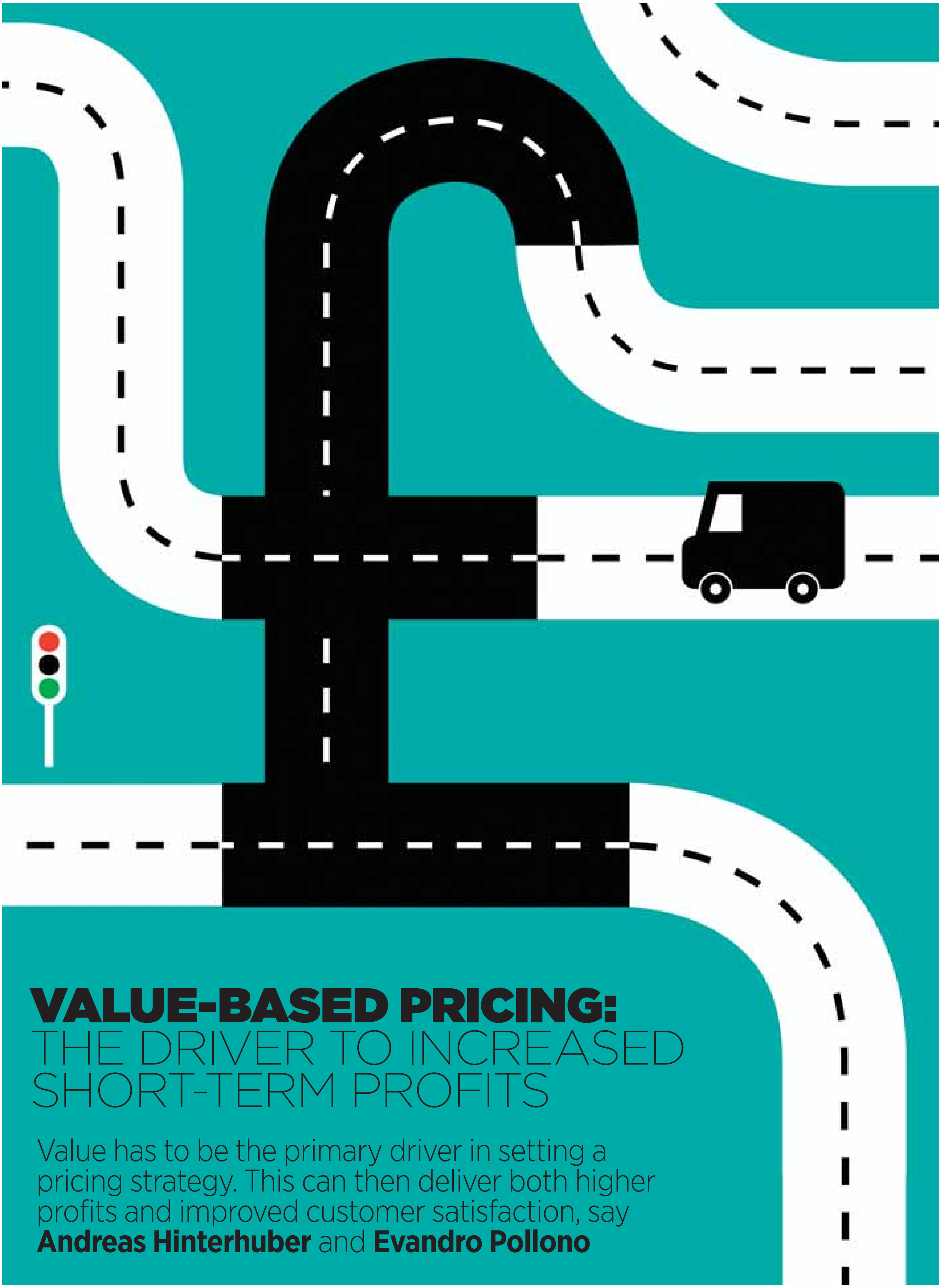


ROBERT HANSON / IKON

VALUE-BASED PRICING: THE DRIVER TO INCREASED SHORT-TERM PROFITS

Value has to be the primary driver in setting a pricing strategy. This can then deliver both higher profits and improved customer satisfaction, say **Andreas Hinterhuber** and **Evandro Pollono**

No business can afford to ignore the importance of pricing. Ensuring you are competitive as well as profitable is a central element of the FD role in any industry. For many FDs, though, pricing strategies are often left to out-of-date formulae and allowed to stagnate. Perhaps a new approach is needed.

