

Pricing approaches at industrial companies: cost-versus value-based pricing



By Stephan M. Liozu

*President and chief executive officer
Ardex America Inc.*



and Andreas Hinterhuber

*Partner
Hinterhuber & Partners
and visiting professor
Bocconi University*



Introduction

Despite its critical importance, revenue-generating power and growing competitive intensity, practitioners and marketing scholars agree pricing is a neglected area of industrial marketing. Of the three main approaches to pricing in industrial markets – cost-, competition- and value-based – the third is considered superior by most marketing scholars. Yet interestingly few industrial firms adopt customer value-based pricing. A meta-analysis of pricing-approach surveys from 1983 to 2006 reveals an average adoption rate of 17 percent. Cost- and competition-based approaches still play a dominant role in industrial pricing practice.

The pricing function at industrial firms has yet to become as widely established and able to substantiate its added value as other functions such as new product development, quality control, etc. To investigate its roles, responsibilities and competencies at industrial companies, we designed a qualitative inquiry based on semi-structured interviews with managers at small and medium-sized U.S. industrial firms. By probing these executives' "lived worlds," our hope was to understand pricing's place at the firms, discover pricing's processes and learn how firms organize for pricing. Our results reflect similarities and differences in the experiences of industrial firms' managers using the three pricing orientations. The results suggest strong contrasts among these firms and their leaders with respect to how they organize for pricing, manage the pricing process, manage the transition

to a more advanced pricing orientation and develop internal capabilities to face uncertain and ambiguous decisions.

Research design

Methodological approach

As we mentioned, the qualitative study used semi-structured interviews to develop a grounded theory about how organizational factors affect the adoption of a pricing orientation at industrial firms. We aimed to better understand how managers there make pricing decisions and what roles those people play in the firm's pricing process.

Sample

The sample consisted of 44 managers at 15 small and medium-sized U.S. industrial firms. Relying on the principal researcher's professional network and advice from the Professional Pricing Society, we identified almost 40 small and medium-sized U.S. firms in three industries: building materials, transportation products, and resins and plastics products. We contacted managers at each firm for initial qualification with respect to their pricing orientation. We then requested participation in the research project from selected firms using the three basic pricing orientations. Fifteen of the qualified companies agreed to participate.

Data collection

The primary method of data collection was semi-structured interviews conducted in a three-month period from April to June 2010. Thirty-seven were done in person

at respondents' place of employment, and seven were done by telephone. The interviews, which averaged longer than an hour, were digitally recorded and subsequently transcribed. We focused on managers' experiences in making pricing decisions and participating in a firm's pricing process. We asked open-ended questions to elicit rich, specific narratives and probed when needed to clarify and amplify responses. The overall goal was to get experience-based practitioner perspectives on the organizational factors that influence a firm's pricing orientation.

Data analysis

Consistent with a grounded theory approach, data analysis commenced simultaneously with data collection. The audio recordings of each interview were listened to several times, and the transcripts of each were read repeatedly. Three stages of rigorous coding then followed.

Findings

Finding No. 1: Pricing is an orphan at industrial firms using a cost or competition pricing orientation.

No dedicated pricing function existed at the 11 firms in our sample using a cost or competition pricing orientation. At these firms, pricing activities are highly fragmented, follow informal pricing review processes and focus only on margins versus prices (seven out of 11 firms). By contrast all firms using value-based pricing have dedicated pricing functions (involving three to 15 members), track specific pricing key performance indicators and conduct pricing reviews at regular intervals.

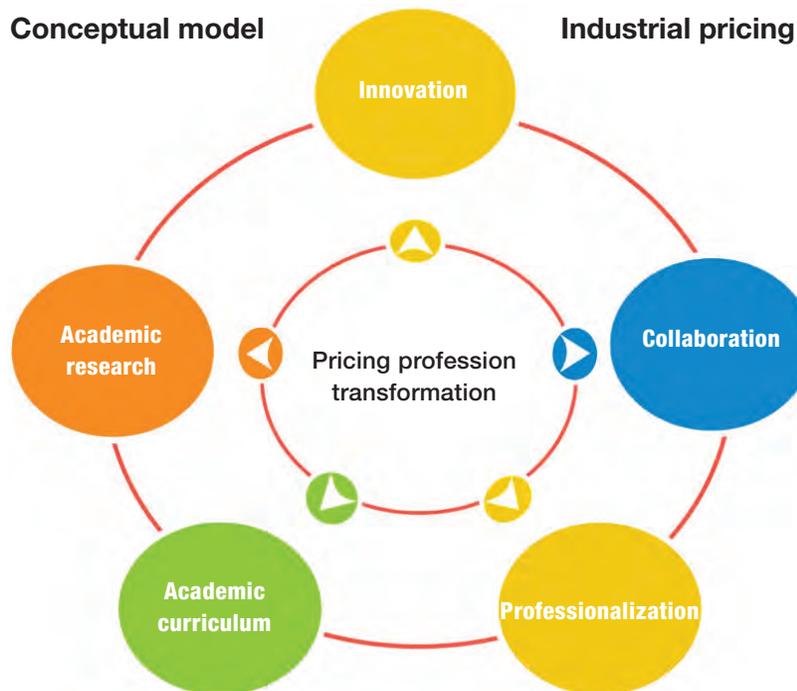
Finding No. 2: In the absence of a dedicated pricing function, prices are largely determined by costs and managed by the sales function.

