Research Article

Pricing strategies and pricing capabilities

Received (in revised form): 8th September 2011

Magnus Johansson[a], Niklas Hallberg[a], Andreas Hinterhuber[b,c], Mark Zbaracki[d] and Stephan Liozu[e,f]

[a]Institute of Economic Research, School of Economics and Management, Lund University, Sweden; [b]Hinterhuber & Partners, Innsbruck, Austria ; [c]Bocconi University, Milan, Italy; [d]Richard Ivey School of Business, Ontario, Canada; [e]Ardex America Inc., Aliquippa, Pennsylvania, USA; and [f]Weatherhead School of Management, Case Western Reserve University, Cleveland, Ohio, USA

Magnus Johansson holds a PhD from the School of Economics and Management, Lund University and has worked with strategic analysis and planning within the IT, telecom, automotive and general industry.

Niklas Hallberg is Assistant Professor at the Institute of Economic Research at Lund University (Sweden).

Andreas Hinterhuber is Partner of HINTERHUBER & PARTNERS (Innsbruck, Austria) and long-term Visiting Professor at Bocconi University (Milan, Italy).

Mark Zbaracki is an associate professor in General Management at the Richard Ivey School of Business (Canada).

Stephan Liozu is President and CEO of Ardex Americas and PhD in Management candidate at Case Western Reserve University, Weatherhead School of Management (Cleveland, Ohio).

Correspondence: Magnus Johansson, Institute of Economic Research, School of Economics and Management, PO Box 7080, 220 07 Lund, Lund University, Sweden
E-mail: a.magnus.johansson@gmail.com

ABSTRACT This article explores the intersection of pricing strategies and pricing capabilities by summarizing four distinct streams of research. By doing so, it provides insights into the challenges involved in implementing value-based pricing strategies as well as the generic challenges of building pricing capabilities. It also outlines the strategic importance of pricing capabilities.

Journal of Revenue and Pricing Management (2012) **11,** 4–11. doi:10.1057/rpm.2011.42

Keywords: pricing strategies; pricing capabilities; value-based pricing; capabilities; resources

INTRODUCTION

This article provides a summary of four different research streams at the intersection of pricing strategies and pricing capabilities. It considers how firms struggle with implementing value-based pricing strategies, how this is reflected in capabilities of the organization and, finally, the general and strategic aspects of pricing capabilities.

Pricing strategies here refers to generic approaches to pricing based on cost, competition or customer value that firms apply (Cavusgil *et al*, 2003; Ingenbleek *et al*, 2003). Cost-based pricing focuses on the cost bases of products and services, competition-based pricing on observations of competitor prices whereas value-based pricing utilizes the value that a product or service delivers to customers.

Pricing capabilities (Dutta *et al*, 2002; Dutta *et al*, 2003) covers the organizational processes and mechanisms of pricing and, thus, how resources are *deployed* (Amit and Schoemaker, 1993) in association with pricing. Pricing capabilities are thus directly linked to the field of strategy and the resource-based view (RBV).

Pricing strategies, in the form of pricing approaches, are mostly associated with the pricing and marketing-oriented literature, which has rather extensively covered the topic (see for instance Nagle and Hogan (2006) and Hinterhuber (2008)). In particular, value-based pricing has received significant attention as it is claimed to be the most profitable approach to pricing (Cannon and Morgan, 1990; Anderson and Narus, 1998). However, the distinction between various pricing approaches as well as research that deals with the implementation of value-based strategies indicate the need to address the topic of pricing strategies from the perspective of the processes and routines as well as the resources involved. Therefore, this article aims at bridging the areas of pricing strategies and pricing capabilities, but also to provide additional insights into each area.

This article is organized as follows: we first summarize key literature on value-based pricing and the implementation of value-based pricing strategies. We then present the results of a recent qualitative study describing distinctive features of firms adopting cost-based, competition-based and customer value-based pricing strategies. We discuss aspects related to the organizational transformation toward value-based pricing and identify key capabilities involved. Next we identify the building blocks of pricing capabilities and the managerial challenges involved. Finally, following a qualitative research among industrial companies, we discuss the strategic importance of pricing capabilities.

