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The Menu Pricing Game: How to Apply Customer Psychology to Win

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Weekly Planner
LL'S GRIL
Price

The Menu PRICING Game

By Dave V. Pavesic, FMP

How to Apply Customer Psychology to Win

Of all the business decisions a restaurateur has to make in the startup phase of the restaurant, the one that causes considerable anxiety is pricing the menu. At first blush, it seems like a numbers game. Simply fire up the business calculator or spreadsheet program and determine what you need to gross in order to reap a reasonable return on the business after all costs are figured. If pricing were only that simple.

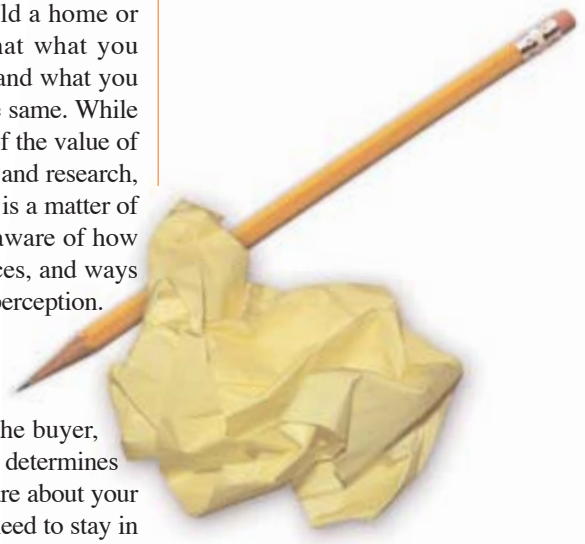
In fact, the pricing process is more of an "art" than a "science." That does not mean that you should price your menu simply by intuition. Just because something is an art does not mean that it is not a discipline. The point is you need to understand how your guests perceive your operation. The psychology of your customer is a significant factor. This requires observation and asking questions. Consider your last visit to a flea market, antique mall, or garage sale as either a buyer or seller. You dealt with the uncertainty of pricing when you were deciding how much to charge or what you thought was an acceptable price that would motivate you to buy. At the end of the day, pricing is all about what someone else is willing to pay for your product or service. If you have ever sold a home or car, you probably found that what you thought you should receive and what you ended up taking were not the same. While most folks form an opinion of the value of an item based on experience and research, in many cases the right price is a matter of perception. You need to be aware of how customers perceive your prices, and ways that you can influence their perception.

But I Need to Cover My Costs!

It has been said that it is the buyer, not the seller, who ultimately determines the price. Customers don't care about your costs, and what margin you need to stay in business. Sure, you want to keep your costs as low as practical so that you can reap as great a return as possible. And clearly, as we will discuss, you need to know your costs. That said, banish from your vocabulary the term "cost-plus" pricing (i.e., setting all your prices based on a fixed "target" margin over your costs). It does not apply in this business.

When I gave a talk several years ago at the New York Hotel and Restaurant Show, I began with several anecdotal comments regarding what I considered extremely high menu prices for food and drink in Manhattan and at the convention center. After I finished my presentation, one of the restaurant owners in the audience came up to admonish me for being so outspoken about their prices. He said that they have higher overhead and, as a result, must charge accordingly. "Operators in the Big Apple have to cover costs and make a profit, or it wouldn't be worth the risk, investment and mental anguish of owning a restaurant," he said.

The tough question, and the one that can only be answered using judgment and observation, is whether you should price an item on the high or low side of the continuum.



I agreed with that statement, but added that prices must be competitive and reasonable, too. If customers do not feel that they are getting sufficient value for their money, regardless of price, they will likely not return to make another purchase. Where to start? You need to create a pricing "continuum," in other words, a price spectrum, which is defined at one end by the lowest price you can charge and still make a reasonable profit and the other end, by the highest price the market will bear. Use this model for every pricing decision, since it will help define your price range. It is easier said than done, but at least will force you to take a methodical approach to pricing. More importantly, because pricing involves a measure of subjectivity, there is great value in determining your absolute boundaries.

So How Low Can You Go?

Determining the lower end of the pricing continuum requires careful consideration of all costs involved in bringing that item to the table, including the costs involved in preparing and presenting an item, or bringing customers in the door, for that matter. As we said, you cannot base your pricing solely on cost; however, you better know your actual costs before embarking on your pricing journey.

Let's review your cost centers. Your direct costs are the ingredient used in each item. It is vital to know the food cost of each item, and to manage those costs with as much certainty as possible. This includes accurate portioning and weighing of ingredients. (For more information on this subject, see "Profit from Proper Prepwork," in the October 2004 issue of *RS&G*.)

