



WHAT IS STRATEGIC PRICING?

By John Hogan and Thomas Nagle

STRATEGIC PRICING GROUP
A MEMBER OF MONITOR GROUP

Although companies invest considerable time and capital to improve pricing performance, transitioning from tactical to strategic pricing in markets characterized by global competition, sophisticated procurement groups, and shortened product lifecycles is difficult, to say the least. That difficulty is magnified because most companies have an incomplete understanding of the interlocking components of pricing strategy and how they must work in concert to achieve sustainable results. When managers in these companies formulate pricing strategies, too often the unfortunate outcome is a patchwork of ad hoc tactical decisions masquerading as strategy.

The impetus to change a company's approach to pricing often starts with customer push-back about prices. When customers complain about high prices it is possible that the price is, in fact, too high relative to the competition. It is also possible, however, that the problem is not with the price but with other elements of the pricing strategy. For example, a new customer unfamiliar with the differential value of a product might, quite naturally, think the price is too high. In this instance, however, the appropriate action is not to drop price, but to educate the consumer on the value created by unique features of the

product in order to justify a higher price. A company can experience price resistance

from customers for many reasons. In most cases, however, the price alone is seldom the only cause of problem, and is often not the real cause at all. More often, it is the symptom signaling a problem with other elements of the pricing strategy. Just as a doctor is trained to look beyond a patient's symptoms to diagnose the underlying disease, companies must look beyond the pricing symptoms to diagnose flaws in their broader pricing strategy. Failing to diagnose the true cause of the pricing problem and treating only the symptom (i.e., cutting prices) can do long-term damage to profitability.

A comprehensive pricing strategy is comprised of multiple layers creating a foundation for price setting that minimizes erosion and maximizes profits over time. These layers combine to form what we call the strategic pricing pyramid. In keeping with the value-based perspective, value creation forms the foundation of the pyramid. A deep understanding of how products and services create value for customers is the key input to the development of a price structure that determines how offerings will be priced. Once the price structure is determined, marketing can develop messaging and tools to communicate value to customers. The

final step before setting the price is to ensure that the pricing processes in the company are able to maintain the integrity of the price structure in the face of aggressive customers and competitors.

The Strategic Pricing Pyramid



Value Creation

Product managers face an interesting challenge when it comes to pricing. They are expected to set prices that capture the value offered by their products and that also maximize profits. What makes the challenge interesting is that very few companies actually understand how much value their products create for customers. Typically, the product manager turns to Marketing to provide insight into customer value. Marketing then conducts research into customer needs, importance weights for features, and overall satisfaction with the product. But how does one put a price on importance or satisfaction? Does the fact that your product scores 10% higher on satisfaction than the competitor's product mean that customers will be willing to pay a 10% higher price? Generally, the answer is no.

Recognizing the limitations of conventional research techniques, some product managers turn to more sophisticated approaches such as choice modeling and conjoint studies. When used properly, these techniques provide estimates of a customer's willingness to pay for a feature or product. But does knowing willingness-to-pay lead to

better prices? Once again, the answer is generally no. Willingness-to-pay can be an important input to the pricing setting process as long as customers understand how much value they derive from your product relative to the competitor's product and believe that your pricing policies require them to pay for the value they receive. The lack of understanding about the value is even more prevalent for new products with unfamiliar features and functionality. Reliance on conjoint techniques in these instances results in low prices that leave money on the table for many customers.

How then, can a company measure the value created by its product? Estimating the value created by a product requires intimate knowledge of the customer's needs. This deep understanding of needs can then be used to translate a product's features into customer benefits which are then translated into a value estimate. In business markets, the value estimate centers on the economic impact a product or service has on the customer's costs and revenues.