The article summarizes four different empirical studies from various industries. The first section applies both a qualitative and quantitative approach. The second and fourth sections rely primarily on a qualitative approach, whereas the third section is based on an ethnographic study. The primary qualitative nature of the studies of this article reflects its focus at the intersection of two fields, that of pricing strategies and that of pricing capabilities.

IMPLEMENTING VALUE-BASED PRICING STRATEGIES, ANDREAS HINTERHUBER

Despite its benefits, value-based pricing approaches are adopted only by a minority of companies. Research indicates that more than 80 per cent of companies base their pricing decisions primarily on costs, or on prices of competitors (Hinterhuber, 2008). Previous research has uncovered the factors that prevent companies from adopting value-based pricing (Hinterhuber, 2008).

These findings were based on a two-stage empirical approach: first, in a qualitative research, the phenomenon of implementation of value-based strategies was explored with groups of business executives participating in pricing workshops. The result of this qualitative stage was then used to develop a questionnaire that was tested upon a significantly larger and more stratified population. Cluster analysis is used to summarize the results of this quantitative research stage.

Based on a survey of 81 executives representing a range of B2B and B2C industries in Germany, Austria, China and the USA, five main obstacles to the implementation of value-based pricing strategies were identified: lack of capabilities in value assessment; deficits in value communication; lack of effective market segmentation; deficits in sales force management; and insufficient senior management support. These findings are summarized in Table 1 (adapted from Hinterhuber, 2008).

PRICING ORIENTATION IN INDUSTRIAL MARKETS, STEPHAN LIOZU

Of three main orientations to pricing in industrial markets – cost-based, competition-based

Table 1: Implementing value-based pricing strategies

Main obstacles	*Manifestation*	*Best practice*
Value assessment	Lack of methods, tools or information to quantify customer value	Customer value is quantified with robust empirical research such as conjoint analysis, expert interviews or value-in-use assessments
Value communication	Communication encourages customers to fixating on price Communication centers around product features and technical product characteristics	Communication discourages customers from fixating on price Communication translates key product features into customer benefits or business impact
Market segmentation	Market segmentation is intuitive or based on easily observable but ineffective criteria	Needs-based market segmentation drives marketing strategy
Sales force management	Lack of incentive schemes and guidelines to encourage sales force to focus on value	Sales force has capabilities, guidelines and motivation to focus on value. Training and monitoring systems are in place. Discounting is not encouraged
Senior management support	Senior management is mainly interested in top-line growth or market share and does not encourage a focus on value	Senior management provides vision, context and incentives to implement value-based pricing

and customer value-based – most marketing and pricing scholars consider the latter as the superior approach for setting prices in business markets (Cannon and Morgan, 1990; Monroe, 1990). However, few industrial firms have adopted it. Marketing literature is silent about how organizational and behavioral characteristics of industrial firms may affect adoption of a pricing orientation and, more specifically, value-based pricing. Semi-structured interviews with 44 managers of small to medium-size US industrial firms yielded insights into firm pricing orientations, processes and decision-making patterns (Liozu *et al*, 2011). We identified five organizational characteristics common to firms implementing value-based pricing: the ability to face deep transformational change, the role of champions as transformational leaders, the creation and diffusion of organizational capabilities, the building of organizational confidence to fuel the transformation, and the design of center-led and specialized teams of experts supporting the firm's pricing process. Figure 1 illustrates these organizational characteristics while Figure 2 summarizes organizational capabilities for value-based pricing.

BUILDING PRICING CAPABILITIES, MARK ZBARACKI

One of the fundamental challenges for a firm is how to arrive at the right price for its products. The value a firm creates with its products can be determined by the difference between the buyer's willingness to pay and costs for the firm to produce the product. How that value gets

Figure 1: Experiental and transformative learning.