While the labor to prepare an item is a significant menu cost, many restaurants treat it as an indirect cost. The time and motion studies to determine the exact labor that goes into each item are more involved than most restaurateurs are willing to wade through. Still, try to bear in mind the time and labor involved in producing a particular made-from-scratch specialty versus premade items that require minimal preparation. Common sense tells you that such "convenience" items do not require as high a markup as others requiring processing and handling, to be profitable.

Indirect costs are those that cannot be assigned to specific menu items but often involve aspects of your business that customers perceive as "value-added," and are weighted in their decision to choose your restaurant over a competitor. These include overhead, such as costs related to providing customer service and ambience, and certain amenities, such as a fancy restroom or crayons for kids. You would not allocate these overhead items to your menu pricing, but you would monitor them carefully to ensure that they are in proper proportion to your gross sales. (See "How to Evaluate Your Prime Cost," on Page 30 of this issue.)

And though indirect costs are not typically allocated to specific menu items in a restaurant, they can be recouped *indirectly*, if they create added value that can

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How to Evaluate Your Prime Cost

By Jim Laube

While local market forces may be the biggest determinate of what your restaurant's prices should be, keep in mind how much you *need* to charge to have a profitable operation.

One way to evaluate the adequacy of your prices is to focus on your restaurant's "prime cost." Prime cost is the total cost of goods sold plus the gross labor of all your salaried and hourly employees plus payroll taxes, workers' comp and other employee benefits.

A good benchmark for table-service restaurants to shoot for is 65 percent (of total sales) or less. In a quick serve operation it's 60 percent or less.

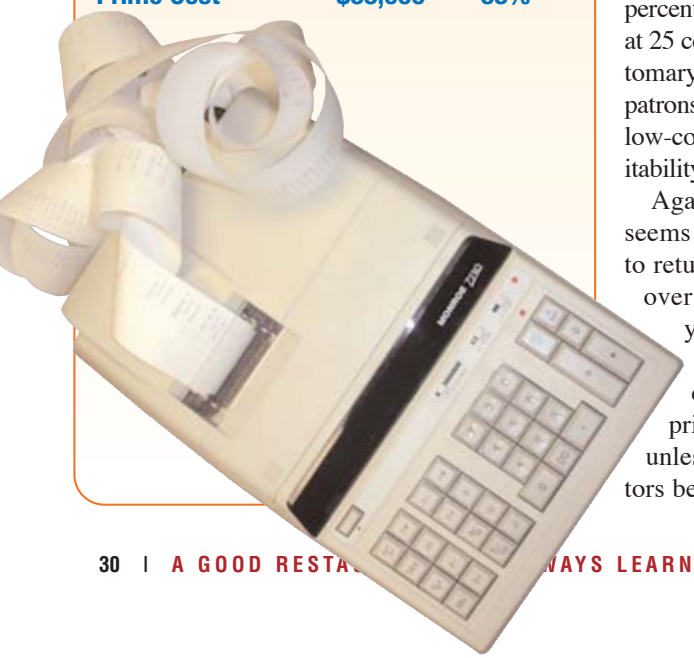
When prime cost gets above these bench marks, a restaurant either isn't doing a good job of controlling its food, beverage or labor costs or its sales volume or price points on the menu are too low.

Keep in mind that there can be exceptions to the prime cost bench marks. For example, bench marks in high-occupancy cost locations such as upscale shopping malls and airports may call for very high price points and sales volume to have any chance of earning an adequate profit and return on investment. In cases like this, a prime cost goal of much less than 60 percent to 65 percent may be necessary.

Understanding and paying attention to your prime cost is valuable for many reasons. Validating and monitoring the adequacy of your pricing is one of them.

Here's a simple illustration of how to determine your prime cost:

Sales	**$100,000**	**100%**
Food & Beverage Costs	**$30,000**	**30%**
Payroll		
Salaried	**$10,000**	**10%**
Hourly	**$18,000**	**18%**
Taxes & Benefits	**$5,000**	**5%**
Total Payroll	**$33,000**	**33%**
Prime Cost	**$63,000**	**63%**



justify higher prices. For example, if your marketing efforts (which are overhead) have helped positioned your restaurant as the most interesting and desirable place of its type in the market, you can price more aggressively than if you were just considered a ho-hum "follower." The atmosphere and decor of a restaurant adds much to the enjoyment of any meal. The perception of value is enhanced when the restaurant is beautifully and tastefully decorated. The service commitment can be the element that makes your restaurant "competitively distinctive" from your competition. This intangible is recognized as an added value by the customer and can be reflected in the prices charged.

