untangle the financial implications of what has become one of the longest running windups in Australian corporate history. In the final days of OneTel the principal investors gave serious consideration to injecting additional funds but the cashflow fundamentals meant this would have been a bandaid solution to extensive damage already caused by an unsustainable pricing strategy. Here was a classic case of a company that took the principle of market penetration pricing too far.

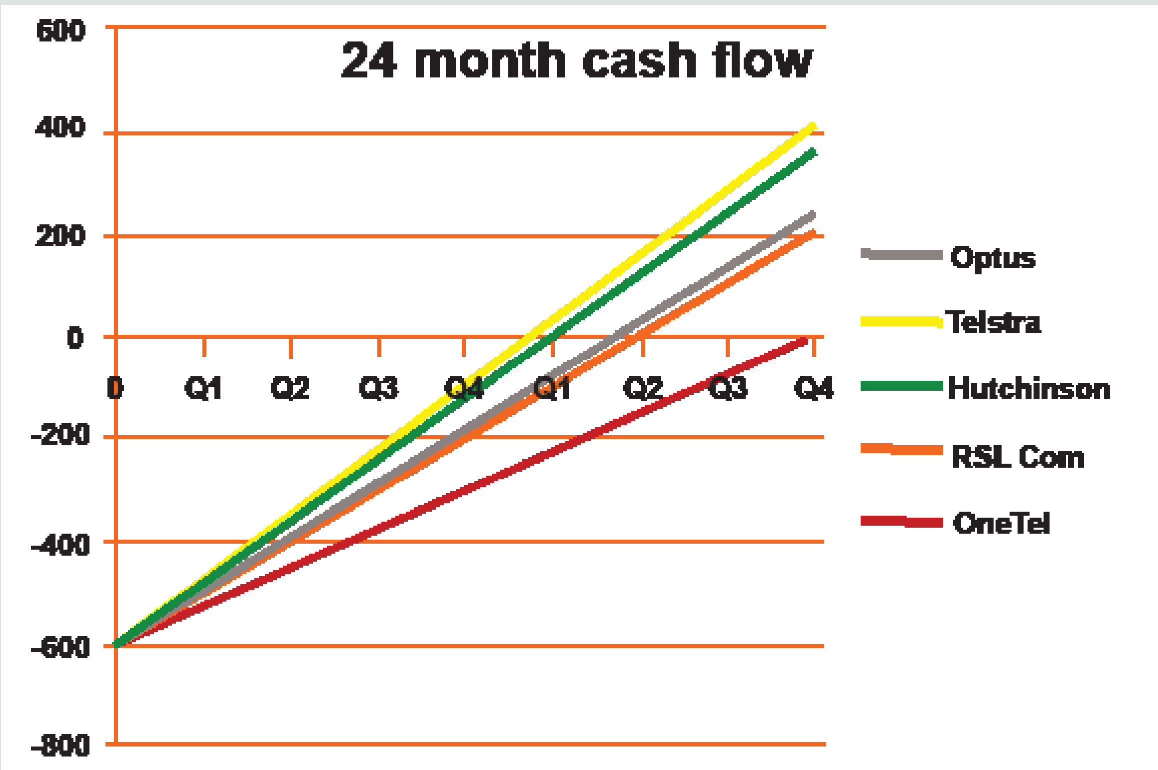
As part of the pricing analysis in setting up a mobile contract rate plan the acquisition cost (marketing, handset subsidy, dealer commission, wholesale network activation fee) needs to be offset with margin generated through monthly recurring charges and usage during the term of the contract.

Assuming a typical user calling profile, a breakeven point should occur at some point prior to contract expiry. Due to high industry churn (and churn often occurring prior to contract expiry) it would be risky to assume that most of the customers on expired contracts would continue to remain loyal to their incumbent service provider.

OneTel won the race to the bottom by quickly becoming the residential mobile price champion through 100% handset subsidies in return for 24 month contracts featuring easy to understand rate plans, with low calling rates. They resold Optus wholesale minutes at minimum markup so that break even was normally towards the final 3 months of a 24 month contract which was much later than other service providers including Telstra, Optus, RSLCom and Hutchinson who had a mix of business subscribers and typically offered lower handset subsidies on 12 or 18 month contracts.

The lesson learned here is that when pricing it is possible to overlook certain costs especially hidden costs such as early churn. A business will become unviable if pricing reviews do not uncover these hidden costs and low margins then become negative.

Assuming similar acquisition costs and customer usage profiles the breakeven for most operators was 2 quarters before OneTel.



Win-Win Pricing Structures

Win-win extends value based pricing by asking how the underlying price structure can support both the buyer and seller. It goes deeper than just price by examining the relationship between the buyer and seller and, where possible, moving the parties towards a partnership arrangement rather than purely vendor and buyer.