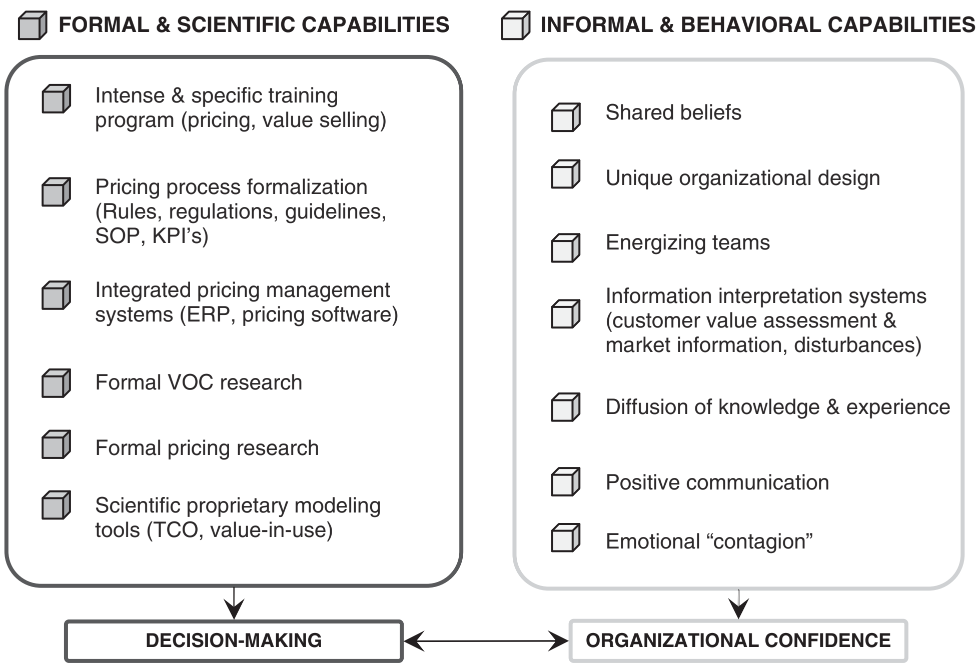

Figure 2: Organizational capabilities for value-based pricing.

allocated, however, depends on the price the firm settles at. If a firm sets its price too low, then the customer garners more than its share of the value. If the firm sets the price too high, then the firm may garner more value for the products it sells, but loses sales. Only by accurately understanding the pricing playing field can a firm arrive at the right price for its products.

Until recently, standard pricing theory has followed a myth of costless price changes (Bergen *et al*, 2003), assuming that firms can readily change their prices. In fact, arriving at the right price requires resources – often significant resources – as firms respond to market conditions (Zbaracki *et al*, 2004). Because of this myth, most companies make two mistakes. One mistake is treating pricing as a tactical activity – a response to local market conditions. In practice, effective pricing requires capabilities – human capabilities in knowledge, skills and techniques; systems capabilities in data, hardware and software; and social capabilities in communication, organization and authority (Dutta *et al*, 2003). A second mistake is assuming that they can easily purchase these capabilities. Managers often assume that if they hire the right people or purchase the latest technology, they can overcome their pricing difficulties. All too often they find that their efforts to improve pricing run-up against the barriers of the organization.

Here we address the further managerial challenge of how to begin to develop the capabilities required to set prices effectively. We begin with the problem of how to understand market forces. We argue that developing the capabilities requires assessing the firm to determine which people are essential to setting prices and understand how those people matter to pricing decisions. Based on a 2-year ethnographic study, we show how competing perspectives from different individuals can lead to different market perceptions (Zbaracki and Bergen, 2010). We argue that people hold competing partial, but coherent models of pricing. To develop pricing capabilities, a manager needs to identify those different models and determine how resource investments will shape the models – and hence market perceptions – of the different individuals holding those models. The framework we present makes pricing at once a strategic, a managerial and a tactical problem.