For example, if your operation is considered the top steakhouse or Italian restaurant in your market, you will be able to charge more than the "customary" menu prices. Similarly, if your service is head and shoulders better than most of your competition, you can charge a little more than the average operation.

In other words, there are certain things that you do better than most that give you a competitive edge over your competition and you can charge a little more than your competition. Examples of other indirect cost factors that could allow you to adjust prices upward (the absence of these items would work the opposite in the pricing decision). These include ambience, location, amenities, product presentation, customer demographics, and specialty menu items. There are further adjustments that one would make to fine-tune menu prices that involve your desired check averages and the high and low price points of your various menu item categories.

The High Side

At the other end of the spectrum, you need to study your market and customer before pricing at the higher end of the pricing continuum. The tough question, and the one that can only be answered using judgment and observation, is whether you should price an item on the high or low side of the continuum. Again, apply common sense. Your gut will not always be right, but it will never intentionally mislead you, and more often than not, it will tell you if an item's price is too high. If you would not pay that price for the item, most likely your customers would feel the same way. But realize that pricing menu items can rarely be completely objective. In addition, avoid the temptation to underprice a menu item. In a business in which success and failure is often measured in pennies, underpricing can be as much of a dilemma as overpricing. You don't want to leave money on the table, anymore than you want customers grousing about your pricing, and eschewing your business for a competitor that is perceived a better value.

And it's another reason why basing your pricing on cost alone can be problematic. Take this very simple illustration. Consider a cup of beef bouillon as an example. The food cost of a 5-ounce cup would be about 10 cents. If it were priced to achieve a 40 percent food cost (a markup of 2.5 times its raw food cost) it would be underpriced at 25 cents. Since this item is usually served in white-tablecloth operations, the "customary price point" could be $3.95 and it would not be considered overpriced by patrons. In fact, one technique for boosting the profitability of your menu is to offer low-cost, but popular items. The margins can be extraordinary, and boost the profitability of the house significantly.

Again, you need to look at each item separately, and determine which price seems reasonable. Applying a single markup method or marking up each item to return the same profit will result in items being overpriced and underpriced over what the customers see as "customary" in the market. If, for example, your cost to produce a common menu item like a hamburger was twice the cost of other restaurants, your price could not be twice the price of your competition. Your cost is excessive and customers would not pay your price. You could only charge the "customary market price" for a hamburger unless you turned it into a "specialty" item. Markup is tempered by other factors besides food costs and desired profit.

More Advice on Picking the Right Point on the Pricing Continuum

While pricing is mostly art, sometimes you need to rely on a little science. For a minute, let's play economist. (Economics is called the "dismal science," so you may need to crease your forehead and frown a little at this point.) With the pricing continuum in mind, pricing can be either "market driven" or "demand driven."

Market-driven pricing is just what it sounds like — the market determines the price. If you stray even a little above what the market is willing to pay, sales plummet. What items are driven by the market? If the menu item is a "commodity" in the economic sense, that is, it is available just about everywhere and quality differences are nominal, a definite price point exists in the market and in the mind of the customer. A quarter-pound hamburger might fall under this category. There is only so much anyone will pay for that burger. While you might try to "add value" to your hamburger (as we will discuss below) to make it a more demand-driven item, you need to really be honest with yourself whether your customers perceive your burger as any better of a product than the guy's down the street. And for the most part, a lot of folks have a pretty set idea what they are willing to pay for a burger. Price it more than a few cents above that limit, and they will head down the street, unless it's a pretty special burger, sold in a pretty special place.

Some other examples of commodity menu items would be your basic pepperoni pizza or barbecue ribs. If there is nothing special about the taste, preparation methods, or presentation, the price charged must fall close to prices of your competitors. This perspective on pricing is also used when introducing new menu items before any substantial demand has been established. Prices that are market-driven tend to be on the moderate to low side of the pricing continuum.

Demand-driven pricing is based on the notion that you have more "flexibility" in the price you can charge, based on demand for your product or service. As an example, consider the price of a ticket to a sold-out concert or sporting event. Scalpers sell tickets for double and triple their face value to those who really want to attend. The buyers will gladly pay the premium for the tickets. In the context of foodservice, airport and sports stadium concession food and beverage prices are more expensive than you would pay for the same items in restaurants near your home. Part of the reason is the high overhead of restaurant concession space and the fact that they have a captive clientele. But the other part of the equation is based on demand. Once you are in the airport or stadium, it is unlikely you'll leave to get a meal. If you are hungry your demand for food is disproportionate to the supply. It's simple economics.

