

## VALUE-BASED PRICING

# PROFITING WHEN CUSTOMERS CHOOSE VALUE OVER PRICE

*Increasingly recognised by academics and practitioners as the most effective approach to pricing for companies that wish to achieve increased profitability and sustained success, value-based pricing faces numerous obstacles. But Andreas Hinterhuber and Marco Bertini say the advantages of this approach to pricing far outweigh any difficulties.*

There are three fundamentally different approaches to set the price of a product, service or idea. A *cost-based pricing* approach uses information from accounting systems and predetermined profitability targets as main inputs for determining prices. *Competition-based pricing* uses anticipated or observed price levels of competitors as main factors for setting prices. Finally, *value-based pricing* uses information on customer willingness to pay and on customer price elasticity as primary bases for pricing decisions. Each of these approaches has its strengths and limitations; academic research, however, strongly suggests that it is value-based pricing which leads to superior profitability.

### The value in value-based pricing

How does value-based pricing actually work? We illustrate the benefits of this approach with the help of a case study from a recent research and consulting project with a large European supermarket chain. The client was planning to launch a private label version of a yogurt delivering specific health benefits. Based on information from cost accounting — and using disguised numbers to protect confidentiality — the company was determined to launch the product at €1.99. With costs of goods sold at €1.29, this price point allowed for a healthy mark-up and still compared favourably to the price for the branded product of €2.99.

The company's CEO solicited our view. As a first step, we examined customer perceptions of value of both the branded product and the private label. Our initial assumption was that the private label would only be compared unfavourably with the brand, especially because of the absence of a recognisable, renowned name. Surprisingly, research with customers revealed that the private label yogurt was superior to the branded yogurt in one aspect customers deemed critical:

## PRICING AND THE BOTTOM LINE

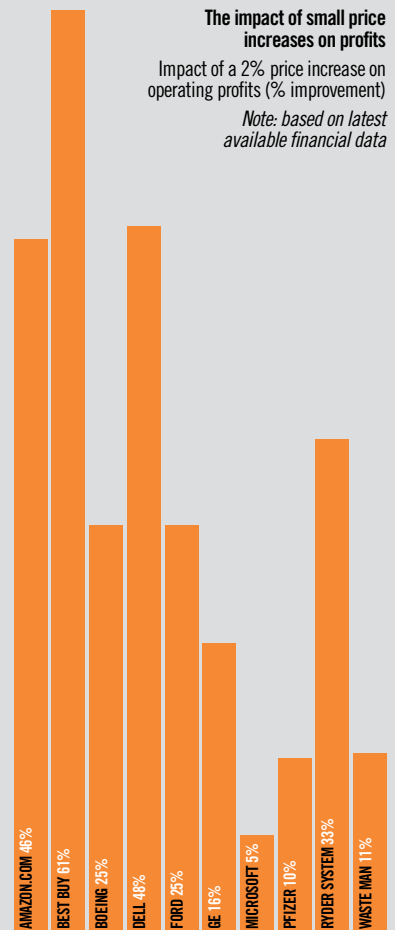
Pricing has a substantial impact on the bottom line. We looked at ten companies from the S&P 500 and found that a two per cent increase in price increases operating profitability by 14 per cent on average. For companies with low profit margins — such as Amazon.com or Best Buy — the impact of small increases in price on profits can be substantially bigger.

The impact of small changes in price usually exceeds the impact of other levers of the marketing mix — such as revenue increases or cost reductions — by a substantial amount: superior profitability is difficult to achieve if weak pricing strategies are in place. Similarly, an effective pricing strategy is a very important prerequisite in achieving sustained above average profitability.

### The impact of small price increases on profits

Impact of a 2% price increase on operating profits (% improvement)

*Note: based on latest available financial data*





mothers perceived the private label product to be less damaging to the teeth of their children than the branded product, which contained a significantly higher sugar content. As a result, mothers were reluctant to purchase the branded product as a complement to their kids' school meal, despite its popularity.

