

Profitable Pricing

By Richard Guha & Kevin Price

Within the world of Marketing, Pricing is probably the least understood and most misused component in the marketer's toolbox...yet, it arguably has the single greatest impact on a firm's profitability. Profitable Pricing, we contend, is achieved by first knowing "who wants what." Profitable Pricing does not mean you have to be expensive...rather, it simply recognizes that you make money and satisfy your customer better than your competition by pricing your product or service consistently with the values you deliver to your target customers. If your focus is on offering the lowest price alone, you can even end up actually *reducing* satisfaction among your customers.

We recently received an email from a very successful B2B marketer saying "as everybody knows," in B2B, the only proposition that counts is lowest price. In industries where the products or services being offered have been commoditized, this statement is likely true. For example, we see entire industries, such as the airline industry, seemingly dedicated to the proposition that if you lower the price far enough, you will eventually reach a point where your volume will compensate for the fact that you lose money on every seat! This commoditization is often the result of actions by the company or industry rather than happenstance. Effective pricing is not only a matter of determining price, but also understanding what actions can provide value which exceeds the cost of the actions. In some cases, the actions may even lower costs while adding value. This is often the case in supply chain improvements or manufacturing technology improvements.

However, in industries where product and/or service values have been made an important part of the offering, pricing can vary dramatically from one competitor to another...and, at the same time, all parties can be profitable businesses! Because regardless of whether your business is B2B or B2C, different customers *value* your company's offerings differently. As consumers, we might think about different brands of shampoo, for example, as being 'discount' or, at the other end of the spectrum, 'premium'. For a brand of shampoo to be justified in capturing a 'premium' price, it has to offer values above and beyond the 'discount' shampoo...otherwise, as a consumer, you're not going to pay that premium price. You may, for example, place a high value on a shampoo which results in shiny, full hair that brushes or combs easily. Or you may highly value a particular brand of shampoo because it's used in and purchased from salons. In other words, higher value typically means higher price, if pricing is set correctly. Your balding next-door neighbor, however, may have little use for a shampoo offering all these 'fancy' values and prefers to buy the 99¢ bottle on special this week. Or your balding neighbor may want a shampoo which invigorates the scalp and is willing to pay for it. Both you and your neighbor buy the shampoo which best fits your needs even though they offer widely varying values...and widely different price points. But you're both satisfied.

This example above illustrates the three primary success principles in achieving Profitable Pricing:

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1. Customers are different and have different needs...therefore,
2. Pricing needs to be aligned with values offered, and
3. Value is defined by the customer

Let's use a couple more examples to bring further life to these principles.

When Apple introduced the iPod, it was priced at \$499...nearly double its closest competitor. A number of industry pundits cried 'ridiculous...nobody is going to pay that much for a music player!' Of course, the rest is history. The key point these pundits did not recognize was that the iPod is not just a 'music player'. It is a storage device, a part of an integrated music management system (in conjunction with iTunes), an enabler of musical choice, a vehicle for musical portability and freedom..., and even an expression of coolness. With all these additional values offered, perhaps the iPod was, in retrospect, UNDER-priced! A perhaps surprisingly large number of consumers have had no problem paying for these values...and Apple's bottom line reflects the 3 principles above.

When you make a trip to the greeting card store to buy a card for a significant person in your life, what are you really buying? If it's only paper, plus a little ink, your price tolerance is probably around 12¢. But you're not just buying paper and ink...so you hand over your \$4.50 for that 'perfect' card. Reason: you're buying a personal expression, a heartfelt communication that makes you feel good knowing you've communicated words you couldn't have imagined yourself. You're buying happiness for another person. In short, you're buying much more than paper and ink. If the greeting card maker had priced their cards at 12¢, that price wouldn't capture all the value the greeting card delivers. And your greeting cards business likely would not be very profitable.

The diagram from A.C. Nielsen on the right provides a basic illustration of the conflicting pressures on pricing. However, we need to go a step further to explore the options available to us in addressing the optimization of price.



False Assumptions of Pricing

There are a handful of commonly held beliefs and actions which explain the why and how of the vast majority of pricing decisions made today.

- "Cost-plus" is the simplest and fairest pricing method.
- Purchasers buy mainly on price.

- Purchasers know how products or services should be priced.
- Price and Cost of Ownership are essentially the same.
- Low price is always in the best interest of the customer.

None of the above pricing philosophies and practices optimize the profitability of a business. Let's examine each of these false assumptions.

Cost-plus Pricing

Cost-plus pricing likely is the easiest, simplest, and most common way to decide pricing. But it is nowhere near the fairest for either the buyer or the business,

Interestingly, around 60% of US businesses use cost plus pricing to some extent, according to a recent Wall Street Journal article. The principal reason why is the prior belief that your product or service offering needs to be competitive with alternative suppliers, and that all suppliers provide essentially the same product and have the same costs. After all, the thinking goes, buyers have a preconceived notion of the price of products or services similar to yours ...therefore; the prior belief is that you need to price within the range acceptable to the market.

