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THOUGHTS

Thoughts: premium pricing in B2C and B2B

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Abstract This paper focuses on the topic of premium pricing in B2C and B2B environments. It clarifies the differences between luxury and premium pricing and offers relevant examples of both. It also identifies five trends that impact premium pricing strategies and that can serve as avenues for further research. To practicing managers, this paper offers guidance on the critical trends affecting premium pricing in the future.

Keywords Pricing · Luxury products · Premium products · Value-based pricing · Value quantification

Introduction

In this paper we summarize current research and future directions for research on premium pricing. We define premium pricing as a pricing strategy that results in prices that are high in relation to both competitor price levels and customer value (see Fig. 1).

The defining element in our view is that both conditions need to be fulfilled: some companies set prices high relative to competitor price levels but low relative to customer value. For example, for a particular type of industrial bearing, SKF sets prices 50% higher than direct competitors (US $15 vs. $10) but captures only a relatively small share of customer value (17%, or $5 of $30 in incremental customer value; Hinterhuber and Snelgrove 2016). Other companies set prices low relative to competitor price levels but capture a high share of customer value. IKEA falls into this category: prices are low vis-à-vis key competitors but high relative to customer value: the overall quality and durability of IKEA products are arguably low. Other companies set prices low relative to both competitor prices and customer value: low-cost airlines are prominent examples. Premium pricing requires high prices relative to both competitor price levels and customer value: luxury product pricing in B2C and pharmaceutical new product pricing in B2B clearly fall into this domain. The pharmaceutical company Spark Therapeutics, for example, is launching its new gene therapy against a rare disease at a price of $850,000; in an interview, Mr. Marrazzo, the company's CEO, states that "the value of a therapy like this is in excess of $1 million" (quoted in Crow 2018, p. 1). Dubbed "the world's most expensive drug" (Crow 2018, p. 1), this product clearly carries a high price, relative to both competition and customer value. Premium pricing has its own, defining challenges. In this paper we outline some of these challenges, first for B2C and subsequently for B2B premium products.

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Premium pricing in B2C

Premium pricing in B2C is relevant for premium brands and luxury brands. We briefly contrast marketing principles for luxury brands with those for premium brands. Luxury brands are products that are not needed and that have, by definition, high prices: Bernard Arnault, CEO of LMVH, defines a luxury product as "a myth, an exquisite product, at an unreasonable price and constant innovation" (quoted in Walpole 2011, p. 13). Luxury brands require a marketing

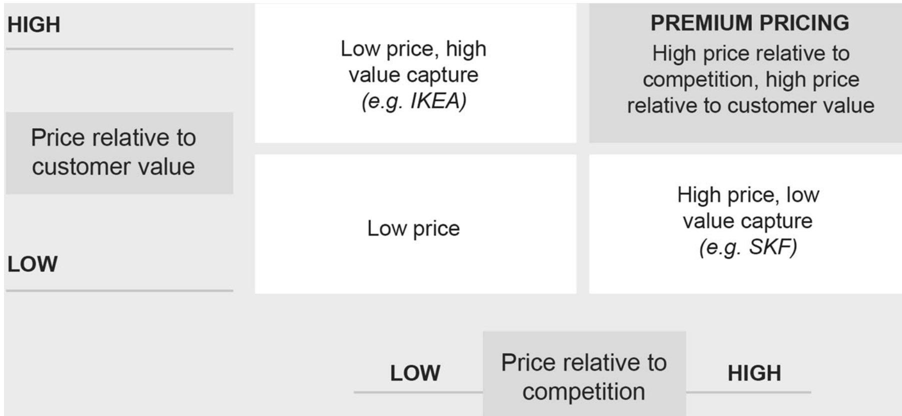

Fig. 1 A definition of premium pricing

approach that in many aspects is diametrically opposed to traditional marketing principles and thus to marketing principles that apply also to premium brands (Bastien and Kapferer 2013). Figure 2 provides an illustration.

