PRICING FOR PROFIT: A PRIMER

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These are tough times in any business, and firms are fixing and improving effectiveness of their organizations. There are many alternatives to improving a firm's profitability but a focus on pricing strategies and tactics offer immediate benefits, and for the long term.

Effective pricing is one of the most underutilized tools in business. The profitability of your firm can be substantially increased with a disciplined approach of breaking down pricing processes into manageable components, and tying then all together with the right people working on the right details at the right time.

First, a definition- what is pricing? Pricing is your firm's ability to create profits by capturing and extracting some (or all) the value that your firm delivers to its customers. Therefore, the entire methodology is focused on creating profits, driven by extracting the value that your firm delivers to its customers.

IMPROVING PRICING EFFECTIVENESS

Figure 1 shows a workflow for improving your firm's profitability through pricing.

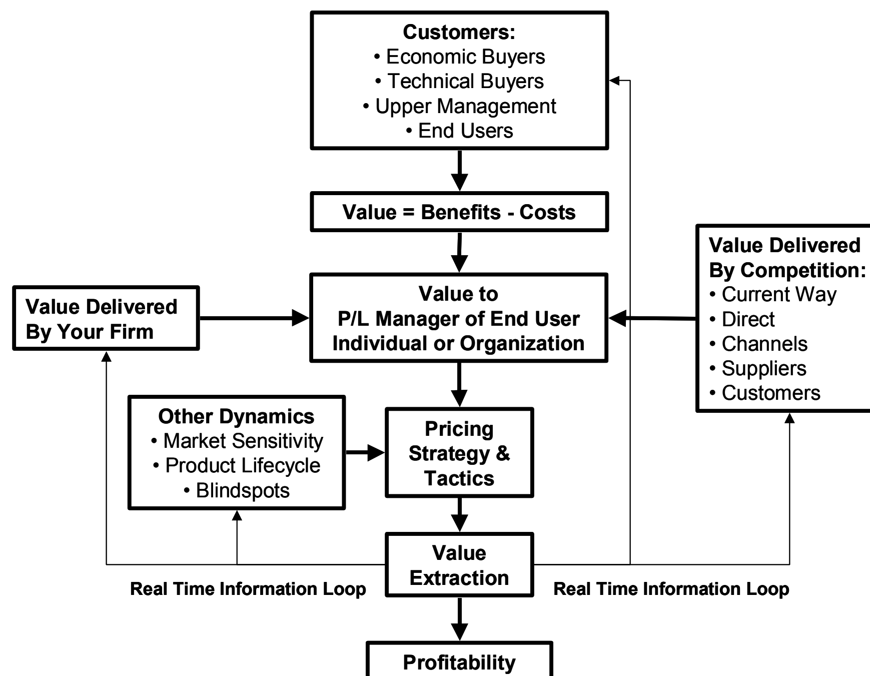


Figure 1: PRICING FOR PROFIT WORKFLOW

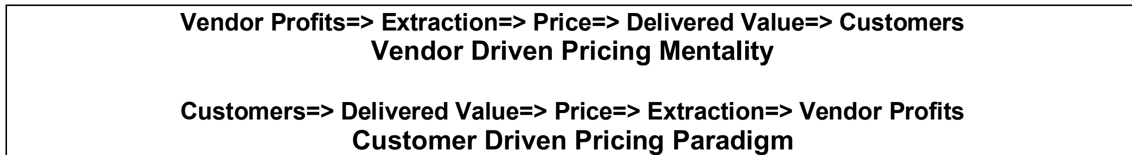
This workflow to improve pricing effectiveness can also be represented as the following seven steps.

1. Customer Driven Pricing
2. Focusing on the Right Customers
3. Value Delivered to Customers

4. Customers' Choices- Competition and Your Firm
5. Internal and External Factors
6. Pricing Strategy Selection
7. Extraction of Value & Execution

1. CUSTOMER DRIVEN PRICING

The first step in improving the effectiveness of your firm's pricing process is to change your firm's pricing perspective- from being vendor driven to being customer driven.