At the 11 firms using cost- and competition-based pricing the locus of both tactical and strategic pricing responsibility was in the sales function. At all firms using value-based pricing the pricing function reports into the marketing organization. At these

of these units is to provide project-related support to managers who make business unit-specific pricing decisions. This phenomenon of specialized expertise is illustrated by the following interview excerpts:

Chief executive officer of a firm using value-based pricing: "We have dedicated (functional) managers. They don't do anything else. And then just (customer research), and this is observation of the customer. It's videotaping of the customer. It's understanding what are the unarticulated needs of the customer and of course also the articulated needs."

Business leader of a firm using value-based pricing: "In a development group ... there are three people like (name withheld) who are development managers. We've got hundreds of development people in the world. ... That's all they do. They don't sell a thing. ... So they're doing the advanced design, advanced development."



industrial firms, marketing is responsible for strategic pricing, resulting in greater integration of pricing programs in the overall marketing planning process.

Finding No. 3: Firms using value-based pricing design formalized processes and establish centralized or center-led pricing expertise.

All firms using value-based pricing created specialized units of highly skilled professionals supporting the pricing decision-making process. These units include a dedicated pricing team, senior pricing managers or a specialized market research team and value assessment or value-in-use engineering teams. The role

At these firms, pricing responsibility is centralized and the department provides pricing support to the entire organization. Our findings suggest a definition of centralization in which knowledge and capabilities are concentrated to create the concept of a pricing center of excellence. Five out of six sales and marketing respondents at firms using value-based pricing indicate this central pricing function acts as a strong resource to improve managerial pricing management. None of the six firms using cost-based pricing reports the existence of a centralized pricing function. Expertise in centralization is illustrated by the following quotes:

CEO of a firm using value-based pricing: "We have three full-time equivalents for voice-of-the-customer studies. We have that centrally. So whenever we develop a product for this market, we get them here and they set the whole system because it's a very formal thing."

Marketing manager of a firm using value-based pricing: "We tap into our corporate sales and marketing (team and) say, 'Hey, they've got professionals that know the terminology, the theory and the strategy associated with pricing in general.' And you do a little bit of negotiation role-playing and that sort of thing. So that's probably once a year or once every year and a half."

profitable and value-based enough to go regardless of what business or trade it is. It's all set up upfront in the system."

CEO of a firm using cost-based pricing: "More (of) the formality is around costing, and the stage gates are you either proceed or don't proceed based on costing (and) cost targets. We set a cost target based on the margin expectations. ... So we put more formality around costing analysis, and there's less formality around the pricing. ... It's funny how this works."

Finding No. 4: The focus level on specific pricing training programs varies greatly by pricing orientation.

All firms using value-based pricing in our sample emphasized the importance

that, you know, we should be doing."

Firms using value-based pricing also focus on developing internal capabilities in the areas of market research (four out of four firms), pricing research (three out of four) and proprietary tool progression (four out of four) to capture and quantify customer value that is more sophisticated than that described by firms using cost- and competition-based pricing. Top executives (four out of four) and sales and marketing personnel (four out of six) at firms using value-based pricing are among the respondents who reinforce the importance of proprietary tools to support the implementation of total-cost-of-ownership and value-in-use pricing methodologies.

Finding No. 5: Pricing is not perceived as a field that is subject to innovation.

When asked about a recent pricing innovation at their firms, respondents were surprised because they do not consider pricing to be a field that is subject to innovation. Managers at firms using cost- or competition-based pricing do not design or implement any pricing innovations at all. These companies' managers refer to basic pricing activities such as rebate approvals or naming a full-time cost analyst. Even within firms practicing value-based pricing, pricing innovations are rare. Some of these firms report the critical need to innovate because of the difficulty in sustainably implementing value-based pricing. Firms face greater complexity in their segmentation practices, distribution model or pricing data management, which triggers the necessity to make changes and innovate.

In sum this research shows that within industrial companies, in most cases the pricing function is static with few instances of companies self-reporting to engage in innovation of pricing practices, tactics or strategies.

Discussion

Our research uncovered stark

Despite its critical importance, revenue-generating power and growing competitive intensity, practitioners and marketing scholars agree pricing is a neglected area of industrial marketing.

All firms using value-based pricing report greater formalization of their pricing process as well as other related activities, as demonstrated by the first quote that follows. Respondents declare using stage-gate processes for product introduction, voice-of-the-customer management processes and automated price-deviation processes embedded in firms' enterprise resource planning systems. Three out of four of these firms implement formal pricing review processes and underline the need for strong pricing discipline to improve the pricing process's robustness.

