

Pricing strategy - Introduction

Agenda

- Introduction to the course
 - *Learning goals*
 - Literature
 - Learning activities
 - Examination

- Introduction to pricing strategy
 - The importance of price
 - Traditional pricing fallacies (tactical pricing)

- Pricing strategy: An integrated approach
 - The Strategic Pricing Pyramid

Learning goals

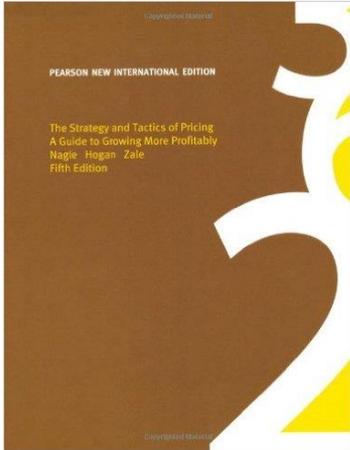
After this course, you should be able to:

- *evaluate* existing pricing policies and strategies in a firm
- *analyze* the role of costs, customer/consumer behavior, and competition in making profitable pricing decisions
- *apply* Economic Value Analysis
- *make an appropriate choice of* pricing techniques based on the information collected/available about customers, competitors, and the general market situation
- *apply* the relevant analytical tools necessary to make profitable pricing decisions

Learning activities

- Discussion questions
 - You need to be active responders to learn...
- Caselets
 - E.g., based on small daily-life examples
- Cases
 - *You have to read and prepare before class!!*
 - Will be uploaded before the lecture
 - Open discussion
- Aligned to the learning goals

Literature



- Textbook Nagle/Hogan/Zale (2014) - “The Strategy and Tactics of Pricing: A Guide to Growing More Profitably” (only English version available)
 - Pricing as strategy, not just tactics
 - Good structure
 - The best textbook on the market, but not the best book...

- Articles as important supplement
 - Special-attention sections will be announced

- Important that you read the book chapters and articles for each lecture!!!
 - Limited time to prepare for exam

Stud.IP

- Lecture: Pricing Strategy (Vnr. 800884)
- Exercises: Übung Pricing Strategy (Vnr. 800885)

Tutorial

- Tutorials (Übung)
Wednesdays, 16:00 - 18:00, ZHG 002

6 Dates:

- 04.11.15
- 11.11.15
- 18.11.15
- 25.11.15
- 02.12.15
- 09.12.15

Examination

- Form
 - 1,5 hour written
 - Open book
 - Based on cases/caselets
 - Learning activities practise for exam
 - Assessing fulfilment of learning goals/aligned

- Date
 - 16.12.2015
 - 16:00 to 18:00
 - VG 2.103 & 4.101
 - Alternate exam date TBA – late April or early May.

Price as part of the marketing mix

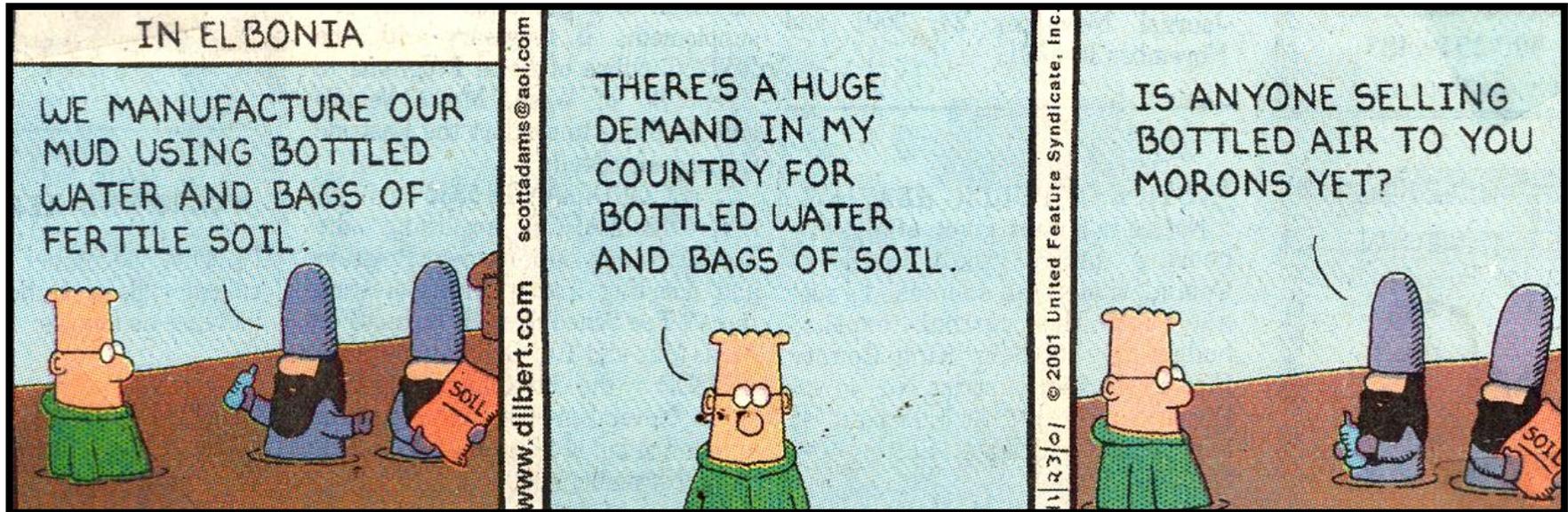
- **P**roduct - creates value
- **P**lace - creates value
- **P**romotion - creates and communicates value
- **P**rice - The "P" of the marketing mix that *captures value* of the good or service being offered to the market