For premium brands, market research plays a significant role, product quality is a key differentiator, price is a function of value, promotion aims to generate sales, distribution is broad and product supply exceeds demand. Luxury product marketing turns nearly all elements of traditional marketing on its head (Kapferer and Bastien 2009): products are frequently developed without market research, guided instead by artistic inspiration or technological leadership. Product quality is necessary, but "flaws give [luxury products] soul" (Bastien and Kapferer 2013). Imperfections are tolerated; experience is key. A high price is a source of value: prices frequently exceed (at least initially) customer willingness to pay. Demand increases as prices increase. The objective of promotion is not necessarily an increase in sales: branding is frequently targeted at non-consumers, highlighting product benefits to those who cannot afford them, thus elevating the status of consumers of luxury good products. Distribution is restricted—luxury products are frequently difficult to buy. Mike Flewitt (2013), CEO of McLaren Automotive, defines the company's products as "highly sought after, difficult to obtain". Finally, for luxury products, supply is artificially restricted to never exceed demand. Sergio Marchionne (2014), chairman of Ferrari, says: "The 7000 limitation is a willful and intended limitation. We have capped the number of cars to ensure we would not be losing the uniqueness and exclusivity of the brand."

Luxury product pricing differs from premium product pricing: luxury products are frequently priced above (at least initial) customer willingness to pay so as to engage customers with the product (Wathieu and Bertini 2007): high prices increase customer perceived value. The pricing

LEVERS	PREMIUM PRODUCT MARKETING	MARKETING OF LUXURY PRODUCTS
MARKET RESEARCH	Yes	No
PRODUCT	Quality	Flaws are ok; experience is key
PRICE	Value > Price	Price = Value
PROMOTION	Generate Sales	No sales
PLACE	Easy to buy	Difficult to buy
SUPPLY	Demand	Limit

Fig. 2 The marketing of premium products versus the marketing of luxury products

of premium products is a function of customer perceived value: value is the upper boundary of prices (Nagle et al. 2011; Liozu 2015). The pricing approach of TV manufacturer Loewe, once the market share leader in the premium category in Europe, illustrates this idea (Raithel 2008) (Fig. 3).

Loewe justifies its price premiums vis-à-vis competitors by clearly highlighting customer benefits of its competitive advantages. Loewe was highly successful, and its position as market share leader in premium TVs in both Germany and Europe was built on meaningful differentiation and on value-based pricing. Fortunes turned in 2013, when the company entered into self-administered bankruptcy proceedings. This does not undermine the principles of value-based pricing. It illustrates that value is always relative to the best available competitor and that value must be sustained over time by a differentiation that matters to a clearly defined customer segment. The competitive advantage of Loewe had eroded by 2013, and its price premium over competitors was significantly larger than the value of its differentiating features. A key challenge of premium product pricing is thus the constant quest to justify prices with value that is differentiated vis-à-vis competitors while being relevant to customers.

A key challenge of luxury goods pricing is the justification of high prices via innovation and exclusivity: exclusivity, of course, is at risk of being undermined once luxury products become successful and widely adopted.

Premium pricing in B2B

In B2B, pricing is all about value quantification, that is, documenting that the price is less than the quantified, customer-specific value (Hinterhuber 2017). B2B marketing executives are implementing value quantification and value-based pricing in many different B2B industries across the world (Liozu 2016). This shift is driven also by procurement: B2B purchasers increasingly demand a quantified value proposition or a business case from suppliers (Hinterhuber 2015a). There are no luxury products in B2B: this restricts the domain of premium pricing in B2B as defined herein. In industrial markets, premium pricing pervades the pharmaceutical industry: new products are frequently launched at significant price premiums to competitors as well as with a high price premium relative to customer value. Pharmaceutical pricing is complex: outcomes are uncertain, patients differ in their willingness to pay, and the value of one molecule varies substantially across indications.

Figure 4 illustrates that Novartis uses at least three different approaches to implementing value-based pricing for new pharmaceutical products (Keskinaslan 2011): prices are tied to either the number of patients or of treatments required (with discounts applied once a quota is reached), or to health benefits achieved (risk-sharing agreements where prices depend on health outcomes), or to patient-specific characteristics that reflect treatment benefits.

Pharmaceutical new product pricing is more nuanced than these examples suggest, but the point is that innovation in pricing can help identify premium pricing strategies and tactics that increase company profits and customer satisfaction conjointly (Hinterhuber and Liozu 2014).