Consider, for example, the introduction of the Intel Pentium chip. One of the differentiating features of the Pentium chip was a built in math co-processor that enabled computer manufacturers to eliminate other chips on the circuit board and thereby reduce manufacturing costs relative to competing chips by Advanced Micro Devices (AMD). For a time, this differentiated feature enabled Intel to charge a significant premium for the Pentium. But AMD had invested heavily in its development program and soon matched the Pentium technology eliminating Intel's pricing advantage. Recognizing that AMD could quickly match future technological advances made by Intel, management turned their attention from features that drove customer costs and were easy to copy to features that drove customer revenues and were harder to copy. Intel management recognized that their brand was well known and respected by many of the computer manufacturer's own customers. Their research showed that end-customers were

more likely to purchase a computer when they knew that the processor was made by Intel. In addition, customers were willing to pay more for a computer with an Intel chip. Once Intel understood how much its brand was worth to computer makers, it launched the “Intel Inside” campaign in order to command a price premium for its chips. To this day, every Dell computer with an Intel processor carries a sticker telling end users that they have an Intel inside.

The Intel example illustrates that understanding how a product delivers value to customers creates a foundation for more profitable prices. But understanding how value is created for a single customer provides an insufficient basis for pricing because the value derived from a product typically will vary from one customer segment to the next. Just as Marketers have advocated for the importance of segmentation to marketing success, we argue that price segmentation is critical to pricing success. By understanding how customer value varies across segments, companies can develop strategies to align price and value and thereby improve profits.

Let’s revisit the Intel example to illustrate this point. Intel can charge a premium for its chips to premium computer makers like Dell because most of Dell’s customers value the Intel brand. But what about makers whose business model involves serving price-sensitive customers that value basic functionality and are indifferent to the brand that delivers it. Understanding how the value of their product differs across the customer base enabled Intel to craft a pricing approach to serve both segments. In this case, the approach involved the creation of a “fighter” brand called Celeron in which was simply a Pentium chip with the math co-processor turned off. Celeron price levels are set at a discount to Pentium chips and enable Intel to compete for both segments.

Although understanding the different values your existing products provide customers is a critical input to a pricing strategy, the ultimate objective is to design for value in

the first place. Companies often design products to satisfy needs and create customer delight. And customers love to be delighted – as long as they don’t have to pay extra for the experience. When price is factored into the decision, however, many customers are willing to give up some delight in exchange for lower prices. The pricing challenge, therefore, is to understand what creates meaningful value for different customers in order to set prices that reflect the actual value received. Instead of creating products to satisfy customers, companies should create meaningful values that customers will pay for.

Price Structure

Once you understand how value is created for different customer segments, the next step to building a pricing strategy is to create a price structure that aligns price with the value delivered and that minimizes the cost-to-serve. A common mistake made by pricing managers is to assume their objective is to set a price for the product rather than the customer segment. As the Intel example illustrated, however, the same product can deliver different value depending on the customer. In these instances, setting one price for the product ensures that at least one group of customers will be getting the wrong price. If you price high for high-value customers, then you risk overpricing to low-value customers and reducing profits. Conversely, pricing low to serve low-value customers leaves money on the table at the high end and also reduces profits. Many companies try to solve this dilemma by setting prices for the “average” customer. But this approach also fails to address the problem because the price will still be too high for low-value customers while still leaving some money on the table for high value customers.

The solution to this dilemma is to create a price structure aligned with the value received instead of the products delivered. There are two techniques to create a price structure: price metrics and fences. Price metrics are simply the unit by which price is applied to the product or service. Barbers

serving primarily male clientele typically charge by the haircut – a metric that seems fair to customers and is profitable for the barber because each haircut takes approximately the same amount of time. But pricing by the haircut is less profitable in hair salons serving both men and women because women’s hair is often longer and takes more time to cut. Pricing by the haircut would mean that haircuts with longer hair would be less profitable than those for shorter hair. To address this issue, salons frequently augment the “per haircut” metric with an additional “per length” metric in which customers with longer hair pay a higher price.