PRICING – THE PROFIT DRIVER

Pricing has a dramatic but frequently underappreciated effect on profits. A study of a sample of Fortune 500 companies (see Figure A below) showed the impact of pricing exceeded the impact of other elements of the marketing mix on profitability (Hinterhuber, 2004). An increase in average selling prices of 5% increases EBIT by an average of 22%, while other activities, such as revenue growth or cost reduction tend to have a much smaller impact.

So why does pricing have a bigger impact on profitability than other tactical measures, such as growth or cost reductions? The answer lies in understanding and analysing customer value.

VALUE-BASED PRICING

Pricing is clearly a key profit driver; however most companies get it wrong. They base prices on costs or on competitor benchmarks. Of course both of these should influence the pricing decision, but they should never be top of the list. Conversely, only a minority of companies - between 15% and 20% - based their prices primarily on customer value (Hinterhuber, 2008). Substantial empirical research over the last few years has confirmed that value-based pricing is the only pricing approach that leads to higher profits (Liozu & Hinterhuber, 2013). By contrast, cost-based and competition-based pricing are likely to be detrimental to company profitability.

So what do we mean by 'customer value'? It is the willingness of the customer to pay and is the sum of the combined benefits that accrue to the customer as a result of purchasing a given offering. It can be calculated and quantified as "the price of the customer's best alternative - reference value - plus the value of whatever differentiates the offering from the alternative - differentiation value" (Nagle & Holden, 2002).

Value-based pricing is especially appropriate for highly differentiated products. But it would be a mistake to assume it is only appropriate for products with a clear competitive advantage, such as branded tablet PCs or life-saving pharmaceuticals. Value-based pricing should guide pricing decisions for apparent commodity products as well.

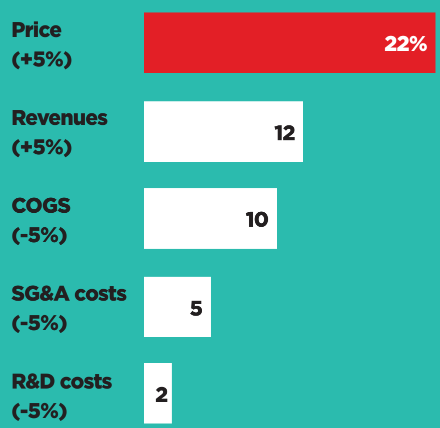
Consider a recent case study in the highly-competitive global chemical industry. Executives at this company assume themselves to be operating in a commodities industry, and are convinced that - in order to achieve meaningful sales - prices for the chemical in question need to be set at parity to price levels of the industry leader (indexed at 100 in Figure B). Workshops with executives and focus groups with core customers and distributors led to the discovery of a number of differentiating factors between the company's main competitor and its own offering.

While there was not a dramatic difference between the two products, we found a number of small but meaningful distinguishing characteristics between the two products. Using internal evaluation and field-value-in-use assessments, we tentatively quantified the additional customer value for these differentiating features.

We found small differences in logistical know-how, in product quality, in ordering costs and complexity, in vendor competence and in customer knowledge added up to a positive differentiation value of 8%, allowing the product price to be up to 8% higher than the customer's best alternative. The highest possible price is, of course, not necessarily the best price. But after applying a series of price optimisations, competitive simulations and estimates of customer reactions, we calculated the most profitable price point to be 5% above the best available alternative. The final price of 105 will - although higher than competitive prices by 5% - still be convenient for customers, since this price is below the maximum value of 108.

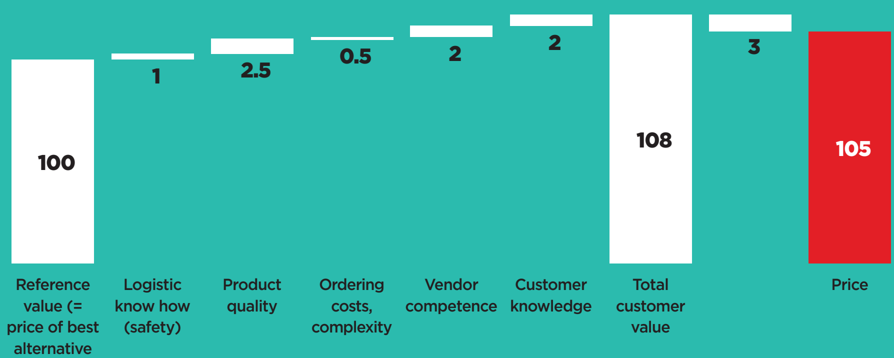
The main learnings of this short case study are also applicable to other B2B and B2C industry settings: (a) even so-called 'commodities' can and need to be differentiated; (b) the sum of many small