Based on an empirical study with existing and prospective customers, we estimated the value of this differential benefit to be around €0.30. On the other hand, our research also confirmed that the lack of an established brand name reduced the appeal of the private label by as much as €0.50. The two alternatives performed equally on all other dimensions. In sum, according to our analysis of customer willingness to pay, the relative value of the private label was about €2.80. After running simulations in which customer price sensitivity, competitor reactions, and other factors were taken into consideration, we recommended a launch price of €2.49. We also recommended a heavy focus on the health benefits as part of the launch campaign. The company largely followed this recommendation. Despite the higher price point, sales volume



exceeded expectations. Profits increased nearly sixfold over plan.

At its essence, value-based pricing aims to align price with real, unique value — the “stuff” that customers care about and competitors currently do not provide. This aligns company and customer interests better than any other pricing method. In circumstances where customer perceptions of value are high, prices can be set accordingly without alienating customers (assuming that the real, unique value is in fact communicated efficiently to the customer). In circumstances where perceptions of value are low, lower prices have to follow suit.

When launching a new processor, for example, Intel sets initial prices high and lowers prices as competition enters and as customer perceptions of value erode. When launching the next generation of processors (for example, Pentium Pro versus Pentium), initial launch prices are typically higher than initial launch prices of the previous generation and exceed the declining price of the older technology by a factor of 3x to 5x. This is possible only because Intel superbly understands and influences the perceptions of value and price of its customers.

Despite these and other advantages, it is interesting to note that value-based pricing is in fact the least popular pricing method, adopted only by a minority of companies. Several academic studies show that more than 80 per cent of companies (this number can vary significantly across industries) base their

Perhaps the most important roadblock to overcome is gaining senior management support for value-based pricing.



pricing decisions primarily on costs, or on the prices of competitors. So, what are the factors that prevent companies from adopting value-based pricing?

### Roadblocks to value-based pricing

To determine what makes adopting value-based pricing so difficult, we interviewed executives from a variety of countries, industries and market segments. The results were refined in a set of workshops, which were again held in different countries with participants from different industries — this time to dig deeper into the awareness of alternative pricing strategies and the experiences executives had with them. These findings led to the development, testing and refinement of a questionnaire that was administered to groups of participants in workshops held in nine different companies in Germany, Austria, China and the United States.



The data was surprisingly consistent. Results show that the main obstacles to adopting value-based pricing are difficulties in assessing value, communicating value, market segmentation, sales force management and senior management support. Understanding the nature of these difficulties, and how they can be overcome successfully, will motivate companies to re-consider (or consider for the first time) value-based pricing.

To begin, one obstacle in implementing value-based pricing is the lack of data, processes and tools to quantify customer value. Companies are frequently forced to revert to cost-based or competition-based pricing, simply because they do not have the tools to measure customer value reliably. In fact, it is not uncommon for marketing and sales teams to be uncertain of what value actually is. Too often they speak about the technical superiority of their offerings compared to those of the competition. But value, as perceived by customers, is seldom found in what the firm thinks it is selling. In the end, customers care about the benefit of a certain feature, specifically the impact of that feature on customers' lives or on the performance of the organisations they work for.

Companies successful at implementing value-based pricing generally employ a series of rigorous empirical tools to reliably measure (and continuously track) customer value. These tools include conjoint analysis, expert interviews and customer value-in-use assessments. A deep understanding of customer value, using the "language" of the customer, allows sellers to quantify willingness to pay with a greater degree of confidence. This information, combined with information on price elasticities (i.e. how demand responds to price changes), competitive responses and behavioural price perceptions, is then used to identify profitable price points.

Next, many companies struggle with communicating the value they are offering. In fact, this is probably the most common, and in many ways most distressing, problem. The main challenge here is twofold.

First, as mentioned, firms are typically poor at empathising with customers. They are excellent at understanding the performance of their products, but really struggle when it comes to communicating what

this performance actually means to a customer using the product.