Sales prices for still mineral water in bottles (Germany)

according to <http://www.ao-getraenke.de/>:

Ambassador Naturell:	0,67€/liter
Regensteiner Naturelle:	0,67€/liter
Vittel:	0,83€/liter
Gerolsteiner Naturell:	0,78€/liter
Volvic:	0,83€/liter
Evian Naturelle: (6x1,5 l)	0,86€/liter
Tap water:	0,005€/liter



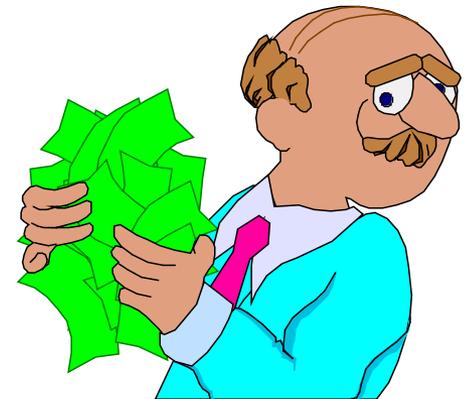
The relevant question is:

Why are consumers willing to pay relatively steep prices for a commodity product?

- They do not always act rational...
- They perceive a **value** from the commodity equal to or higher than the price

The PRICE is important!

- Price is the fastest parameter to change (4 P's)
- Price directly influences profit (ST and LT)
- Quality, healthiness, history are important but price is still one of the most important elements:
 - The Internet provides easy access to (global) price information
 - Purchase cooperation (buying clubs, B2B)
 - Supply management systems to lower costs
 - Trendy to be a smart shopper (bargains)
 - The discount wave - *e.g. groceries, glasses, cars, furniture, plain tickets, building materials...*
- Result: a situation with much focus on the PRICE



Common Perspectives on pricing

1. “Prices should cover our costs and enable us to earn a fair rate of return”

- Implies we can force customers to pay whatever is necessary. We cannot!
- Good guide to product managers and New Product Development

2. “Prices should reflect the customer’s willingness to pay”

- Hidden assumption $WTP = \text{value}$. *Always true?*
- Innovative products
- Perceived value $>$ perceived fair price = WTP
- Implies costs are irrelevant. Value $<$ costs...

Common Perspectives on pricing (cont.)

3. **“Price cutting is a useful marketing tool for gaining sales”**
 - Yes to induce people to try a new product
 - Coke vs. Pepsi - educate loyal users to wait for the price promotion
 - Double-edged sword - easy to imitate, lower profit

 4. **“The purpose of good marketing is to avoid competing on price”**
 - True for some (e.g. Rolex, IBM...)
 - WalMart and Ryan Air has a competitive advantage due to their willingness to undercut competitor prices
- *None of the statements are universally right or wrong*

Tactical pricing orientations

- Pricing is a powerful tool to meet short-term goals
- Pricing tactically to achieve short-term goals \neq achieving greater profitability in the long run
- **C**osts, **C**ustomers, **C**ompetitors are the *key issues*
- The problem is the way managers ask the questions that causes them to make mistakes
- Three tactical pricing fallacies managers fall into:
 - *Cost-Driven Pricing*
 - *Customer-Driven Pricing*
 - *Competition-Driven Pricing*

Cost-based Pricing

Example:

Projected costs and revenues at

Expected Sales =

1,000,000 units

750,000 units

	<u>Total</u>	<u>Per Unit</u>	<u>Total</u>	<u>Per Unit</u>
Direct Variable Costs	\$3,000,000	\$3.00	\$2,250,000	\$3.00
Direct Fixed Costs	\$3,000,000	\$3.00	\$3,000,000	\$4.00
Overhead	\$1,500,000	\$1.50	\$1,500,000	\$2.00
Full Cost	\$7,500,000	\$7.50	\$6,750,000	\$9.00
Revenue	\$9,000,000	\$9.00	\$6,750,000	\$9.00

Profit

\$1,500,000

\$1.50

\$0

\$0

How would you solve this problem?

Cost-based Pricing

Example (cont.):

Projected costs and revenues with price increased with \$1.50 per unit to \$10.50

	<u>Current</u>	<u>5% decline in unit sales</u>	<u>33% decline in unit sales</u>
Price	\$9.00	\$10.50	\$10.50
Unit Sales	750,000	712,500	500,000
Variable Costs	\$3.00	\$3.00	\$3.00
Fixed Costs	\$4.00	\$4.21	\$6.00
Admin. Overhead	\$2.00	\$2.11	\$3.00
Unit Cost	\$9.00	\$9.32	\$12.00
Unit Profit	\$0	+\$1.18	-\$1.50
Total Profit	\$0	\$843,750	-\$750,000

Cost-based Pricing

- **Higher prices are not necessarily more profitable prices!**
- **The financial effect of a price increase depends on the *impact of that increase on sales volume* and on the *impact of changes in sales volume on unit cost*!**

Cost-based Pricing

Example (cont.):

Financial implications of a 10% price cut

	<u>Current</u>	<u>5% increase in unit sales</u>	<u>33% increase in unit sales</u>
Price	\$9.00	\$8.10	\$8.10
Unit Sales	750,000	787,500	1,000,000
Variable Costs	\$3.00	\$3.00	\$3.00
Fixed Costs	\$4.00	\$3.81	\$3.00
Admin. Overhead	\$2.00	\$1.90	\$1.50
Unit Cost	\$9.00	\$8.71	\$7.50
Unit Profit	\$0	-\$0.61	+\$0.60
Total Profit	\$0	-\$480,375	\$600,000

Ask The Right Questions

The COST question in pricing is *not*:

- What prices do we need to cover costs and achieve our profit objectives?

The *right* COST questions in pricing are:

- How much sales gain would be required to profit from a *price cut*?
- How much sales loss would be tolerable to profit from a *price increase*?
- What costs can we afford to incur and still earn a *profit*?

Summing up: Cost-based pricing

- Rationale
 - Price is set to yield a *fair return* over all costs
 - Easier to estimate costs than demand

- Problems
 - Assumes unit costs of production are “sticky”
 - The starting point is the *product*, not value
 - Typically results in *under*-pricing in strong markets and *over*-pricing in weak markets

- Conclusion
 - Cost is important, but it does not act alone...
 - Market response to price must be considered

Customer-driven Pricing

The demands of the market require pricing every product to reflect the customer's willingness-to-pay.



Problems with Customer-driven pricing

- Willingness to pay (WTP) is not given - it is a **variable**
 - situation-specific WTP (e.g., small bag of chips)
 - segment-specific WTP (e.g., ocean view)

- Price is set based on customers' WTP - not on the **value** of the product
 - Satisfaction can be bought by over-delivering on value and under-pricing products
 - Rather than lowering the price to reflect WTP, the firm should try to raise WTP

Problems (cont.)

- **Selling on *price*** is easier than selling on *value*
 - If it pays of to be 'difficult' customers they will *hide the true value* from the sales person
 - Perceived value > WTP = perceived fair price

- For ***innovative products***
 - customers may not yet see the value
 - *or* be uncertain about the value they think they see
 - E.g., photocopiers, mainframe computers and food processors

Ask The Right Questions

The CUSTOMER question in pricing is *not*:

- What price is the customer willing to pay?

The *right* CUSTOMER questions in pricing are:

- What prices can we convince buyers are supported by the *value* to them of our products and services?
- How can we better *segment* the market to reflect the differences in value to different types of customers?