Pricing manager of a firm using value-based pricing: "We have the prices structured in the system so what we call the profit desk underneath the pricing team can look to see whether or not the price points are too low or are at least

of training and designed specific formalized training programs for both existing and newly hired personnel. Only one of the six firms using cost-based pricing, however, has formalized training despite recognizing its importance. The following excerpts illustrate the contrast by pricing orientation:

CEO of a firm using value-based training: "Train, train, train, train. ... We are just making a contract with a training company in the U.S. ... to really teach them value selling, strategic selling and distribution management. ... That's a program for the next 18 months."

CEO of a firm using cost-based pricing: "You know, I don't think we're going to do formal training on it."

CEO of a firm using competition-based pricing: "No, we haven't done (training), and honestly that's probably something

differences in key organizational characteristics among firms with different pricing orientations. Our discussion will focus on two areas. First we will examine the state of the pricing dimension in the industrial marketing concept. Next we will discuss specific actions that might be required to increase the pricing function's effectiveness. Following this discussion, we will summarize our proposals for a road ahead for industrial pricing.

The pricing dimension's position in industrial marketing

Previous research from marketing practitioners and scholars reported that pricing was a neglected area of industrial marketing. Our findings confirm this phenomenon. At 11 of the 15 companies in our sample, the pricing function does not exist. At these firms, pricing activities are highly fragmented and pricing strategies are not clearly defined. Even more paradoxical is the fact that managers at 13 of 15 firms report a severe lack of pricing capabilities with the sales force. Yet 11 of 15 firms completely delegate tactical and strategic pricing activities to the sales function. These findings ring a warning bell to marketing academia and the pricing profession in general. We posit that there is a need for more professionalization and promotion of the pricing function in industrial markets. The pricing profession should tackle the perception that pricing is a complex function too often associated with finance and accounting.

The road ahead for industrial pricing

The transformation of the pricing profession at industrial firms requires the combined positive impact of the five elements described as follows:

More academic research: Our findings point to the need for more research on industrial pricing preferences and practices. First, the dimensions of the three pricing orientations (cost, competition and customer value) need to be articulated and empirically validated. Second, though the marketing literature

documents the relationship between market orientation and firm performance, there are no empirical studies on the relationship between pricing orientation and firm performance. Marketing scholars and practitioners claim the superiority of value-based pricing, but so far we lack empirical studies substantiating this. Empirically documenting the pricing function's return on investment leads to greater visibility of the function with top executives and makes it easier to justify critical investments in pricing capabilities, systems and methods. Recent research undertaken at The Pennsylvania State University's Institute for the Study of Business Markets and Georgia State University's Center for Business and Industrial Marketing is critical for the pricing profession to create knowledge, educate practitioners and bring documented, tested evidence of the positive impact on firm performance.

A systematic academic curriculum: Tomorrow's marketing leaders should be equipped with the most relevant, rigorous academic knowledge on pricing. It should become an integral, systematic part of the marketing curriculum. Currently only about 9 percent of business schools offer a course with a significant pricing emphasis.

Greater innovation levels in pricing: Our results show that industrial managers generate hardly any innovation with regard to pricing. Industrial pricing needs innovation, experimentation and specific training programs. Experimentation is an important requirement for the internalization of new pricing concepts, frames of reference, language and forms of interaction. Earlier academic research has shown that the transformation of pricing orientation demands that the organization realize through a process of experiential learning or trial-and-error experiments. Experimentation matters because it fuels the discovery and creation of knowledge, thereby leading to the development and improvement of products, processes, systems and organizations.

Collaboration between academia and practice: We posit that the profession requires a coordinated, collaborative profession-wide transformation process involving academia, practitioners, consultants and professional associations such as the Professional Pricing Society and Strategic Account Management Association. Dialogue and collaboration among these parties will lead to defining a research agenda and common goals for the profession.

Professionalizing the pricing function: Joel Podolny, former dean of the Yale School of Management, says, "An occupation earns the right to be a profession only when some ideals, such as being an impartial counsel, doing no harm or serving the greater good, are infused into the conduct of people in that occupation." Professionalizing the pricing function demands the establishment of an ethics code for the pricing community, the development of capability matrices and formal entry requirements for pricing professionals, pricing governance mechanisms and dedicated career paths for pricing professionals at companies and emphasis on continuous formal learning. Some of these activities are already under way. We feel that much remains to be done for pricing to become a true profession. 

Stephan M. Liozu will conduct a session about increasing profits through value-based pricing strategies at SAMAs 47th Annual Conference in May in Orlando, Fla. Liozu is president and chief executive officer of Ardex America Inc. (www.ardex.com/default.asp). Andreas Hinterhuber is a partner of Hinterhuber & Partners (www.hinterhuber.com) and visiting professor at Bocconi University (www.unibocconi.it). He can be reached at andreas@hinterhuber.org or +43 664 402 7 402.

Additional resources

For more information on this subject by these writers in SAMAs library, the editor recommends: Andreas Hinterhuber, "Pricing strategies for increasing profitability," Pan-European Conference, March 9, 2009, www.strategicaccounts.org; and Andreas Hinterhuber, "On-demand webinar: pricing strategies for increasing profitability—what every account manager needs to know," Feb. 24, 2009, www.strategicaccounts.org.