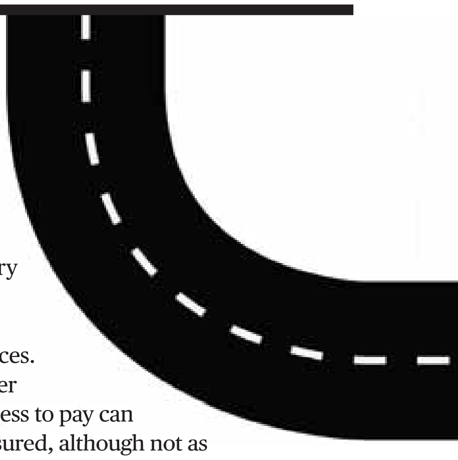
A) IMPACT OF PRICE, COSTS, REVENUES ON EBIT (% improvement of EBIT)



B) VALUE-BASED PRICING FOR B2B COMMODITIES

Key learnings: Even commodities can/need to be differentiated • sum of many small differences makes a big difference • price premium of 5% leads to dramatic differences in profitability • need to sustain price and premium





differences in product characteristics can add up to a significant difference in customer value; (c) even apparently small price premiums over competitive products (eg, 5%) translate into significant profitability differences between companies; (d) the price and value premium between two competitive offerings needs to be sustained over time.

STEPS TO IMPLEMENTATION

Clarity on goals

The first step in the successful implementation of value-based pricing is to define the objective of the company. As much as improving profitability seems a straightforward objective, different companies may pursue different objectives during different stages of their own life cycle. Growth in absolute revenues (as opposed to growth in profits) is frequently an important goal – especially for products with network externalities. Finally, the growth for ancillary products (eg, razors versus blades) may be the main consideration behind the overall pricing strategy in case of interdependencies between products. The mutually incompatible goals of profit maximisation, revenue maximisation, and the maximisation of sales of ancillary products do require substantially different pricing strategies.

Know your customer

Customers have a subjective measure when deciding to buy or not – value. The value a customer assigns to the product and which determines the price a company should charge can be assessed by asking a few questions:

a) What is the underlying need customers are willing to pay for? Answering this question allows a business to understand how customers are best served, what variables of the product or service make them chose you over competitors and ultimately allows the company to assign a monetary value to the variables that are important to customers. And of course, charging for them.

b) What of market segmentation and segment selection? What are commonalities and differences between market segments that affect customer willingness to pay? This question is probably the most crucial for companies willing to charge different prices for different segments, yet it is still relevant for those who have only one price. Theatres leverage the willingness of different customer segments and offer lower prices during weekdays and afternoons, in order to maximise the profit from a perishable offer.

c) How much more is the customer willing to pay? How can that threshold be increased? Some products can be easily customised and in this case, willingness to pay appears on a single-sale basis. For other products, customers self-select and companies must look at what makes their products unique against comparable competitors' products and then analyse the monetary value to such differences. Customer willingness to pay can be measured, although not as easily as companies analyse their costs. The most widely-used approach for measuring customer willingness to pay is conjoint analysis, which, if augmented with qualitative data – eg, focus groups, customer observations, ethnographic research – yields actionable results. We need to keep in mind that customers need change. The champions of value-based pricing routinely analyse how changes in customers need affect perceptions of value, and so the maximum willingness to pay. It is dangerous to base prices on factors that were relevant for customers in the past, but are not anymore.

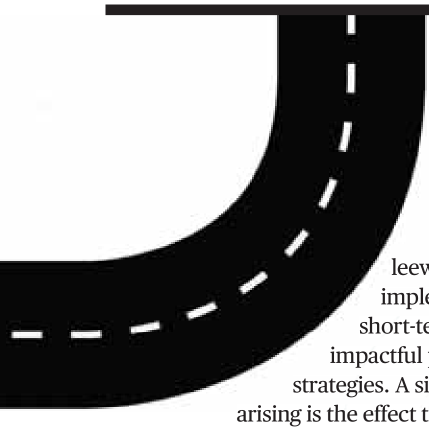
d) How do different price points affect the bottom line? Once data is gathered, a company must understand how these new price points will impact sales. The result can often be in terms of different prices for different segments and one must ask what is the likely economic value created based on the weight of each segment, which is useful data to take into account for the second and next key element of pricing decision.