Virgin Mobile Australia customers purchase a partnering of the Optus mobile network and Virgin's mega brand. It changed the traditional model of Optus wholesaling minutes to a service provider who then marked up and resold the service to the end customer. Optus invested $1M in network and systems infrastructure. Virgin matched the Optus investment with $1M in branding, advertising and customer care. A joint venture was formed between two companies creating a combined consumer customer value proposition greater than the sum of its two individual components.

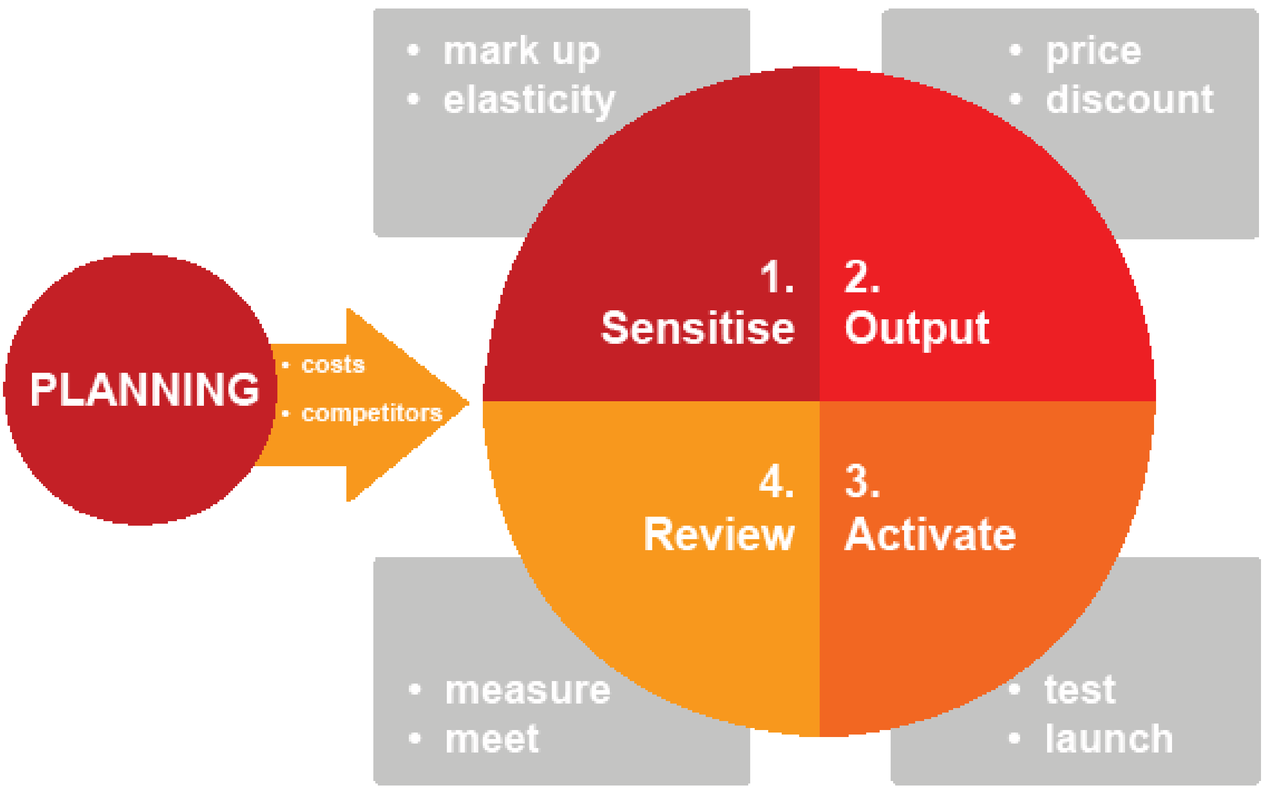
Apple effectively partnered with their customers by aggregating their purchase power onto the music industry.Apple insisted on a model that allowed them to retail music downloads at a single price point of $1 per song regardless of artist. In April 2003 this product was released in the US and overnight the buyer decision making process was made easy and online music retailers no longer required complex accounting systems. A recent parliamentary enquiry into digital pricing in Australia highlights that there is a still a long way to go in terms of establishing win-win partnerships in this market where, despite being launched since 2005, consumers are still paying up to $2.19 per iTune song downloaded which is more than double the price paid by their American counterparts. Apple has laid blame on record labels, movie producers and TV networks for the discrepancy in pricing.