For a very few products or services, cost-plus pricing may be the only apparent option. That's because many products and services are undifferentiated from their relevant competitive set. Many products and services do NOT visibly offer values above and beyond competitive products and services...therefore, the most logical pricing method is to price the way competitors do, which is most likely Cost-plus pricing.

The iPod, however, vividly demonstrates both the concept and the benefits of pricing consistent with values offered rather on a Cost-plus basis. Apple works very hard at building additional values into all the products it produces and markets...and the company prices its products accordingly. And, as one can see by observing their computer business, this approach does not appeal to everyone judging by Apple's less than 5% share of the computer market. Still, Apple is a highly profitable company...because they understand "who wants what." The 'who' in this case is a relatively small, select group of computer users who value what Apple has to offer and, as such, are willing to pay for those values. In the totally different, broader, commodity-like market of rice, Uncle Ben's is also priced in line with customer perceptions of value rather than cost of manufacture, yielding well over twice the profit margin for its owner than other rice brands.

As a service business example, if a consultant prices by the hour or the day, he or she has every incentive to maximize time spent, and slow down results. Conversely, the client has every incentive to reduce time demands even when they help accomplishment of the task (e.g. attending an internal meeting). McKinsey knows better. Like all the top consulting firms and practitioners, it charges by the assignment. The client gets a result which it knows up front is worth the money spent, and McKinsey has every incentive to be efficient, but without sacrificing effectiveness. We do not buy cars or aircraft or haircuts by time spent. The only fair way to price is on the basis of value to the customer. As a client once told us, "How can I value

someone highly, who does not value him or herself highly?” The problems with Cost-plus pricing in a service business:

- It sets up inherent conflict between supplier and customer – the customer has an incentive to reduce time spent by the supplier, while the supplier has an incentive to increase it.
- It inhibits development of new products or services which provide better value to the customer.
- It does not reward results, but simply effort.

Whether service or product, cost-plus pricing provides little incentive for companies to reduce their own costs, nor to seek ways to add value. Worse, Cost-plus pricing fails to financially capture the value many of your customers are willing to pay for.

Do purchasers buy on price?

In some ways yes, in some ways no. A customer that insists on buying solely on the basis of price is a customer only interested in the essential values you have to offer. In this situation, the ‘problem’ is not with the customer. The problem is with your product and service offering. If what you are offering is virtually indistinguishable from your competitors’ product or services offerings in terms of values, then the rational customer will seek out the lowest price, regardless of who offers it.

To illustrate further, with B2C products there are two fundamental levels of values the customer considers: (1) the product values offered by the manufacturer, and (2) the service values offered by the reseller.

Let’s say you are a manufacturer of backpacks. Further, let’s assume you have created an ultra-light backpack using competitively superior space-age materials in a design which enables the user to carry his or her desired articles with minimal stress to the back. This product, of course is NOT for everyone...in fact, the “who” is likely to be a small segment of the total population who are interested in backpacking (and maybe even a specific type of backpacking). But as a manufacturer of backpacks, let’s say you’ve done an excellent job of truly understanding and then providing the values desired by this customer segment (i.e., the “what”). In short, you are manufacturing a highly differentiated product with significant values desired by your target customers. And, as such, you can price this product, for your target customers, at a level commensurate with the values you are providing (regardless of their cost to you as a manufacturer).

Now let’s say your target customer has been made aware of your new backpacking product and wants to buy it. What does the rational customer do? They may search online for the lowest price! And the reason, of course, is that the reseller offers few or no additional values which differentiate their offering from competitive resellers. So while the product itself may have many competitively differentiating features important to a target customer group and, therefore, command a profitable price, the customer still may shop for the best price when alternative resellers offer no compelling supplemental values to the shopping experience.

If price were the largest purchase determinant for most people, Hyundai would be the automotive market leader. Few would buy a house solely on the basis of price and

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even fewer would select a heart surgeon based on price alone. Yet many sellers assume and act as though price is the key purchase decision factor. To be sure, for some customers and products or services, it is. But for most, it is not.

Purchasers Know how Products or Services Should Be Priced.

Sellers often assume that purchasers know as much as the seller does about price. While electronic markets have made price-shopping easier to do, most buyers do not really know what prices, or importantly, terms and discounts are available. When people are asked to write down the prices of items they buy often, consumer research shows that most have only a vague idea of actual prices. Assuming buyers know more than they do can result in pricing your product or service lower than necessary.

Some years ago, while carrying out an assignment for a major accounting firm, we interviewed the CFO of a company which had just switched to our client. He shared with us he had called the partner at our client to tell them that they had won the contract. But before he could tell him the good news, the partner started to cut price. So the CFO simply kept quiet while the partner in the accounting firm cut his own price by 20%! This accounting firm assumed the purchasing client knew more about pricing than he, in fact, did. Worse (and more tellingly), the accounting firm essentially undervalued the worth of their services to this client, resulting in significantly less profitable pricing than necessary.