A key challenge for premium pricing in B2B is value quantification and documentation (Liozu 2015; Hinterhuber 2017). The next frontier in B2B pricing is psychological: an understanding of psychology permits favorably influencing customer perceptions of value and price without actually lowering the price (Hinterhuber 2015b). Another emerging trend in pricing research and practice is

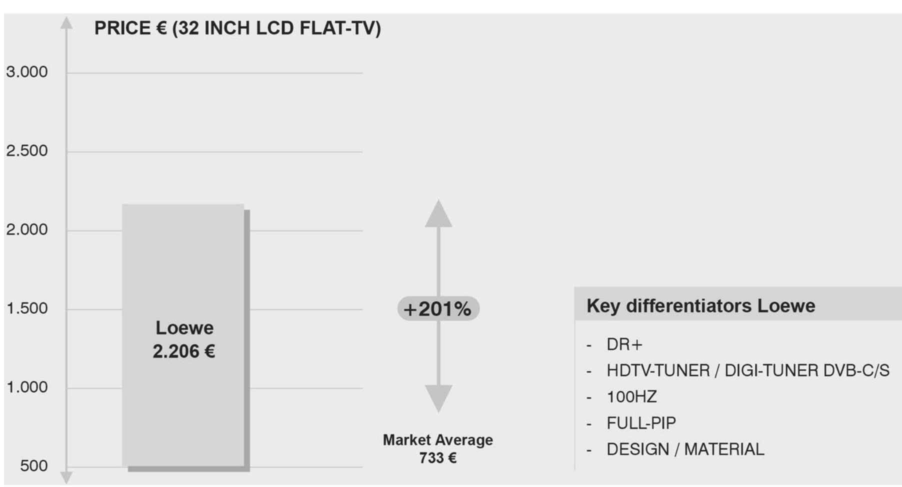

Fig. 3 Premium pricing in B2C: Loewe case study. Reproduced with permission from Raithel (2008)

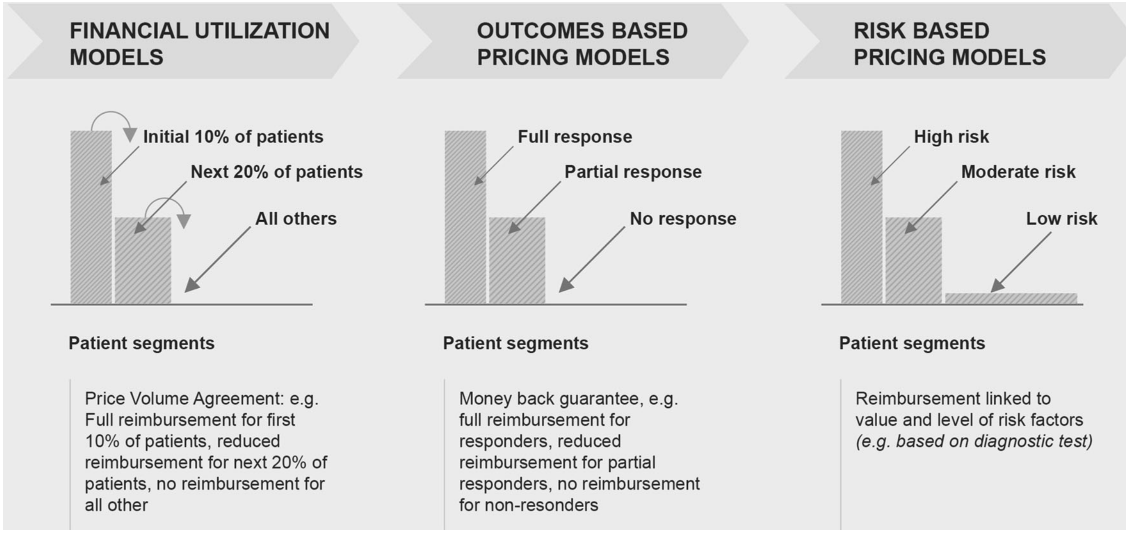

Fig. 4 Premium pricing in B2B: pharmaceutical product pricing case study. Reproduced with permission from Keskinaslan (2011)

the exploration of the micro-foundations of pricing: how individual psychological traits or individual activities influence pricing activities or performance at the organizational level (Hinterhuber and Liozu 2017). We expand on these and other future trends below.