A word of caution. Pricing may appear to be win-win and but actually turn out not to be the case. For example, in order to facilitate customer replacement purchasing the automotive industry introduced the concept of trade-ins. However research conducted by the University of British Columbia indicates that trade in customers end up paying on average $452 more for their new vehicle than a customer who does not trade in. The trade-in customer is so pre-occupied with the sale price of their old vehicle that they lose focus on the negotiable price on the new vehicle. However, a customer approaching the transaction as a pure buying exercise is freed up to negotiate a better deal. (6)

(6) ***Can Trade-Ins Hurt You? Exploring the Effect of a Trade-In on Consumers' Willingness to Pay for a New Product,*** **Juliet Zhu et al**

The Brainmates Pricing Framework

The Brainmates SOAR framework for pricing may be depicted as a planning phase followed by 4 steps:



Disparate internal pricing processes may be distilled down to a more structured pricing framework that benefits the customer and business.

Planning

The planning stage is the most important because it aligns the pricing exercise with the business strategy. During this phase four major product pricing questions need to be answered:

1 Who is my customer?

2 What is my customer willing to pay to have his or her problem solved by my product?

3 What are my competitors charging?

4 What are my costs?

If the costs to serve are known and comprehensive customer research plus competitive analysis has been undertaken then the act of pricing becomes much easier. Costs to serve are the fixed and variable costs including, staff opex, upstream provider costs, license fees, advertising costs and general manufacturing costs associated with the product. Incremental pricing does not require costings on the capex and sunk items but, if available, these may be apportioned and then used to perform a fully allocated costing exercise to work out the true break even of a product.

A competitive analysis will highlight what price points exist in the market place and help focus thinking on a suitable top down strategy, for example use of a flanking strategy for challenging an incumbent as opposed to engaging head-on in an all out price war. It also brings to the front of the pricing analysis the value of the product attributes and what the target market expects to pay for features based on where the product sits in its lifecycle.

Sensitise

The background research into costs and competitor pricing now serves as input to the establishment of a pricing model. Sensitising this input is now performed in the price modeling phase where a suitable markup on the cost is determined. Often this is facilitated by the use of worst, base and best case scenarios that test what happens to sales volumes and overall margins if price is tweaked up or down from the base case assumptions. Sensitivity analysis is centered around elasticity of demand Vs price for a product and a number of analysis tools including conjoint may be used. During this step of the pricing exercise the Product Manager is asking "What is the optimal price point needed for increased sales and maximum margins?"

Output

The Output consists of a business case including summary objectives, recommendation, business justification plus sensitivity analysis. This business case and launch dates are endorsed and locked-in by the management team as the go-to-market standard pricing. In the B2B environment it is also important during this step to also seek pre-approval on any volume/contract term based discounting plus the maximum discount thresholds that the sales, product teams and senior management representatives are each authorised to offer a client during the course of winning a strategic bid.

'Like a great Thanksgiving meal the key to pricing success is quality ingredients, upfront preparation and following a basic recipe'

Activate

Updates to billing, reporting and sales commission systems plus website, online sales portal and any customer facing product collateral must be scheduled in with legal, IT and marcoms prior to launch. Activation of pricing may include a soft launch to a test market segment (with a full billing cycle recommended to test system compliance) followed by a hard launch with associated promotional activity. Training and frequently asked questions should be made available for sales and customer care.

Review

Post-launch measurements include daily, weekly and monthly customer acquisition reporting as well as product upgrades, downgrades and cancellations (and churn where applicable) by sales channel and product type. Review sessions should be scheduled with finance, sales, and customer care to oversee the product sales performance, overall margins and operational impacts. Where the analysis around sales performance indicates that product pricing is the major reason for failure to deliver against the baseline business case objectives then it shall become necessary to repeat the pricing process through a second cycle of sensitising a new data set, outputting new price points, activating and reviewing.

‘When you know your costs and what customers are willing to pay for your service, the art of pricing becomes much more scientific.’

Conclusion

Good pricing takes the customer on a value journey and is done for the customer first and business second. Cost plus is a useful starting point for consumer based pricing but ideally should then be overlaid with value based methodologies. The use of conjoint analysis can further the Product Manager’s understanding of the consumer purchase decision and the competitive environment. B2B pricing should have an equal emphasis placed on the support structure behind the pricing as well as the actual price list. Using a development cycle approach to pricing will allow the Product Manager to adapt to the changing stages of the product and market maturity.

ABOUT THE AUTHOR

Roy McBurney is a seasoned manager of product portfolios worth a total excess of one hundred million dollars in annualised margins. His business acumen, technical knowledge and ability to execute strategy make Roy a key influencer whose opinion is sought by senior business leaders aiming to build successful product solutions.

Roy has held a number of leadership roles including Director of Global Infrastructure and Director of International Carrier Product Marketing at Emirates Integrated Telecommunications Company. He led diverse teams, including procurement of international networks plus he had accountability for voice and data portfolios generating one billion dirhams in high margin revenue per annum.

About brainmates

brainmates leads companies to strategise, design and deploy customer-centric products and services. We offer professional services and training and have helped leading clients enhance their products and services. Our clients include industry leaders in media, communications, financial services, medical devices, software and hardware manufacturers. Contact us today to find out how we can help you.

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