An interesting aspect of this example is that the metric was changed to align price with cost-to-serve and not value. Strategic pricing requires using the price structure to drive profitability by capturing value created across segments as well getting paid for cost differences between segments. This last point is frequently overlooked by marketers with a strong customer orientation because they fail to appreciate how price can be used as an incentive to change customer behaviors in a way that reduces costs. Although it is unlikely that customers would adopt shorter hair styles simply to reduce the cost of a haircut, in many instances price can be used to shape customer behaviors. In business markets, for example, customers that have a pressing need for rush orders will gladly pay more for a guarantee of quick delivery. We frequently counsel companies to augment their “per unit” pricing metric with a “delivery time” metric that forces customers that value quick delivery to pay for it. Although this price structure ensures the company gets paid for value delivered, it also creates an incentive for customers that would prefer quick delivery but are not willing to pay for it to reduce their usage of a high cost service.

Fences are another way to create a price structure to align price with value and cost-to-serve. Every airline traveler is familiar with the price fences and their effect on the price paid. Why do airlines put policy

restrictions on discount tickets such as requiring a Saturday night stay and 14 day advance purchase requirements? The airlines recognize they are serving two segments that value an airline seat very differently. Business travelers require flexibility in their travel plans and may have to travel with very short notice to serve a customer or to address a pressing company issue. Leisure travelers that plan vacations months in advance do not value flexibility as highly and are willing to commit to their travel far in advance in exchange for better prices. By using the policy fences, the airlines have created a price structure that captures the value of travel flexibility from only those customers for whom it is important.

Price & Value Communication

The next step in pricing strategy requires communicating your prices based on the value created for different customers. Poor communication of value results in higher price sensitivity and more intense price negotiations. Customers might not understand the value of your product because they may be unaware of new features, lack knowledge about how use them, or not understand how a particular feature might satisfy an unmet need. It is the marketer’s responsibility to address these issues through effective price and value communications.

Consider the Ipod music player by Apple for example. The Ipod enables customers to purchase and consume music in entirely new ways. But some consumers thought the \$299 launch price was too high because they believed the investment in their existing CD collection would be lost in the new format even though the IPOD enabled them to upload their entire CD collection into memory. Others objected to the initial price because they didn’t understand that the Ipod would enable them to purchase individual songs they heard on the radio without having to buy an entire CD. The lack of knowledge about the value created by the Ipod lowered willingness-to-pay and slowed initial sales. Interestingly, Apple chose a two-prong approach to communicate the

value of the IPOD. Apple targeted its advertising to cultural trend leaders by featuring cutting edge songs and creative graphics in order to communicate to a broader audience that the IPOD was both functional and trendy. Apple then invested heavily in a public relations campaign to give the new technology credibility with less informed potential customers. The communications strategy worked brilliantly – over 10 million IPODS have been sold in the 3½ years since its introduction at a price far above that of traditional music players.

Value communications are equally important in business markets. Business purchases are driven largely by the economic value delivered by the product. Thus, sending a sales person into negotiate price with a business customer without the right value communication tools is like sending a football player into the game without pads and a helmet – he would be forced to give up a lot of ground or get hurt. The tools and messaging will vary depending on whether the value is more economic or psychological in nature. Value communications for products delivering primarily economic benefits will be delivered using tools ranging from basic selling sheets to web-based applications capable of customizing value estimates, designing offerings, and supporting negotiations depending on the complexity of the product. Value communications for products delivering primarily social-psychological benefits such as status, security, or pleasure will rely on other types of tools such as testimonials and pictorial illustrations. The challenge for marketers is to determine which approaches are most appropriate and develop the messaging and tools to help customers understand the value offered by their products.

Pricing Policy

Academic pricing research has increased the scientific and analytical quality of pricing strategy significantly over the last decade. But no amount of scientific research changes the fact that pricing involves the art of managing expectations of customers and

employees to incent more profitable behaviors. These expectations are set by the company's commitment to enforce its pricing policies in the face of aggressive customers. For example, a policy of never walking away from business sends a clear message to customers encouraging them to be extremely aggressive on price in order to test just how low you will go.

