MAKE VALUE YOUR PRIORITY

Pricing in business models and the importance of customer perceived value in innovations were on last month's agenda. This time **Andreas Hinterhuber** takes these ideas further and considers how a shift to value-based pricing can provide the winning edge

I maintain that most industries should be looking to move away from traditional pricing mechanisms often based on cost. I recognise that in any industry there may be products or services where differentiation is not feasible, at least not in the short term, where the move from cost-based to value-based pricing would be impractical or meaningless. Take a supply contract for a ton of standard-grade office paper; this has a basic value to the customer and may vary in terms of delivery times or look and feel, but essentially it is a ton of 80gsm paper. In these or similar cases, after a conscious decision on whether or not to participate in a bid, I suggest reverting to competitive pricing, adjusted to reflect differences in offer quality if relevant.

Changing pricing practices is a true organisational transformation, a bit like changing the company DNA. Pricing is part of the company culture and changing pricing practices requires a change in capabilities, structure, incentive systems and in how the company interacts with customers. Any company aiming to change from cost-based to value-based pricing is well advised to treat this change as a true organisational change management (OCM) programme.

This process should not be undertaken lightly as it represents a fairly radical approach to pricing and profitability. Here the eight-step change model, from *Leading Changes* (Kotter, 1995), provides a very useful framework for kick-starting this organisational transformation related to pricing (see box, right).

Businesses can undertake this strategic pricing change on their own, but since consultants like us are not attached to a company's history and we don't fully understand the politics, our only concern is the future, and maybe that is an advantage.

VALUE-BASED PRICING

When looking at value price we are no longer looking at margin here, but the price that a customer perceives the product to be worth. We assume that this is in excess of the costs of making and delivering the product. If it isn't then businesses should not be delivering the product.

Businesses wanting to embark on a radical change in approach to pricing will need to establish a sense of urgency, a compelling vision while also communicating it, and to win over the board and stakeholders to remove the inevitable obstacles to change. Those implementing the change will need quick wins to demonstrate that new pricing works and to be able to build on these wins. Finally, a business will need to institutionalise the new approach to pricing.

As mentioned, a change in pricing practices is an OCM program and as such it needs CEO support. In a recent research project (Liozu & Hinterhuber, 2013) we polled more than 300 CEOs of mostly medium-sized companies. We documented that CEO support of pricing leads to both increased pricing capabilities and improved business performance in industry; CEOs play a very important role by acting as champions of pricing and the pricing function. This is something that few organisations appreciate and understand.

ESTABLISHING VALUE

Over the past five years, Hinterhuber & Partners has completed a major research project investigating how companies quantify their value proposition. It found that for many companies the capability to quantify value is the single area where improvements are needed most. Our research also seems to suggest that those companies with the most developed capabilities to quantify the value proposition to customers in monetary terms are also the

EIGHT STEPS TO TRANSFORMING YOUR ORGANISATION

1 ESTABLISHING A SENSE OF URGENCY
Examining market and comparitive realities. Identifying and discussing crises, potential crises, or major opportunities.

2 FORMING A POWERFUL GUIDING COALITION
Assembling a group with enough power to lead the change effort. Encouraging the group to work together as a team.

3 CREATING A VISION
Creating a vision to help direct the change effort. Developing strategies for achieving that vision.

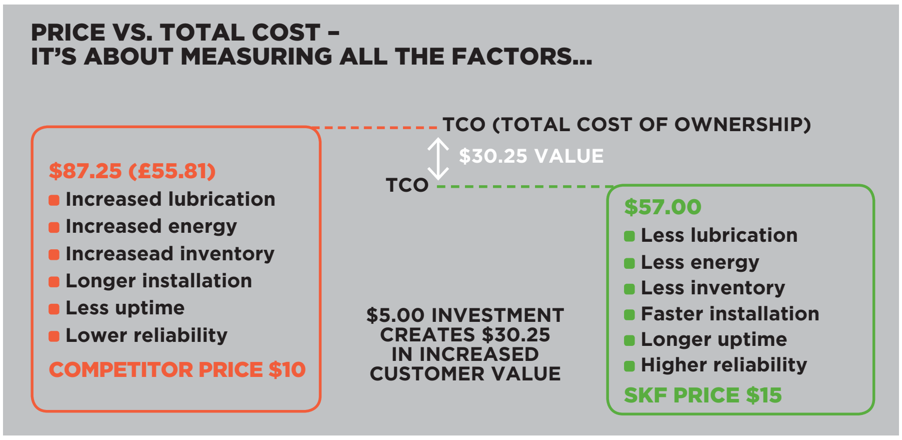
4 COMMUNICATING THE VISION
Using every vehicle possible to communicate the new vision and strategies. Teaching new behaviours by the example of the guiding coalition.

5 EMPOWERING OTHERS TO ACT ON THE VISION
Getting rid of obstacles to change. Changing systems or structures that seriously undermine the vision. Encouraging risk taking and non-tradional ideas, activities and actions.