By the same token, the fact of the matter is that purchasers often actually know MORE about pricing than the seller. And that's because each customer knows better than anyone else what they value most in a product or service. As such, each customer knows better than anyone else what they will pay. Therefore, it is up to the supplier of the product or service to first understand "who wants what" in order to profitably price products or services.

Pricing often needs to incorporate Cost of Ownership.

It is simplistic to assume that price is the same as cost of ownership. Yet, sellers often sell solely on price leading buyers to buy on price, without regard to cost of ownership.

Let's examine two cars, one with a price of \$ 30,000 and the other \$ 40,000. The more expensive car comes with free maintenance for four years while the less expensive car does not. Also, after four years, the more expensive car is known to hold its value better than the less expensive car, partly because with free maintenance, a buyer can be more confident of its condition. So, after four years, the \$40,000 car is now worth 50% of its new price (or \$20,000), whereas the \$30,000 car is worth only 30% of its new price (or \$9,000). As a result, the apparently more expensive car has cost its owner \$20,000 over four years, whereas the "cheaper" one has cost its owner \$21,000 (not to mention the costs of maintenance), even though

the manufacturer of the more expensive car sold it for a \$10,000 higher price. More importantly, the \$40,000 car is more profitable for its manufacturer as the added cost to the manufacturer of the 'free maintenance' program is less than \$2,500 over the four years.

Again, it is up to the supplier to first determine "who values what." In the real world example above, the pricing decision needs to incorporate cost of ownership into the pricing decision. To do so, the seller(s) need an accurate assessment of the value of the 'free maintenance program' among target customers before the pricing decision is made.

Lowest price may not be in the best interest of the customer.

At times, the lowest priced offering may well be sufficient. Our balding neighbor has no real need for the technology enabling delivery of thicker hair in that \$12.99 bottle of shampoo. For other customers, however, the lowest price offering may be dismissed altogether, simply because its lowest priced.

A monopsony is the inverse of monopoly. It is the situation where there is only one buyer, but several suppliers. Classical economics forecasts that existence of a profit maximizing monopsonist eventually leads to market failure. The classic instance is that of defense equipment, where the government is the only buyer, but several companies compete for business. In theory, if the government purchased only on price, it would always be rewarding the most efficient, unless the least efficient were prepared to price below cost. Eventually, however, the least efficient go out of business and the government is left with a monopoly supplier situation, which impacts not only price, but competition in technological innovation. For this reason a monopsony buyer has a power which is short-sighted to use without restraint. (Then we hear about the \$1,000 toilet seats the government is buying on the evening news.)

Most people think of electricity as a classic commodity...and for many, it is. Yet, it is possible to add value to electricity and charge a higher price. One example lies in "power quality." Electricity normally fluctuates slightly in terms of voltage and even cycles per second. This is kept within specs based on the needs of typical electric equipment of 50 years ago! Modern electronics, in particular the kinds of equipment used in data centers, require better power quality than this. Many large users have equipment to "condition" the power they buy to smooth out fluctuations. This results in asset spending and power losses. However, often the power company can do this more efficiently, charge enough to save the customer money and inconvenience, yet still make more profit.

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The Profitable Pricing Opportunity

Fortunately, buyers don't always buy on price alone...even the government. In fact, they rarely do. Buyers buy based on values provided. For some customers, this means the lowest priced product or service is the best option, particularly in low-value, undifferentiated categories. Other times and/or for other customers, the higher value/higher priced product or service is the best option.

Unfortunately, many businesses talk themselves into unprofitable price competition by using simplistic pricing methods and/or making pricing decisions based on simplistic philosophies.

Profitable Pricing is most dependent on first accurately identifying the product or service values desired by current and potential customers (i.e., knowing "who wants what"). Once these values and customer targets are well-defined and understood, products and/or services can be designed (or redesigned), value-appropriate distribution vehicles can be determined, and communications can be created which support the delivery of these values to the appropriate target customers. Easier said than done, we know. But it can and HAS been done. Max Brand Equity has much experience in addressing these issues. Call us to discuss how we can help you with this strategically and financially important issue of Profitable Pricing.

Richard Guha has worked in and with large and small businesses for over 30 years, building several \$ Billion of businesses and growing the market value of many by multiples of from 2-12 in a short period of time. With a Masters degree from Cambridge University, and a career starting in Marketing at Procter & Gamble, Richard went on to become a CMO and CEO in several Fortune 500 companies, as well as an advisor and Board member to a number of other Fortune 500 Corporations and start-ups. He works hands-on to maximize the value of businesses from a customer perspective.

Kevin Price has also helped numerous blue chip consumer product, information services, health care, and financial services companies achieve greater success in the marketplace. Kevin's background includes Marketing, Sales, and General Management experience at General Mills and Campbell Soup prior to entering the consulting field 20 years ago. Kevin has written and published a number of articles relating to his marketing, sales and strategy expertise and is frequently quoted in leading trade press and general publications such as Advertising Age, USA Today, The Wall Street Journal, and Fortune.

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