THE STRATEGIC RELEVANCE OF PRICING CAPABILITY, NIKLAS HALLBERG

This qualitative, interview-based, case study of pricing capability in the European packaging industry examines the process and mechanisms whereby pricing capability (Dutta *et al*, 2003) affects product market value appropriation (MacDonald and Ryall, 2004). Pricing-related challenges illustrated by the five cases included in the study ranged from keeping track of and setting consistent prices for up to 5000 different products spread across almost a thousand different customers, gaining relevant market and product-related information in novel and highly idiosyncratic pricing situations, and controlling the personal discretion of employees involved in pricing decisions.

The results of the case study show that firms commit to complex configurations of assets, routines, activities and pricing policies, which enable value appropriation through the ability to discriminate prices, and leverage firm-specific demand and cost conditions. The main function of the assets and routines that were deployed in the pricing process was to enable the information and control necessary for the execution of pricing activities and the successive implementation of pricing policy. Hence, information about production costs and the willingness to pay of customers, and the control with which the pricing process was managed, was found to be an important driver of product market value appropriation. This indicates that pricing capability is of strategic relevance because it enables the firm to overcome external and internal information asymmetries (see Coff, 1999; Makadok and Barney, 2001) that prevent it from setting prices that maximize returns to product market strategies. Pricing capability thus allows firms to appropriate a larger share of the created value by setting prices that match the perceived benefit of products in specific customer segments (price discrimination), the overall demand elasticity in the market (price elasticity leverage), and the focal firm's cost structure (operating leverage).

The RBV attributes performance differentials to immobile and heterogeneous resources that have intrinsically different levels of efficiency (Peteraf, 1993). Hence, some resources are superior to others in that they allow the firm to produce at a lower economic cost or provide products with a higher perceived benefit (Peteraf and Barney, 2003). Firms with marginal factors will perform at break-even while firms with superior resources can earn economic rents. The theoretical position adopted by the RBV thus suggests that pricing capability is not a strategically relevant factor in itself, but rather that price is jointly determined by firm-level value creation in the first step, and by market economics and industry structure in the second step (see Besanko *et al*, 2010, p. 364). This notion of firm pricing capability as a non-strategic factor is inconsistent with the notion that firms could be making consistently good or bad pricing decisions because of the differential levels of pricing capability they have in place. Hence, the broader theoretical issue concerns the fact that contemporary strategy theory has only to limited extent addressed the question of how product market value appropriation, and ultimately firm profits, might be affected by firms' appropriation abilities (see Brandenburger and Stuart, 1996, 2007).

While industrial organization economics (for example, Bain, 1956; Tirole, 1988) and the competitive forces framework (Porter, 1980) assumes rivalry restraints on product markets, factor markets are assumed to be efficient and firms are portrayed as identical in terms of their ability to identify and exploit these market opportunities. Almost as a mirror image of Porter's competitive forces framework, the RBV portrays firms as heterogeneous in terms of their expectations of the value of resources in strategic factor markets (Barney, 1986; Makadok and Barney, 2001) while the same firms are assumed to be homogeneous in terms of their ability to identify viable product market prices, bargain and, ultimately, appropriate value. This potentially problematic asymmetry in how firm resources and capabilities are linked to the processes of creating and appropriating economic value has to a certain extent been addressed by research stressing the relationship between firms (and the unique ways of creating and appropriating value in these relationships) as an important unit of analysis for understanding firm performance. This research includes the relational view (for example, Dyer and Singh, 1998; Kale *et al*, 2002; Dyer and Hatch, 2006) and the added value approach to business strategy (for example, Brandenburger and Stuart, 1996, 2007; Lippman and Rumelt, 2003; MacDonald and Ryall, 2004; Ryall *et al*, 2008; Adegbesan, 2009). However, despite progress in identifying the determinants of successful inter-firm collaboration and the necessary conditions for value appropriation, there still remain important questions concerning the firm-level factors, such as pricing capability, that determine the distribution of value in exchange relationships.