One thing to always keep in the back of your mind is that no restaurant will be able to sustain demand-driven pricing over the long run.

How else do we shift demand? One of the objectives of advertising is to increase consumer demand for product and services. If you spend millions of dollars convincing the public that your can of carbonated water and syrup, which cost you pennies to produce, is really special, you can sell that can for 50 cents. In the context of a restaurant, a really special concept can have the same effect as advertising. Consider that pepperoni pizza sold in a nice but unremarkable family restaurant tucked away in a strip mall. Now consider the same pizza in a family restaurant with a huge arcade and a floor show with mechanical cartoon characters that delight young children. You can probably charge more for the same pizza, because of the demand created by the entertainment. (Remember what we said about recouping indirect costs?) In fact, like the advertiser, you will have to charge more for the same pizza, so cover the added costs. Your goal will be to charge enough and bring in enough traffic to make that concept profitable overall.

Think back to what we said about how your indirect costs influence your pricing. Again, in the context of a restaurant, demand-driven pricing can be used on menu items where the operation has a monopoly, as few competitors offer the "specialty" menu items, or, as illustrated above, concept. This is a short-term advantage in the restaurant business because no matter how special your food or service, competition will eventually cancel out the competitive advantage. But if you have an exciting concept or have been successful in creating a menu or ambience that is considered unique in your marketplace, your overall pricing can be demand-driven when you have long waiting lines to get a table in your operation. You can be aggressive in your pricing and be on the high side of pricing continuum. However, if you charge the highest price you think your clientele will pay, expect your customers to be more critical of food quality and service. In addition, you better be on the leading edge of new menu items, decor, service and food quality; your customers are paying for it. The aspect of product presentation proclaims, "Sell the sizzle, not the steak." Product presentation is very important in forming the value perception of the customer. A beautiful plate presentation, custom-designed china and glassware can really enhance the appearance of the food and drink served and a higher price can sometimes be charged. These are just a few of the "subjective"

factors that need to be considered in the pricing decision.

One thing to always keep in the back of your mind is that no restaurant will be able to sustain demand-driven pricing over the long run. Competition will eventually add your special items to its menus, or match your concept. If you are able to pack your house with a unique concept and menu, and charge a fortune for items, it will only be a matter of time before a competitor shows up to tap into your market. When you are the higher-priced restaurant, you need to constantly scan the horizon for competitors.

Also, keep in mind that you need to create parity between your pricing and your desired customer base. If your restaurant is near business offices and luxury condominiums, and the inhabitants of those buildings are your target customers, your prices can — and should — be higher than if you were in a suburban area and your customer base was middle-income families, for example.

The take-home message: You need to keep your eyes wide open, and be aware of your market and how it is changing. It is very difficult to recover from gross errors in pricing judgment. You cannot radically increase your pricing without chasing away customers. If you develop a reputation as being overpriced, that will be as hard to eradicate as a bad tattoo.

Psyche Out Your Customers

Psychological aspects of menu pricing reflect the attitudes and images in the minds of the customer. There are several psychological aspects of menu pricing: odd-cents pricing, mental accounting, reference pricing, and time-and-place factors.

Odd-cents pricing is a technique used in retail pricing of everything from clothing to cars and real estate. Prices are stated in amounts that end in a number nine or five. Psychologically, it will be seen as a lower price than if the price ended in a zero. For example, $9.95 is preferred to $10. Psychologically, it is rounded to $9 rather than $10. The element of low-price perception is an important pricing strategy. I recommend that you set your menu prices with digits ending in .25, .50, .75, and .95 or .29, .59, .79 and .99. When incremental increases move the item to the next highest price, e.g., $8.25 to $8.50, it is rarely detected by the customer. It's a way to gain pennies without losing customers.

Another psychological aspect of pricing is related to the customer's process of "mental accounting" when making a purchase. Customers will sort food purchases into budget categories of groceries, entertainment, or social expenditures. Each budget category is controlled to some degree by a spending restraint. Consequently, the amount spent on a meal purchased away from home will vary depending on whether the expenditure is debited to the grocery or entertainment expense categories.

Generally speaking, there is freer spending if the entertainment or social account is being debited. For example, eating out during the week instead of cooking at home takes money from the grocery budget, not the entertainment budget. The expenditure is influenced by price and convenience. They will spend considerably less than if they dined out on the weekend for social and recreational reasons. With this knowledge, we can more effectively price your menu items.