Second, even if they are excellent communicators, in many instances buyers are reluctant to buy into the "sales pitch". This is where sellers have to be very creative in devising interesting and compelling ways for buyers to listen and display trust. Some of the best companies achieve this by mixing sophisticated software that can be customised to the conditions of each customer and generate actual value calculations (often in money savings through cost reductions now and in the future), and with detailed case studies documenting success stories involving other customers in the same domain. Taking this a step further, value selling practices have evolved to include performance-based clauses, where sellers ensure value delivered by linking it to their own compensation.

The third difficulty to overcome is market segmentation. Many companies use multiple variables to segment their customer base, most of them tracking demographical or behavioural information. Examples of such variables are age, disposable income, gender, account size, industry type, and so on. While these variables have the advantage of being easy to observe, at best they only scratch the surface of customers' underlying needs — their motivation for buying in the first place. Failure to uncover the true drivers of behaviour prevents managers from taking meaningful actions in understanding what value actually is, and how it can be communicated effectively.

Managers are often surprised to learn that many pricing problems are actually the consequence of poor segmentation. Companies that implement value-based pricing successfully understand that effective segmentation starts with mapping customer needs. This allows marketers and sales people to differentiate between groups of people with varying willingness to pay and prepare tailored offerings. In addition, a clear understanding of customer needs typically reduces the perception that most customers are quality-insensitive, price-conscious buyers.

Next comes the problem of sales force management, in particular sales force remuneration. A workshop participant from the automotive industry gave the all-too-common

example of members of her team systematically discounting products with the sole purpose of reaching monthly quotas. This behaviour, fuelled by short-term goals and misaligned incentives, destroys customer value because it promotes a culture of price concessions, irrespective of whether they are in fact warranted. The long-term consequence is a lack of confidence in the value added of one's offerings, which in turn fuels further price discounting.

To combat this downward spiral, our research identified several key steps in sales force management that should be taken, in particular: establishing clear guidelines for price promotions; staggering levels of approval for granting concessions; restricting discounting latitude at the level of sales representatives; continuously monitoring the gap between list and realised prices; remunerating sales people based on margin, volume and price target criteria, training sales people to engage customers in value discussions (as opposed to pure price negotiations), and supporting these value conversations with the intelligence sales people need to confidently demonstrate the economic value of their products to customers.

The final main roadblock to overcome when implementing value-based pricing is the lack of senior management support. Explicitly or implicitly, many C-level executives assume that high market share leads to high profitability, despite substantial empirical research to the contrary. Thus many senior executives set targets which reward top line growth. Under these conditions, sales managers are encouraged to discount to reach volume or market share targets and have no incentive to sell value. The establishment of a value-based pricing culture requires recognition by senior executives that the "quality" (profitability) of market share is more important than its sheer amount. In addition, senior executives need to provide clear direction and support for pricing proposals that promote the use of customer value as the starting point, they need to help build capabilities in key functions to better understand and monitor customer value, and they need to follow up these initial steps by rewarding and reinforcing desired behaviours at all levels of the organisation.



### Value-based pricing — a new way of doing business

Our research suggests that the implementation of value-based pricing is contingent on five distinct types of capabilities working in synchrony to understand and communicate value: capabilities in value assessment, capabilities in value communication, capabilities in market segmentation, capabilities in sales force management, and, finally, capabilities in leadership.

Companies that try to implement value-based pricing but ultimately fail often treat this endeavour as a simple project. At times, we even observe the appointment of a Head of Pricing with dedicated resources and personnel. Yet, a project mentality is limited in this case because too many other projects are simultaneously competing for scarce

managerial resources. In this pool of project, pricing changes are typically put aside or relegated to the back of the line because pricing is, mistakenly, perceived to be a tactical lever only.

In contrast, we find that when the adoption of value-based pricing is understood for its implications, that value-based pricing will change the way the firm views the relationship between its products and its customers, in particular by putting customers first, then the chances of successfully completing a transition increase dramatically. The end result is definitely worth the effort. Price changes have by far the largest impact on the profitability of a business, and value-based pricing forces managers to think about how prices relate to what customers actually care about paying for. ■

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## OVERCOMING THE OBSTACLES TO VALUE-BASED PRICING.

### ► 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 fixate on price. Communication centres 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.