CONCLUDING DISCUSSION

The distinction between cost, competition and value-based pricing strategies provides us with a framework with which to understand and categorize different types of pricing practices. Different types of pricing approaches, and a transition towards, for instance, a stronger dependence on value-based pricing, provide highly interesting settings in which to study utilization of resources and organizational processes and routines. Pricing capabilities, on the other hand, is a key concept in order to understand the organizational and strategic challenges involved in pricing, through its focus on different types of resources and the way that the organization deploys them.

This article has illustrated the importance of combining these two areas. This is most apparent in the second section, which outlines capabilities involved in value-based pricing activities. However, cost, competition and value-based approaches are not mutually exclusive.

Implementing a value-based pricing strategy, with all the challenges it involves, is largely a general price capability-building process, which is discussed in the third section of this article.

Furthermore, the extensive organizational challenges involved in the transition toward value-based pricing illustrated in this article underline that pricing is an organizational effort. This can also be seen in the application of quality models on pricing such as organizational pricing maturity or six sigma pricing (Sodhi and Sodhi, 2005). When recognizing that pricing is an organizational effort, the routines and processes, and thus the capabilities, become fundamental factors in being successful with pricing.

To sum up, this article has highlighted the obstacles of moving towards value-based pricing strategies. It has also outlined five organizational characteristics of firms moving towards value-based pricing as well as the generic challenges involved in building pricing capabilities. Finally, it has provided insights into the strategic importance of pricing capabilities. Thus, this article links the fields of pricing strategies and pricing capabilities, and thus explores an important area at the intersection of pricing approaches and pricing practices versus resource utilization and organizational routines and processes.

However, further research dedicated at exploring the intersection of pricing strategies and capabilities is necessary. Such research should not be limited to the development of capabilities but also to resources (cf the discussion of distinctions and dependencies in Makadok, 2001) in association with various pricing practices. In addition, as this article is mainly concerned with pricing in business to business settings, additional research at the intersection of pricing strategies and capabilities in consumer industries is called for.

REFERENCES

Adegbesan, A.J. (2009) On the origins of competitive advantage: Strategic factor markets and heterogeneous resource complementarity. *Academy of Management Review* 34(3): 463–475.

Amit, R. and Schoemaker, P.J.H. (1993) Strategic assets and organizational rent. *Strategic Management Journal* 14(1): 33–46.

Anderson, J.C. and Narus, J.A. (1998) Business marketing: Understand what customers value. *Harvard Business Review* 76(6): 53–65.

Bain, J. (1956) *Barriers to New Competition*. Cambridge, MA: Cambridge University Press.

Barney, J.B. (1986) Strategic factor markets: Expectations, luck, and business strategy. *Management Science* 32(10): 1231–1241.

Bergen, M., Ritson, M., Dutta, S., Levy, D. and Zbaracki, M.J. (2003) Shattering the myth of costless price changes. *European Management Journal* 21(6): 663–669.

Besanko, D., Dranove, D., Shanley, M. and Schaefer, S. (2010) *Economics of Strategy.* Hoboken, NJ: John Wiley & Sons.

Brandenburger, A.M. and Stuart, H.W. (1996) Value-based business strategy. *Journal of Economics and Management Strategy* 5: 5–24.

Brandenburger, A.M. and Stuart, H.W. (2007) Biform games. *Management Science* 53(4): 537–549.

Cannon, H.M. and Morgan, F.W. (1990) A strategic pricing framework. *The Journal of Service Marketing* 4(2): 19–30.

Cavusgil, S.T., Chan, K. and Zhang, C. (2003) Strategic orientations in export pricing: A clustering approach to create firm taxonomies. *Journal of International Marketing* 11(1): 47–72.

