

POSITIONING AND PRICING

A simplistic approach to setting prices is a common strategic mistake. Pricing consultant **Andreas Hinterhuber** explores the ways a business can be sure when the price is right

Pricing decisions are not only made when bringing in new product lines. Even well-established products should have their prices reviewed to ensure that they align with the business. I have argued before that pricing has a dramatic, but frequently underappreciated, effect on profits (*Value-based pricing, F&M, May 2014*).

An increase in average selling prices of 5% raises earnings before interest and tax (EBIT) by an average of 22%, while other activities, such as revenue growth or cost reduction, tend to have a far smaller impact.

How does a business know if its prices are incorrect?

Pricing decisions are the result of a long chain of prior decisions, typically either horizontal chains - different departments within an organisation - or vertical ones - different hierarchical levels.

We cannot improve pricing just by changing prices. We have to work on the

chain of effects to grasp which decisions, structural configurations and other elements influence pricing effectiveness.

POSITION ON THE GRID

In a 2012 article, co-written with Stephen Liozu (*Is it time to rethink your pricing strategy?* in *MIT Sloan Management Review*), I highlighted the difference between 'price setting' and 'price getting'; I've combined these in our pricing capability grid (below).

Price setting refers to the different approaches companies use to determine selling prices: cost-based pricing, competition-based pricing or customer-value-based pricing. Price getting refers to varying abilities to get the price that's been set out in the first place.

Some businesses are very good at realising their list prices through factors such as value communication, customer value quantification or price controlling. Yet others are less expert in this area, and

prices erode as a result of poor negotiation, poor value communication and weak price realisation capabilities. Sales force incentives may play a role as well in placing products on the grid.

We use this framework to map where our clients stand today in terms of price setting and price getting. We then define a one- to two-year target of where the business should be in terms of price setting (price orientation) and price getting (price realisation). This typically leads to specific actions and projects in these two areas.

THE SHRINKING MIDDLE GROUND

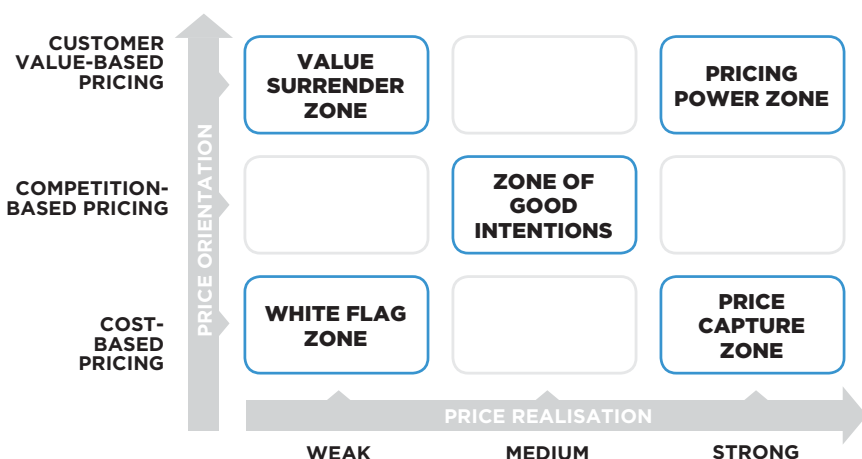
In many industries we see that those in the middle ground - companies that are neither the low-cost nor the most-differentiated suppliers - come under pressure from both ends of the grid. These companies are poorly positioned, and this directly reflects on their pricing strategy.

Take the car industry: Opel lost market share both to low-end Korean manufacturers and to high-end, premium ones. In retailing, a similar pattern is happening largely at the extreme ends of the markets, in the low-price bracket and the premium price segment.

The implications are straightforward: many apparent pricing problems are positioning problems. Companies need to understand their strengths and weaknesses as their customers see them. They need to understand how much value they create for their customers, as those customers see it - not how much value senior managers think their companies create for customers.

Only when management has clarity on a company's competitive advantages - and the monetary value of these advantages to customers - can we explore pricing.

This harks back to what we've previously said about pricing being the final move in a



A CHAIN OF DECISIONS

We have developed diagnostic pricing tools and checklists for businesses to analyse the '3 Cs': customers, competitors and the company itself. We map the processes that involve pricing decisions, typically the business-to-customer (B2C) sales process and the business-to-business (B2B) offer development process, and complement this in structured interviews with executives in marketing, sales and pricing, and with customers and distributors. We then analyse company documents on profitability by product, sales rep, region, customer and segment. This allows us to assist businesses to determine their best pricing strategy.

chain of decisions. For example, for a company such as Marks & Spencer, changing its pricing strategy would probably be ridiculous. Maybe the company does need to change its pricing, but it would also need to change a whole range of other elements in its customer-value proposition before taking this decision. It would probably involve product assortment, maybe store layout, selection, services and other options, such as loyalty cards. Only after the senior leadership team had established a compelling value proposition - including an understanding of customer willingness to pay - would the time be right to explore adjusting the pricing strategy.

THE DYNAMIC APPROACH

Many companies have pricing processes that are, counterintuitively, both too rigid and too flexible. Too rigid when they have a one-size-fits-all pricing strategy, and too flexible if, as often happens, the business offers too many price exceptions.