Future of premium pricing

Whether in a context of B2B or B2C marketing, premium pricing is anchored in customer perceived value. Perceptions are of course based on competitive and relative positions of multiple vendors in customers' minds. Premium pricing is not immune to changes in the marketing and analytics worlds. The following trends will shape firms' ability to identify, quantify, and capture the price premium of their offering. We propose five:

1. *Justification of price premiums as a key requirement*: Competition for share of customer mind and share of wallet grows fiercer each year. This trend will not end. Given transient competitive advantage and increased competition, the management and justification of a price premium requires agility. As more and more firms switch to value-based pricing, price premiums will need to be justified based on quantified customer-specific value. This requires the development of sustainable value creation and pricing capabilities and the management of tangible and intangible value drivers. This justification is critically important in the pharmaceutical industry: premium pricing for exclusive, innovative, and in many cases life-saving products raises ethical questions: access for patients in low-income countries, access for patients that lack the ability to pay, and the general question to which extent it is permissible to capture an overwhelmingly large portion of value for a product that is a necessity, not a luxury. As of today, pharmaceutical companies have not fully answered these questions, but it appears that they will need to do so in the future to maintain or gain the goodwill of customers, regulators, and legislative authorities.
2. *Technology as enabler of premium pricing*: Following our first point, the role of technology will be essential for managing prices of premium products. Algorithms and software solutions permit automatically managing premiums through rules and mechanisms on e-commerce platforms, in stores, or in price catalogs. This allows for faster and more dynamic management of premiums. Some firms have also developed proprietary value-based pricing dynamic software to include a blend of cost, competition, and customer information to dynamically adapt pricing in their retail stores and online, borrowing from Amazon's dynamic pricing science.
3. *Development of integrated solutions and the management of intangibles to justify premiums:* more firms are adopting solution-centric business models and focusing on customer experience. Customer experience and other intangible value drivers are increasingly factored into price premium calculations as more firms move to value-based approaches. This trend has several implications. First, the use of pricing research is essential to include all relevant value drivers in the premium equations (e.g., conjoint, A/B testing). Second, elements of psychological pricing (e.g., compromise effect, "9" endings, decoy effect, anchoring, framing), once a near exclusive feature of B2C pricing, are now

increasingly adopted in B2B pricing (Hinterhuber 2015b). Third, customer experience dimensions must be measured and tracked for inclusion in value quantification exercises (e.g., net promoter score, customer satisfaction, customer loyalty). Finally, personality traits and individual capabilities related to pricing professionals might affect how pricing decisions are made.

4. *Value-based selling requires value-based pricing*: Price premiums are great on paper, but they are only captured with a strong and confident sales team. Sellers need to understand the rational justification for a calculated price premium before they can defend it. Convincing the sales team first and creating a strong belief in that justification can create the sense of collective confidence required in the B2B world. Storytelling about the price premium is also needed before any interaction with customers occurs.
5. *AI and machine decisions for premium pricing strategies*: Technology is changing the world of marketing and pricing. We expect price premiums in the future to be managed dynamically by data-based algorithms that will factor in all relevant variables. We posit that the future science of dynamic pricing will integrate all social media information, shopping history, willingness-to-pay data, and so forth. One can imagine the day when all data is collected by machines, and processed by machines, and when pricing is set autonomously by machines. Is the future of premium pricing autonomous pricing?

Conclusions

In an era of transient competitive advantage, increased competition, and emerging technology, the future of premium pricing is potentially challenging for today's pricing community. The combination of customer and competitive information requirements might make the difference between good premium pricers and great premium pricers. Some leaders are already emerging (Disney, Starbucks, Grainger, and others). Advanced B2C and B2B premium pricing strategies will be essential to the success of marketing strategies requiring constant justification of dynamic differentiation value. Firms cannot rely on the old way of doing premium pricing: "4% on top of my competitor's price." They will have to integrate the dimension of customer value as well. And that in a world where customers expect prices to change very quickly!

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