Coff, R.W. (1999) How buyers cope with uncertainty when acquiring firms in knowledge-intensive industries: Caveat emptor. *Organization Science* 10(2): 144–161.

Dutta, S., Bergen, M., Levy, D. and Zbaracki, M.J. (2002) Pricing as a strategic capability. *Sloan Management Review* 43(3): 61–66.

Dutta, S., Zbaracki, M.J. and Bergen, M. (2003) Pricing process as a capability: A resource-based perspective. *Strategic Management Journal* 24(7): 615–630.

Dyer, J.H. and Hatch, N.W. (2006) Relation-specific capabilities and barriers to knowledge transfers: Creating advantage through network relationships. *Strategic Management Journal* 27(8): 701–719.

Dyer, J.H. and Singh, H. (1998) The relational view: Cooperative strategy and sources of interorganizational competitive advantage. *Academy of Management Review* 23(4): 660–679.

Hinterhuber, A. (2008) Customer value-based pricing strategies: Why companies resist. *Journal of Business Strategy.* 29(4): 41–60.

Ingenbleek, P., Debruyne, M., Frambach, R. and Verhallen, T. (2003) Successful new product pricing practices: A contingency approach. *Marketing Letters* 14(4): 289–305.

Kale, P., Dyer, J.H. and Singh, H. (2002) Alliance capability, stock market response, and long-term alliance success: The role of the alliance function. *Strategic Management Journal* 23(8): 747–767.

Liozu, S., Boland, R., Hinterhuber, A. and Perelli, S. (2011) *Industrial Pricing Orientation: The Organizational Transformation to Value-based Pricing*, First International Conference on Engaged Management Scholarship, Case Western Reserve University. Social Science Research Network by Social Science Electronic Publishing, Inc., Cleveland, OH.

Lippman, S.A. and Rumelt, R.P. (2003) A bargaining perspective on resource advantage. *Strategic Management Journal* 24(11): 1069–1086.

MacDonald, G. and Ryall, M.D. (2004) How do value creation and competition determine whether a firm appropriates value? *Management Science* 50: 1319–1334.

Makadok, R. (2001) Toward a synthesis of the resource-based and dynamic-capability views of rent creation. *Strategic Management Journal* 22(5): 387–401.

Makadok, R. and Barney, J.B. (2001) Strategic factor market intelligence: An application of information economics to strategy formulation and competitor intelligence. *Management Science* 47(12): 1621–1638.

Monroe, K.B. (1990) *Pricing: Making Profitable Decisions*. Burr Ridge, IL: McGraw-Hill Pub.

Nagle, T.T. and Hogan, J.E. (2006) *The Strategy and Tactics of Pricing: A Guide to Growing More Profitably.* Upper Saddle River, NJ: Pearson Education.

Peteraf, M.A. (1993) The cornerstones of competitive advantage: A resource-based view. *Strategic Management Journal* 14(3): 179–191.

Peteraf, M.A. and Barney, J.B. (2003) Unravelling the resource-based tangle. *Managerial and Decision Economics* 24(4): 309–323.

Porter, M. (1980) *Competitive Strategy.* New York: The Free Press.

Ryall, M.D., Gans, J.S. and MacDonald, G. (2008) The two sides of competition and their implications for strategy. Unpublished manuscript, http://works.bepress.com/michael_ryall/15.

Sodhi, M. and Sodhi, N. (2005) Six Sigma pricing. *Harvard Business Review* 83(5): 135–142.

Tirole, J. (1988) *The Theory of Industrial Organization*. Cambridge, MA: The MIT Press.

Zbaracki, M.J. and Bergen, M. (2010) When truces collapse: A longitudinal study of price adjustment routines. *Organization Science.* 21(5): 955–972.

Zbaracki, M.J., Ritson, M., Levy, D., Dutta, S. and Bergen, M. (2004) Managerial and customer dimensions of the costs of price adjustment: Direct evidence from industrial markets. *Review of Economics and Statistics* 86(2): 514–533.