6 PLANNING FOR AND CREATING SHORT-TERM WINS
Planning for visible performance improvements. Creating those improvements. Recognising and rewarding employees involved in the improvements.

7 CONSOLIDATING IMPROVEMENTS AND PRODUCING STILL MORE CHANGE
Using increased credibility to change systems, structures and policies that don't fit the vision. Hiring, promoting and developing employees who can implement that vision. Reinvigorating the process with new projects, themes and change agents.

8 INSTITUTIONALISING NEW APPROACHES
Articulating the connections between the new behaviours and corporate success. Developing the means to ensure leadership development and succession.



companies that outperform their competitors in profits and sales growth. On top of the agenda of any business to business (B2B) senior sales or marketing manager worth their salt is the question of tools, processes and capabilities to document and quantify value to customers. This, I think, is the litmus test of pricing.

We have to remember that the most important feature of selling in industrial markets is the need of sellers to quantify value for money. It requires the ability to document, in monetary terms, how much incremental profit our product or service delivers over the customer's next-best alternative.

Buying and selling in industrial markets is thus increasingly akin to performing return on investment calculations. Buyers evaluate the monetary benefits against costs and prices of competing offers. Sellers justify any price premium by documenting that the quantified value to customers is substantially larger than any price premium over the customer's best available alternative.

Let's take a real life example. SKF, a Swedish company with about €8.5bn (£6.2bn) in sales, is a leading supplier of industrial bearings and other equipment to the automotive and machinery industry. SKF is operating in a heavily competitive industry, and the company's product range frequently carries a price premium of 20% to 50% over the customer's best available alternative. Yet SKF is thriving in this industry with profitability and growth levels substantially higher than its direct competitors. How does SKF do this? It has established a function, led by Todd Snelgrove, chief value officer in charge of documenting and quantifying value to customers. He uses a value calculator to document to customers that the product of SKF, sold at a premium of 50% over the customer's next best alternative, is delivering monetary benefits that substantially exceed this price premium (Hinterhuber & Snelgrove, 2012). This is rolled out to the salesforce and B2B customers selling the product on, reinforcing the idea that this is a quality product and will save you money in the longer term.

Marketing, pricing and sales managers in B2B should take notice. If SKF is able to quantify the value of industrial bearings, so should other companies with products that are frequently even more differentiated than those of SKF.

This is the area where I see a huge investment of many companies in B2B. This investment is directed at equipping their salesforce with the capabilities, tools, processes and value calculators which enable them to quantify and document value to their customers. In the past, this was clearly not the case. In the past, the traditional approach was - if we play out the example above - "my asking price is 15 and the competitor is 10, so we meet somewhere in the middle around 12 and we both walk home happy". Companies such as SKF, and others that excel in quantifying the value proposition, do not sell like this anymore.

Today, and I would contend in the future too, leading-edge B2B companies will equip their salespeople not only with the confidence, but also with the tools (value calculators and value quantification tools) that empower them to convert competitive advantages into quantified monetary customer value. These tools and this confidence will help the salesforce resist customer pressure for lower prices.

Andreas Hinterhuber is a partner at Hinterhuber & Partners, a consulting company specialising in strategy, pricing and leadership
andreas@hinterhuber.com

PROFESSIONAL SERVICE PROVIDERS

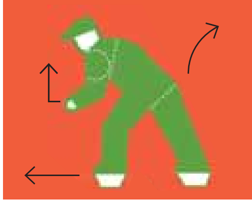
Service providers, comprising some 78% of the UK economy, do not fall outside the pricing process. Services, especially lawyers, auditors and consultants tend to deliver services at an hourly charge-out rate for their staff and partners. The hourly rate charged is driven by market prices and tradition. How many of these firms have actually looked at the value of their offering from a customer point of view?

These businesses should be looking to move towards value-based or outcome-based pricing. Many will find this a very difficult proposition, but professional services have started moving over to this system for some time. An example of this is services offering discounts to the overall bill to placate customers. However this is not addressing the fundamental flaw in the whole approach.

If a consultant, delivering a service at a set rate per hour, has an existing customer used to paying so many thousand pounds a year, who then announces that the service is going to tender, how would they go about determining their price?

There is one golden rule when assessing pricing: don't look at the issue from your perspective of what you are doing for the client and the time it takes, but rather what the client is able to do as a result of working with you (as opposed to working with your closest competitor). You have to ask what your competitive advantage is incrementally worth to customers in monetary terms. In this example, a consultant aiming to implement value-based pricing could thus tie the professional fees to quantifiable outcomes, jointly defined with clients. This way, relevant outcomes could be the level of compliance achieved, and the key performance indicators agreed would be the indicators that matter to clients.

One point needs to be made clear: value-based pricing requires differentiation. In these terms, the statement "if you are not perceived as being different, you will be benchmarked purely on price" should be the mantra for any supplier.



OTTO DETTMER / IKON