As operators, we must determine how the customers categorize our restaurants (e.g., eat-out or dine-out). For example, a meal at a fast-food restaurant is likely to be considered as a food or grocery expenditure. Subsequently, if your restaurant wanted to attract this customer during the week, nightly specials would need to be offered and priced accordingly. (Have you noticed that most fine-dining discounts are not honored on Friday's and Saturday's?)

If we follow the logic of the mental accounting theory, we can approach the pricing decision from the consumer's perspective. The objective would be to have the expenditure classified into a higher budget category or combined with two or more categories. The budget category can change depending on the occasion, e.g., birthday or anniversary, and the day of the week. Such considerations may prompt promotions such as early bird specials and discount coupons to entice weeknight customers on grocery budgets to eat out instead of home.

Most customers do some kind of price comparison when they shop for shoes and clothing. It is not surprising that they do the same when eating at restaurants. When a competitor opens in our market we will check them out by comparing their prices with ours. Customers do the same thing. If the prices of the new restaurant are lower than those in our "reference" restaurant, we perceive a good price-value. However, if they are higher than the reference price, the price-value is diminished. The more one pays, the more critical they will be of the food and service provided. If you charge at the high end of the market for comparable food and service, expect customers to be more critical of even the little things.

The last psychological aspect of menu pricing has to do with where and when you make your purchase. It is called time and place. I think it is best explained in the context of your price tolerance for a hamburger and a Coke® at a sports stadium versus the price you would pay at your neighborhood restaurant. Another example is your price tolerance when on vacation versus eating out on a weeknight at home. Restaurants that cater to a tourist market should bear this in mind. Folks on vacation expect to pay a little extra for food.

Such knowledge is needed to effectively determine which items to offer and how they should be priced to appeal to your customers.

Some Questions to Consider When Pricing Your Startup Menu

The following is a checklist of questions you should consider when pricing a menu item. Your answer will influence whether you are pricing toward the high or low end of the pricing continuum.

Many of the questions are subjective rather than objective but just the same, will affect the price you can charge on your menu. Customers will come in with "reference" prices that they expect to pay for certain items and will not think twice about paying $1.50 for a glass of iced tea that has a cost of about a nickel, and complain if they feel that the price you are charging for chicken tenders or a

hamburger is perceived as too high. If the item is on your appetizer menu, you might have more pricing latitude than if the same item is served as an entrée. For example, consider a shrimp cocktail with six shrimp for $5.95. Would you purchase the same dish as an entrée for the same amount?

Each menu item will be marked up individually and produce a range of food cost percentage from single digits to the high 40s. Remember, it is the sales mix of all the menu items that produces the food cost that shows up on your monthly income statement.

- ✓ What kind of menu item is it? (e.g., appetizer, entrée, dessert, side dish)
- ✓ What is the direct labor involved in its preparation? Does it require skilled preparation or just simple heating and plating?
- ✓ What is the portion size?
- ✓ Is it a seasonal item with limited availability?
- ✓ What are competitors charging for similar menu items?
- ✓ Is it is "commodity" or a "specialty" item on your menu?
- ✓ What is the desired food cost percentage?
- ✓ Is it a demand-driven or market-driven menu item?
- ✓ What kind of restaurant are you? (e.g., fast-food, fast-casual, limited-service, fine-dining)
- ✓ What meal period are we pricing it for? (e.g., breakfast, lunch, dinner)
- ✓ Where is the restaurant? (e.g., center city, suburban, office building, resort area)
- ✓ What are the accompaniments served with it?
- ✓ Who is your target market or clientele? (e.g., local residents, tourists, business people, shoppers)
- ✓ What is the perish ability of the product and its cost? (e.g., live lobster, fresh seafood)
- ✓ What is the service delivery method in the restaurant? (e.g., table service, self-service, drive-thru)
- ✓ What is the check average you seek?
- ✓ What are the prices of other menu items in the same menu category and the spread among items in other categories?
- ✓ What are the prices of complimentary and competing items of the menu?
- ✓ What is the ambience of the restaurant?
- ✓ What is the plate presentation for the menu item?
- ✓ Is there live entertainment or music in the restaurant?
- ✓ What is the status of the restaurant in the market? Is it one of the top restaurants in the market?

Clearly, your customer does not weigh each of these individual factors when sitting down at your table to order. But he does consider them intuitively. Remember that Americans are expert consumers. They know a deal when they find it. Pay attention to the psychology of your customers when selecting menu prices and you will increase your chances of being on the money. **RS&G**

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