Know your company

Each company is different and different cost structures will allow different degrees of

C) CONTRIBUTION MARGIN (%)

		10	20	30	40	50	60	70	80	90
		Required volume increase to maintain same level of profit								
Price decrease %	-30	-	-	-	300	150	100	75	60	50
	-25	-	-	500	167	100	71	56	45	38
	-20	-	-	200	100	67	50	40	33	29
	-15	-	300	100	60	43	33	27	23	20
	-10	-	100	50	33	25	20	17	14	13
	-5	100	33	20	14	11	9	8	7	6
		Affordable volume loss to maintain same level of profit								
Price increase %	5	-33	-20	-14	-11	-9	-8	-7	-6	-5
	10	-50	-33	-25	-20	-17	-14	-13	-11	-10
	15	-60	-43	-33	-27	-23	-20	-18	-16	-14
	20	-67	-50	-40	-33	-29	-25	-22	-20	-18
	25	-71	-56	-45	-38	-33	-29	-26	-24	-22
	30	-75	-60	-50	-43	-38	-33	-30	-27	-25



leeway for implementing short-term, impactful pricing strategies. A simple issue arising is the effect that an increase in price might have on demand. Since even small price changes have a substantial effect on profitability, we need a structured approach to understand how price and volume affect profits. A structured way to calculate this is through CVP (cost-volume profit) analysis. The following table provides an overview of the volume impact of price changes. It allows us to calculate the required volume increase to compensate for price reductions, and the maximum affordable volume loss associated with price increases, if the overall goal is to maintain profits.

For example, a product or service has a 30% contribution margin. A 10% price reduction – eg, a special one-off discount granted to a customer – requires an increase of 50% in sales to keep overall profits constant. The implied price elasticity of demand is unlikely in practice. Conversely, a 10% price increase for the same product maintains its profitability even if volumes decline by up to 14%. The implied price elasticity of demand for price increases is considerably lower. This table (see Figure C on page 23) visualises the substantial volume implications of price reductions and increases and allows pinpointing of opportunities for price increases, especially for those products providing substantial customer value.

Know your competition

Competitive analysis is an important aspect to take into account when deciding what strategy to implement. A thoughtful look at competition may show unexplored markets, or better segmentations by others, as well as unserved niches or needs that the firm can tackle. It can also be important to assess the effectiveness the strategy is going to have in the arena. Price wars often come from overlooking the power of pricing, such as when companies with new superior products charge the market average without considering the value they create; this forces competition to respond fiercely.

In other situations, and against common sense, companies may charge a premium to gain market share by eliciting exclusiveness and high quality in the mind of customers, as well as distinguishing their offering from the competition. In some situations, the pricing strategy adopted by some players may influence and actually determine the competitive structure.

MAKING IT WORK

The final step on the road to successful pricing is to implement and follow up the pricing decision. It all comes down to setting price and leveraging the newly discovered value of the company's product or service.

The decision to change price in itself is not enough – a correct implementation is key. A few guidelines can ensure that the price orientation (the ability to set prices based on value), matches the price realisation (the ability to enforce the prices):

- Communicate value. The company will gain a better understanding of its own value proposition when it analyses the key attributes of its consumers. What emerges from that stage should be constantly communicated and the consumer reminded of the reasons why he or she chooses you over competitors. This is particularly true when the customers are big companies whose purchasing departments have to justify expenditures: they must be able to explain the "value they are getting" not "the money they are spending".
- Company effort. Having the support of all stakeholders in the company helps make better decisions. Also in a previous stage, technical developers and sales managers can provide useful, if not critical, insights on value since they are the ones dealing directly with the product and the customers.
- Pricing rules. Those responsible for the change must make sure there won't be deviations from list prices, unless specified and for given order sizes. For example, when dealing with a sales force paid on revenue rather than profitability, sales managers may be inclined to give discounts to close a deal.
- Negotiation and value communication. Companies that champion price realisation tend to have a sales force that knows why the price reflects the value the company is delivering, and is able to communicate this factor, escaping the downward spiral of negotiating price reductions.

In conclusion, pricing is one area where small changes can set a company apart from competition. Value-based pricing is a road that secures results in the short run; it also sets the direction for a path toward serving customers better, in light of the understanding of what value really means to them.

VALUE-BASED PRICING IS MORE THAN PERFORMANCE PRICING

We have to make one aspect clear. Performance pricing is an example of value-based pricing, not more: value-based pricing is more than performance pricing. Take the global advertising industry. In the old days, agency fees were based on man-hours, pricing was strictly cost-based. Today, an increasing number of clients and agencies alike are linking fees to performance, eg, incremental sales. It ensures that client and agency interests are aligned – prices reflects performance and agencies have every incentive to perform. But two considerations are important. First, it risks not rewarding agencies for performance improvements that are difficult to measure, such as change in preferences and attitudes towards a brand; furthermore, in this case performance pricing can lead to corrode agency efforts towards building short-term sales as opposed to investing in building long-term brand equity. Second: we need to stress that value-based pricing is indeed possible without performance pricing. After all, we do not pay for our car (or toaster for that matter) after the last mile (or loaf of bread), but we are all prepared to pay for superior safety, durability, status – ie, value. Value-based pricing means customers pay for higher expected performance, and not necessarily for higher actual performance.

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