The financial impact of poor pricing policies can be tremendous. Consider the self-inflicted problem faced by Gillette in the late nineties. Senior management at Gillette was under pressure to generate revenue growth each quarter in order to sustain its lofty stock price. Not surprisingly, the management team tracked sales closely to ensure the company hit its revenue targets each quarter. If the sales forecasts indicated a shortfall in the final month of the quarter, management would offer "one-time" price discounts to any customer that would accept delivery before quarter end. This unstated policy of quarter-end discounts had a powerful effect on the expectations and behaviors of both customers and sales people. Customer's quickly learned not to purchase in the first half of the quarter because the expected "one-time" discounts never failed to materialize at the end of the quarter. Sales people learned not to work too hard to sell to customers during the first half because their efforts would not be rewarded. One sales person we know said he couldn't go into accounts and say there would be no more quarter-end discounts because they would just laugh him out of their office. Ultimately, management's lack of price discipline caught up with them and was a major contributor to the more than 50% decline in the stock price that occurred between 1999 and 2001.

Strategic pricing recognizes the link between formal and informal price policies and the expectations and behaviors they encourage with customers and employees. Unfortunately, many companies set prices in reaction to customer expectation instead of using price proactively to influence them. As the Gillette example demonstrates, the

consequences of mismanaging pricing policies can be significant.

Price Level

There can be only one objective for setting prices – to maximize profitability. The problem is that everyone in the firm has a different view on which price will achieve the goal. Sales believes that lower prices will be rewarded by higher close rates and more volume resulting in higher profits. Finance believes that rigorous enforcement of minimum contribution margins ensures price integrity leading to more profit. Marketing believes that price should be used selectively to sustain market share leading to higher long-term profits in exchange for short-term discounts. The critical questions for the pricing manager are “who is right” and “how do I get support for whatever price I set when no one can agree on a common perspective”?

One reason that companies find pricing challenging is because they lack a systematic process to translate diverse inputs such as customer value, costs, competitor prices, and broad strategic objectives into the right price. What is required is a decision model that leverages all relevant data while leaving room for managerial judgment about how the market might respond to price changes.

Such a model would enable different functional areas to debate the appropriate price while explicitly identifying the profit impact of each price move. We recently coached a maker of electronic test equipment through such a process for a new product it had recently launched at a low introductory price. The product team performed depth-interviews with a variety of customers and used the findings to estimate the value of the product to key segments. For each segment, the team evaluated 10 factors contributing to higher or lower price sensitivity to estimate how much of the value could be captured through a price increase. The price was adjusted downward in one segment in order to dissuade a competitor from entering the market.

Finally, financial analyses were performed to understand how much volume the company could afford to lose for various levels of a price increase. The analysis indicated that if the company increased price by 25% it could afford to lose nearly 30% of its volume and still improve profits.

A careful analysis of the customer base convinced the team that it would lose few, if any, of its relationship accounts at the higher price although it might lose some price-buyers. Despite the loss of price buyers, the team was convinced that it would lose no more than 10% of its total volume and increase profits by \$3 million in the first six months following implementation. The team gained an interesting insight into the nature of pricing when it presented their recommendation to the Division General Manager. Although he was convinced that the price change would increase profits as predicated, he was still reluctant to lose sales because of a sales oriented culture. Overcoming that reluctance is just one example that inherent challenge of transitioning to strategic pricing.

Summary

To say that pricing strategy is challenging would be an understatement. It requires analyzing data on costs, customers, and the competition and integrating that analysis into prices that lead to long-term profitability. Experience has taught us that achieving sustainable improvements to pricing performance requires adjustments to multiple elements of the strategic pricing pyramid. Companies operating with a narrow view of what constitutes a pricing strategy miss this crucial point leading to incomplete solutions and lower profits. Building a strategic pricing capability requires more than a common understanding of the elements of an effective strategy. It requires careful development of organizational structure, systems, individual skills, and ultimately culture. These things represent the foundation upon which the strategic pricing pyramid rests and must be developed in concert with the pricing strategy. But the first step toward strategic

pricing is to understand each level of the pyramid and how it supports those above it.



Tom Nagle and John Hogan are Group Leaders in the Cambridge office of Strategic Pricing Group, a member of Monitor Group. They can be reached at tom_nagle@monitor.com and john_hogan@monitor.com.

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