Vendor Profits=> Extraction=> Price=> Delivered Value=> Customers
Vendor Driven Pricing Mentality

Customers=> Delivered Value=> Price=> Extraction=> Vendor Profits
Customer Driven Pricing Paradigm

A vendor-driven pricing mentality creates some major blindspots. The most important and devastating of these is that your firm will fall into the trap of cost-based pricing, which will limit your firm's profitability. Time and time again, customer value driven pricing has delivered more profitability, if not a

2. FOCUS ON THE RIGHT CUSTOMERS

Central to a customer driven strategy is the question: who is the customer? Whether it is business-to-business environment (or a consumer), the customer has four dimensions- End User, Technical Buyer, Economic Buyer and Upper Management, amongst many others. Errors in judgment in clearly defining your customer will lead to erroneous pricing, and, more important, leaving money on the table

For all practical purposes, in a business-to-business situation, your customer is the P/L Manager of the End User organization. The rest of the players are influencers, filters, and facilitators. The rubber meets the road and value meets costs in the end-user organization, or individual. Take your sights off this person, and you will quickly slip and slide down the slippery surface of declining value.

For example, in the early nineteen eighties, when directional MWD was introduced, the drilling engineer was the end-user. However, when Formation Evaluation MWD (now called Logging while Drilling or LWD) was introduced, recent habits persisted and the Drilling engineer was still considered the end-user, when in fact he or she was an influencer. This contributed to immense pricing pressures and slowed down market penetration. Refocusing on the real end-user, the petrophysicist, quickly altered fortunes, on two fronts- higher margins and rapid acceptance.

3. VALUE DELIVERED TO CUSTOMERS

In order to deliver value to the P/L Manager of the End User organization, "value" has to be defined. For simplicity Value is defined as a trade-off between Benefits and Cost of Alternatives, where:
Benefits= the value added by purchasing your offerings, product and/or service
Costs= Cost of all alternatives to fulfill the need, including your solution

Both of these are difficult to estimate. It is easier said than done but firms should not run away from these challenges because of their complexity or their uncertainty. Determining value-add from an end-user's perspective is difficult but must be done. A pricing strategy or tactic that is established without this understanding is harmful to the economic health of any firm.

At the outset, learn the customer's dimensions of value. Very often, it goes beyond economics alone. Purchasing decisions are always a balance between needs, greed and fear. At enlightened firms, risk of doing business with your firm and your firm's ability to absorb risks are always part of evaluation criteria. Psychological and emotional factors are often ignored by firms that are product-centric.

Analogies: At times the value your firm delivers is not entirely quantifiable for end-users and, in these situations, they often use rules of thumb to determine value. In the absence of a good value story from a vendor, customers will seek alternate methods to quantify value. One common method is to draw analogies from similar areas. In the early days of the computing business, end users and buyers resorted to analogies from the tangible, mechanical engineering world, equating different aspects of the software to different parts of say, a motorcycle. To establish a good value story, it was important to head them off at the pass by establishing other analogies that were closer to conveying and explaining the value delivered by the solution.

Anchoring: An effective method is to anchor the end-user's perception of value with a high price that is backed by a value story. Yes, consumer behavior research and our own personal experiences teach us that "anchoring" has a significant impact on final sale prices, especially the perceived relationship between quality and price. However, this " anchoring" strategy needs the ability to do both- walk the walk and talk the talk. In other words, the perception of a firm's price-quality should seem real, not an empty boast.

For example, in the early days of 3D Seismic, one vendor (Company A) had a unique combination of being the price leader while simultaneously having a dominant share of the market. A competitor (Company B), driven by leadership that came from mature businesses, thought that the market was price driven when in fact it was not. In the scenario, Company A could anchor customers at substantially higher prices, and reinforce the price-quality relationship, to the benefit and delight of their shareholders.

Uneven Perceived Value: Value of the same offering is not perceived uniformly by all your customers. For products with multiple dimensions of value, different customers will attribute different value for each attribute. Consequently, the overall perception of value will vary. For example, the same product offered in the Gulf Coast region, and in offshore West Africa will be valued very differently.

Customers are not the best judges of total value: They are good judges of the core value of your offerings. There can be a big gap between the absolute, potential value you deliver and the perceived and appreciated value that they see. Additionally, these "value gaps" vary from customer to customer. An astute and affective pricing strategy is backed by tactics that build solid bridges over these value gaps.

Pareto's Law: Focus and gather all sources of value from your offerings. Empathizing with your customers, separate them into two silos- Core and Adjacent- from your target customers' perspective. Avoid overwhelming your customers, and focus on a few that follow Pareto's eighty-twenty rule.

Metrics: Finally, learn the customer's language for defining metrics for value add. If you don't speak the same language of metrics, chances are that you are talking past each other.

4. CUSTOMERS' CHOICES- COMPETITION AND YOUR FIRM

Repeat this mantra- Pricing is a function of alternative available to your customers. Pricing is a function of alternative available to your customers. Pricing is a function of alternative available to your customers.