Take the case of how airline companies set ticket prices until about 30 years ago. They sold tickets in the way that many bus companies sell tickets today: one price for one destination. This, of course, fails to capture the value that different customer segments may place on a ticket. For some, value means evening return flights; for others it may mean flexibility, or service quality, or airmiles. This is an excellent example of dynamic pricing, where prices are set by customer willingness to pay and it is nearly universal in airline ticketing. Many other businesses have adopted dynamic pricing as their key pricing mechanism.

But pricing needs an element of rigidity as well: we need rules, guidelines and policies. Tom Nagle - a pioneer in pricing - defines pricing criteria as the requirements that customers or orders must meet to qualify for lower prices (see *The Strategy and Tactics of Pricing: A Guide to Profitable Decision Making* by Nagle & Holden). The key insight is this: sales managers will implement pricing policies, but they shouldn't have primary responsibility for defining these policies in the first place. In this respect, and in this respect only, pricing needs to become more rigid, especially in B2B companies where prices are generally negotiated.

TREADING NEW GROUND

We are also called in at the early stage when companies want to understand their strategic direction - including the key

issue of pricing for the future. In this case, articulate, analytical and independent thinkers can be quite helpful. Since we are not attached to a company's history and its politics, our only concern is the future; maybe that is an advantage.

NEW PRODUCT PRICING

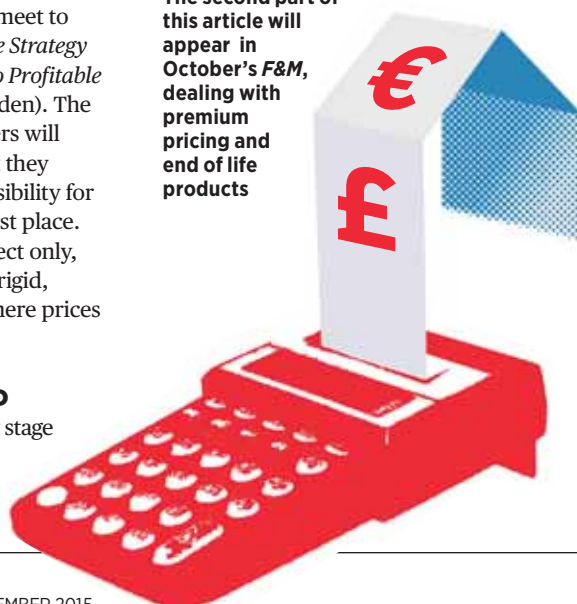
Many companies, both in B2B and B2C areas, struggle when setting prices for innovations, especially radical ones. The pricing of innovations is particularly challenging because there is no reference value for true breakthrough innovations, no benchmark against which to compare.

To establish a price for new products we have to unbundle: break down the innovation into the benefits delivered, and determine customer willingness to pay for each of these benefits. With this approach, summing up customer willingness to pay for the components and adjusting the sum for any interactions, if relevant, allows us to quantify customer willingness to pay for breakthrough innovations very accurately.

A global tobacco company wanted to launch a new product: the smokeless cigarette. This product contains nicotine, and therefore satisfies smokers' cravings, but it does not emit smoke and can be used wherever smoking restrictions would apply.

Using ethnographic research to see how this new product might fit into the lifestyles of customers, we showed that the most likely substitutes were energy drinks and coffee, which were consumed by potential customers when smoking was not an option and they felt in need of a boost. This insight - helped by more research, modelling and a few other steps - let us attach a precise price point to a product that can be considered a major innovation. ■

The second part of this article will appear in October's *F&M*, dealing with premium pricing and end of life products



THE MISSING MILLIONS - HOW MISTAKES TRICKLE DOWN

We recently completed a pricing project for a German B2B organisation with sales in excess of €5bn (£3.5bn). As part of our diagnosis, we mapped the key processes where pricing decisions were made.

This offer development process covered six elements: generation of customer insights; identification and evaluation of market opportunities; offer development; quotation; negotiation; and offer delivery. Our client had this process in place, but analysis showed that profitability was suffering as a result of poor design on nearly every aspect of this process.

Customer insights, for example, were not shared between sales managers and regions, so the sales force was seen as out of sync by some customer segments. Sales managers responded passively to requests for proposals, rather than actively developing new markets and cross-selling new products to existing customers. Sales managers used revenues and not gross margins to evaluate market opportunities, meaning the company's best technical talent was regularly assigned to large but unprofitable deals. The offer development reflected what salespeople imagined customers wanted instead of using insight to develop the value proposition: solutions were thus frequently over-engineered or unnecessarily quoted at rock-bottom prices. Quotations were done strictly on a cost-plus basis: the company had a pricing tool which, upon close inspection, was nothing but a revamped costing tool.

As a result, sales managers had neither the ability nor tools to include issues about customer value - how much customers would pay - into the price quotation. And there was no follow-up on quotations that were not won. There was no post-deal follow-up tool inviting sales managers to indicate the reasons why a tender was lost.

This win/loss analysis is a key part of improving pricing in competitive bidding situations, but it was absent. Negotiations were sometimes ineffective because sales managers did not know how to sell and price supplementary services to customers.

Our analysis identified several million euros in profit improvements. Delivery was the only element in the company's process that worked really well - it was the only area where we recommended no changes at this stage.



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