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Ideas for Leaders #402

How Crowdfunding Affects Product and Pricing Decisions



Key Concept

Seeking investors through crowdfunding sites such as Kickstarter requires entrepreneurs to rethink their pricing and product line strategies, taking into account the mix of investor/buyers who will attach different levels of value to the new product or service.

Idea Summary

Through crowdfunding, investors choose to participate in new projects by becoming 'pre-buyers'. The term 'pre-buyer' is used because no money changes hands until the venture has enough funds to start operations. If not enough money is raised in the allotted time, the venture fails.

The investment occurs sequentially, so that new pre-buyers can see the prices that previous pre-buyers paid for the goods sold; they are also aware of the total amount that has been raised.

A simple example can illustrate the different ways that the crowdfunding dynamic impacts pricing and product line strategies.

Imagine a venture that offers two periods, representing the sequential nature of crowdfunding, in which to invest in its product or service. (We'll assume there is just one product available.) A pre-buyer makes a decision to invest in the venture in the first period. After the first period expires, a second period begins and a second pre-buyer invests in the venture.

With the *volume* strategy, in which prices are set low in both periods (but high enough so that the sum of the two buyer contributions covers the cost of the project), the low cost ensures that both pre-buyers will participate and the venture thus raises enough to move forward.

However, if the two pre-buyers are high valuation buyers — for example, they are both excited about the new technology in the product — the optimal pricing

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strategy to follow is the *margin* strategy, in which prices are set high in both periods. There is less of a chance of success, since high payers are required, but the margin is high, making the venture more profitable if it moves forward.

These are extreme cases. Often, buyers will be heterogeneous — with different levels of valuations — which calls for discriminatory rather than uniform pricing. One approach is a *dynamic* pricing strategy, in which the prices change between periods (from low to high, or vice-versa). Another approach is the menu strategy, which calls for both high and low prices for the same product to be offered in both periods.

The menu strategy seems fanciful: why would someone pay a higher price if a lower price is available? The answer lies in the crowdfunding mechanism. Remember that if enough money is not raised, the product or service is not produced. Therefore, someone very interested in the product might be willing to 'subsidize' lower valuation buyers by opting for the higher price.

Crowdfunding can have a similar non-intuitive impact on product choices, notably whether to offer one product or several products of different quality. For example, the qualitative gap between higher and lower priced products on a crowdfunding site does not have to be as large as in traditional retail: the high valuation buyer will still opt for the higher priced product in order to ensure the venture's success.

Because the success of a project is a factor, pre-buyers involved in crowdfunding have linked goals and strategies that are not present in a traditional purchase situation. For example, a high valuation pre-buyer may choose the higher-priced product, as described above, if he believes that most of the pre-buyers that follow are likely to be low-valuation buyers (thus putting the venture at risk).

Business Application

Choosing the most optimal pricing and product strategy for crowdfunding among the four alternatives depends on market characteristics, specifically the distribution of pre-buyers' product valuations.

A menu of pricing and product options might be the most optimal strategy when the market consists of a low or moderate fraction of high-type pre-buyers and a moderate level of valuation heterogeneity (moderate high-to-low ratio). As the fraction of high-type pre-buyers and the heterogeneity of the valuation increases, a dynamic then a margin strategy becomes more optimal; decreasing fractions of high valuation buyers and heterogeneity leads to a volume strategy. Remember that product options don't have to have a wide gap of quality between the higher and lower price range.

However, the particular dynamics of crowdfunding are lost as the entrepreneur moves to large-scale production and retailing; thus, even when overall market strategies stay the same, product line

strategies should evolve. (For example, the gaps between product quality should increase.)

Belief about the valuations of future pre-buyers impacts pre-buyer decisions in the earlier periods. Therefore, entrepreneurs must be careful about any marketing activities that change the mix of pre-buyers. If early pre-buyers believe that high-valuation buyers are on their way, they may 'free-ride': opting for lower-priced alternatives and expecting the later buyers to ensure the success of the project.

Further Reading


[Product and Pricing Decisions in Crowdfunding. Ming Hu, Xi Li & Mengze Shi. *Rotman School of Management Working Paper No. 2405552* \(March 2014\).](#)

Further Relevant Resources

[Ming Hu's profile at University of Toronto Rotman School of Management](#)

[Mengze Shi's profile at University of Toronto Rotman School of Management](#)

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