Determine the value delivered by your competition but hidden in that statement is the trap of defining your competition. Answering the question “Who is your competition?”, provides an array potential alternatives. However, many firms have been blindsided by a very a narrow view of competition.

At a minimum, there are four sources of competition:

1. Your Customer: The Current way of doing business OR doing nothing is always an alternative to your customer. Moreover, it is not uncommon for customers to integrate backward and eliminate their suppliers. In these cases, a customer believes that there is greater value-add by embarking on producing the solution, under its control. Sometimes, “Not Invented Here!” or NIH raises its ugly head and prevents value recognition, but usually good sense eventually prevails.
2. Direct competition with similar offerings: This is the most commonly accepted definition of competition. Of course, your solution must be differentiated- perceived by the customer as being “different in important ways”.
3. Your channels or intermediaries: There is only so much available margin in the market, and your distribution channels redirect some of that margin, to their coffers. While from a revenue perspective, a firm can be deluded into thinking that an intermediary is a “channel partner”. In reality, any entity between you and the end-user is a potential absorber of margin, with potential to increase its advantage with the end-user.
4. Your supplier: This firm your firm in the same light as you would your distributor and could absorb your role. What’s sauce for the goose is sauce for the gander, and your supplier with the right leverage, can turn into a competitor.

Having defined the competitive forces, it’s now time to dig deep into your competitive intelligence to define the value delivered by these alternatives.

5. EXTERNAL AND INTERNAL FACTORS

There are several other factors that affect your pricing decisions. Some of these are internal to your firm and are somewhat controllable. Others are external to your firm and are uncontrollable. More often than not, managers ignore or are delusional about the uncontrollable factors that affect pricing strategy and tactics, and hence your profitability.

Competitive Responses: Ignoring potential competitive responses to pricing actions is at the top of charts for pricing blind-spots Every pricing action will inevitably receive perhaps a more pronounced and opposite reaction. A thorough understanding of your customers’ competitive alternatives, and their potential responses to your pricing actions are critical to increasing your firm’s success and profitability. At a minimum, reactions from direct competitors who will be immediately affected, should be considered in the pricing decision process.

Market Sensitivity: Demand sensitivity to pricing is often ignored and for good reason- it is difficult to measure and predict. Market demand does depend on price but it does not display a smooth curve that is typically displayed in textbooks. Experience shows that the demand curve for a complex product or service is a jagged, step function, where demand remains stagnant despite price changes and suddenly increases or decreases when pricing thresholds are crossed.

Product Life Cycle: Pricing strategies are different for different stages of product lifecycles. Market revenue share driven strategies require entirely different strategies than margin driven specialty businesses. It is critical to plan pricing across an entire lifecycle, recognizing signs of transition from one stage to another.

Irrational Competitors: Very often, your firm will be confronted by what seem to be “irrational competitors”. These are firms that sell their wares at ridiculous prices. In most cases, irrational competitors are far from irrational. They are rational pursuers of the same economic gain that

your firm seeks. However, their path to these gains is substantially different from yours. In many instances, these so-called irrational competitors have a lower cost base than your firm or even lower margin expectations, If not a longer term penetration strategy, backed by a large war chest.

Cost-based Pricing: Market prices are independent of your costs. All things being equal, pricing is driven by the least cost competitor in the market.

Pricing Umbrellas: Market leaders with high market and margin share, often do not realize that they create pricing umbrellas that their competitors use as cover to sneak and steal share away. It is easy for leaders to be anchored by their price leadership, which typically erodes over time. The secret to success is to be cognizant of where the offering is in the product life cycle, and have a concerted effort to increase profitability while reducing prices. This also implies an immediate and continuous focus on reducing costs.

Market Positioning: Pricing is also function of your product's positioning in the market, and within its family of products.

Internal Pressures: Anchoring is a double-edged sword. On one hand, it can be used effectively with customers to catalyze higher prices and margins. On the other hand, it has the same effect internal to a firm, when decisions-makers turn into a chain gang, shackled together by internal perceptions of price, independent of perceived value in the marketplace.

6. PRICING STRATEGY SELECTION

Broadly, there are three core pricing strategies that firms can adopt (Figure 2). Two dimensions define these three core strategies:

1. Your firms' value-add compared to your alternatives- your competition- as perceived by the customer
2. Your firm's pricing, relative to your comparative value-add.

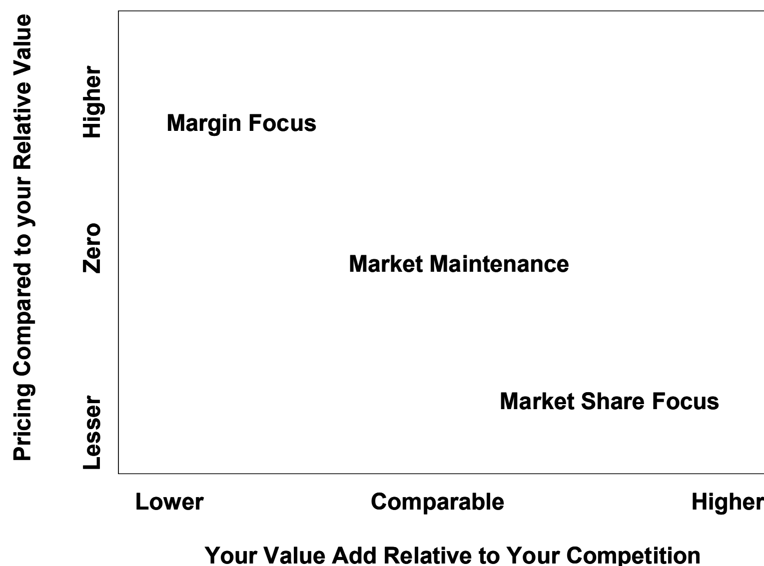


Figure 2: Alternate Pricing Strategies

These three core strategies, as shown in Figure 2, are:

1. Higher Relative Price (HRP). This is at one extreme, where your relative value-add is lower and yet you choose to price higher than the expected value in the market. It is appropriate to use this game plan when you are playing in price insensitive markets,

especially during the early stages of a product lifecycle. In price sensitive markets, the HRP strategy is useful when you do not have the capacity to deliver the volume of demand generated by lower prices. A variation is to use HRP strategy during the early stages of a lifecycle, and ratchet down to extract maximum margins during the entire lifecycle.

2. Lower Relative Price (LRP). This is used when you want to attract a large customer following, in price sensitive markets and market segments. This strategy is used in situations when the incremental cost of serving additional customers is substantially lesser than your LRP- in other words, your margins are quite substantial. LRP is an effective strategy for preempting competitors from entering the market. It closes the pricing umbrella on the competition.
3. Zero Relative Price (ZRP): This strategy is used when neither of the former strategies is appropriate. For instance, on one hand, HRP could create a pricing umbrella for swift-footed competitors, and on the other hand, LRP may not be justified because uncertainties in costs, production capacities, market sensitivity, dependencies on other product lines, and other factors may not justify gains in market share. It is used to maintain a neutral stance in the market.

These three strategies can create many hybrids that can be successfully deployed over a period of time, over a product lifecycle. At a given instant in time, different hybrids can be applied across different market segments. A quick, popular example is airline pricing of seat. Travelers with unpredictable itineraries pay HRPs while those with predictable itineraries and time on their hands (can stay overnight on Saturday!) pay LRPs.

7. EXTRACTION OF VALUE & EXECUTION

Extraction of value from your customers cannot happen without the right people focusing on the right details at the right time.

Right People: The pricing organization cuts across traditional structures, going across all departments that touch the economic value delivered by your firm. However, the key people in the pricing decision process have two significant skills:

1. Ability to gather, process and synthesize diverse information in a dynamic environment, for decisions and actions
2. Ability to negotiate, to obtain what your firm is entitled to, in a fair and principled manner

Pricing is everybody's business. Every individual or group in an enterprise is a reservoir of internal and external information, relevant to pricing decisions. Harnessing these untapped reservoirs create further opportunities to increase your firm's profitability.

Right Details: To spotlight the right details, factors that are internal and external to your firm come into play. Internal clarity in business goals combined with clarity in external forces, expose the high priority details that need to be worked on. A simple rule of thumb: start on the outside and then turn inwards. Focus on establishing your relative value to your customers before determining your relative price.

Right Time: Pricing is a real-rime activity. Forget about price lists that are valid for specified periods. These are valid only if you are the sole player in the market, which for the majority is unlikely. While the benefits delivered can stay static over time, a customer's alternatives- your competition- will be active, making this a dynamic, real-time situation requiring real-time responses. Timely and accurate pricing decisions can only be accomplished when decision-makers have access to real-time information, from all domains- customers, markets, competition, value, your firm, and your business goals. The greater the span and distribution of your firm's resources greater is the challenge in synthesizing relevant information in relevant time.

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