Competition-driven pricing

- Pricing dictated by competitive conditions
- Price is seen as dynamic element in company strategy, but from a *reactionary* perspective
- Price is set based on maintenance of market share or strengthening market share
 - It allows the **“tail to wag the dog”**
- Prices should be *lowered only* when they are no longer justified by *the relative value offered* in comparison with competitors
- Easy to match a price cut
 - *Result: only short-term gain at the expense of permanently lower margins*

Ask the Right Questions

The COMPETITIVE question in pricing is *not*:

- What level of price will enable us to achieve our sales and market share objectives?

The *right* COMPETITIVE questions in pricing are:

- Which shares of the market can we most profitably serve?
- How can we most profitably serve them?

Value-based Pricing

- Maximize the difference between the *value* created for the customer and the *costs* of the company to provide that value
- Reverse the process - customers are the starting point

The Cost-based Pricing Process

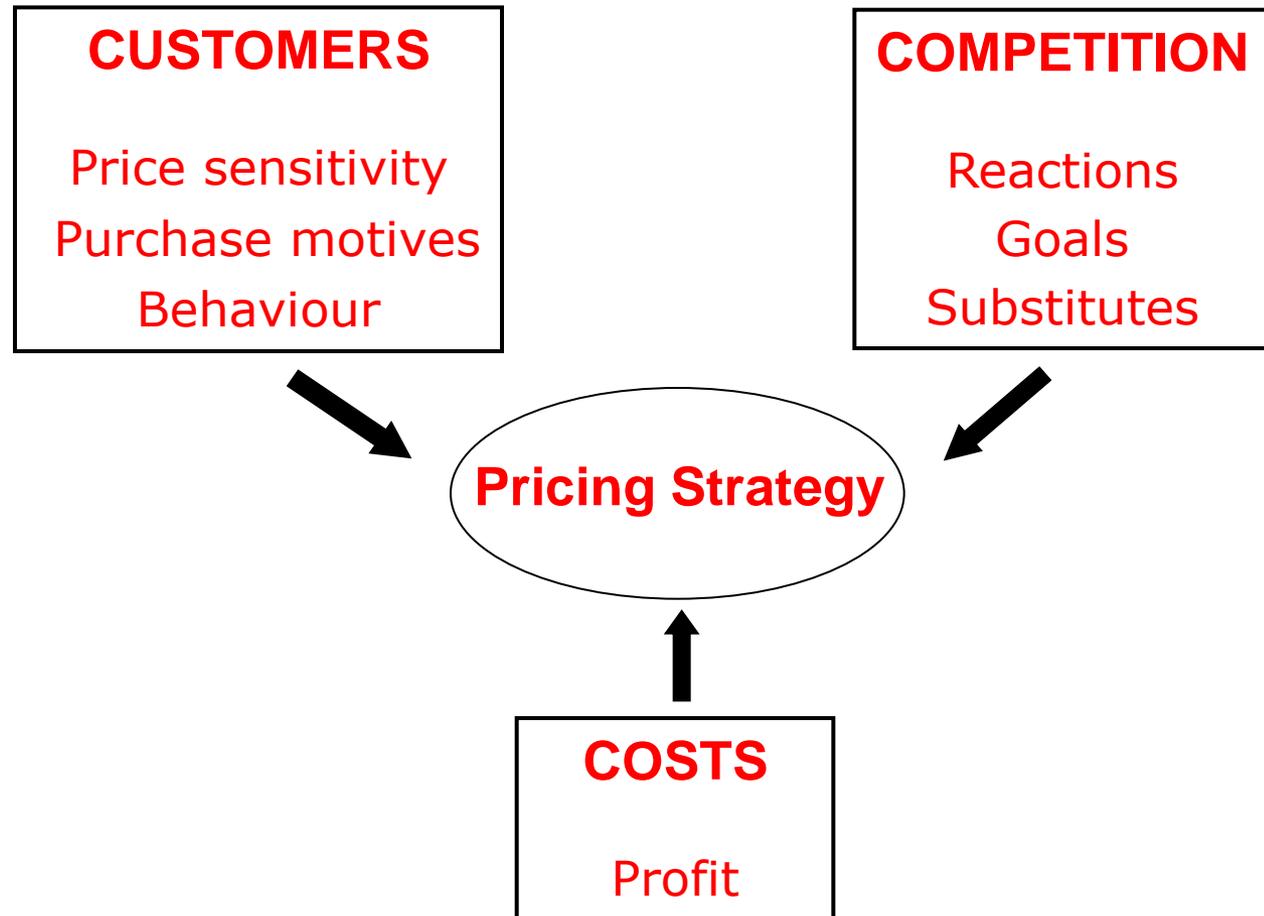


The Value-based Pricing Process



The three C's of pricing

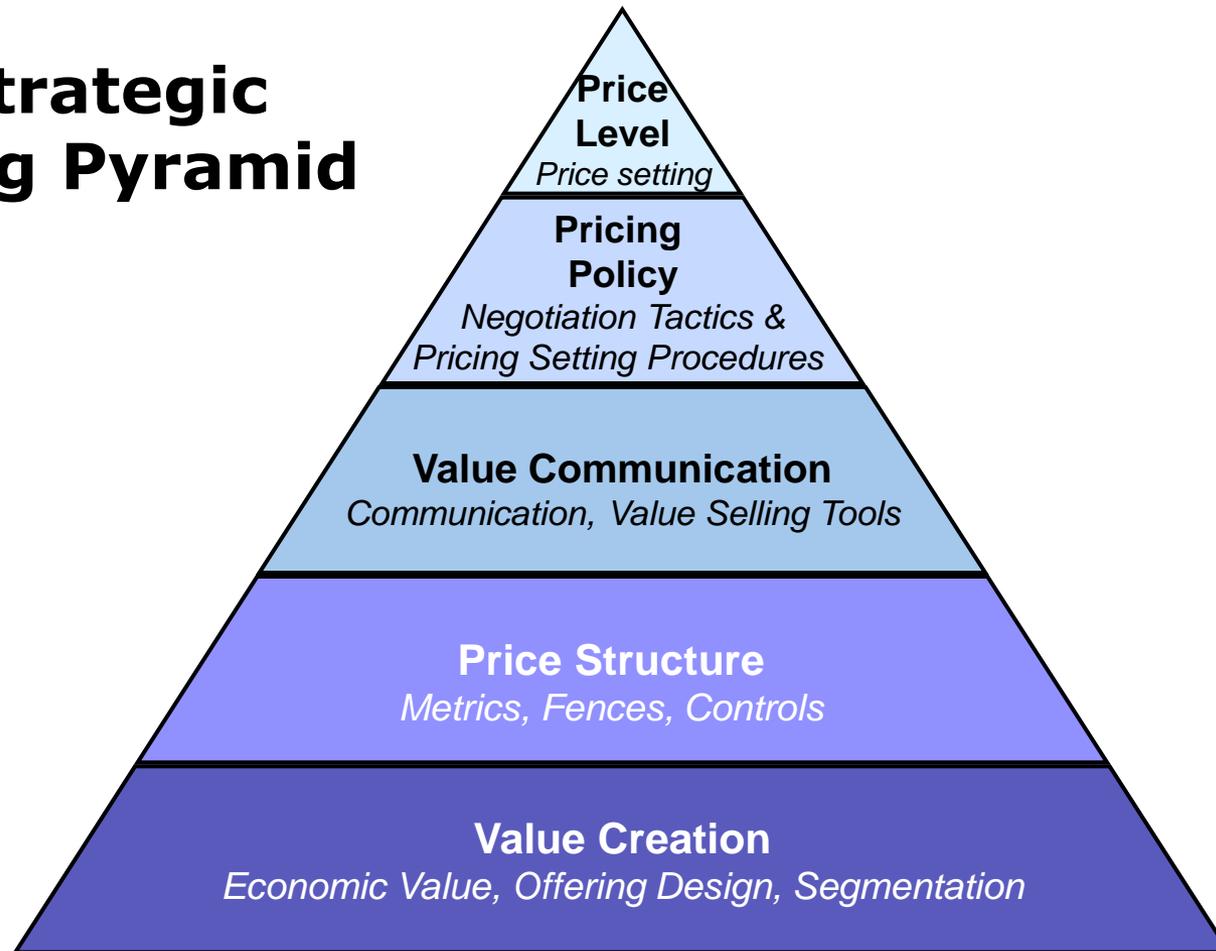
Effective pricing strategies should be based on 3 factors



Pricing strategy: An integrated approach

- Pricing strategy is about *proactively* managing customer behaviour rather than simply adapting to it
 - “What has changed to make the price unacceptable and how can we fix it?”
- ? Why might customers tell you that the price is too high?
 - prices in fact are too high relative to competition
 - customers are unfamiliar with differential value
 - the product might not meet customers’ needs
 - they are trying to see if they can get a lower price
- Margin erosion is not always caused by price issues
- Companies must look beyond the *pricing symptoms* to diagnose flaws in their broader pricing strategy

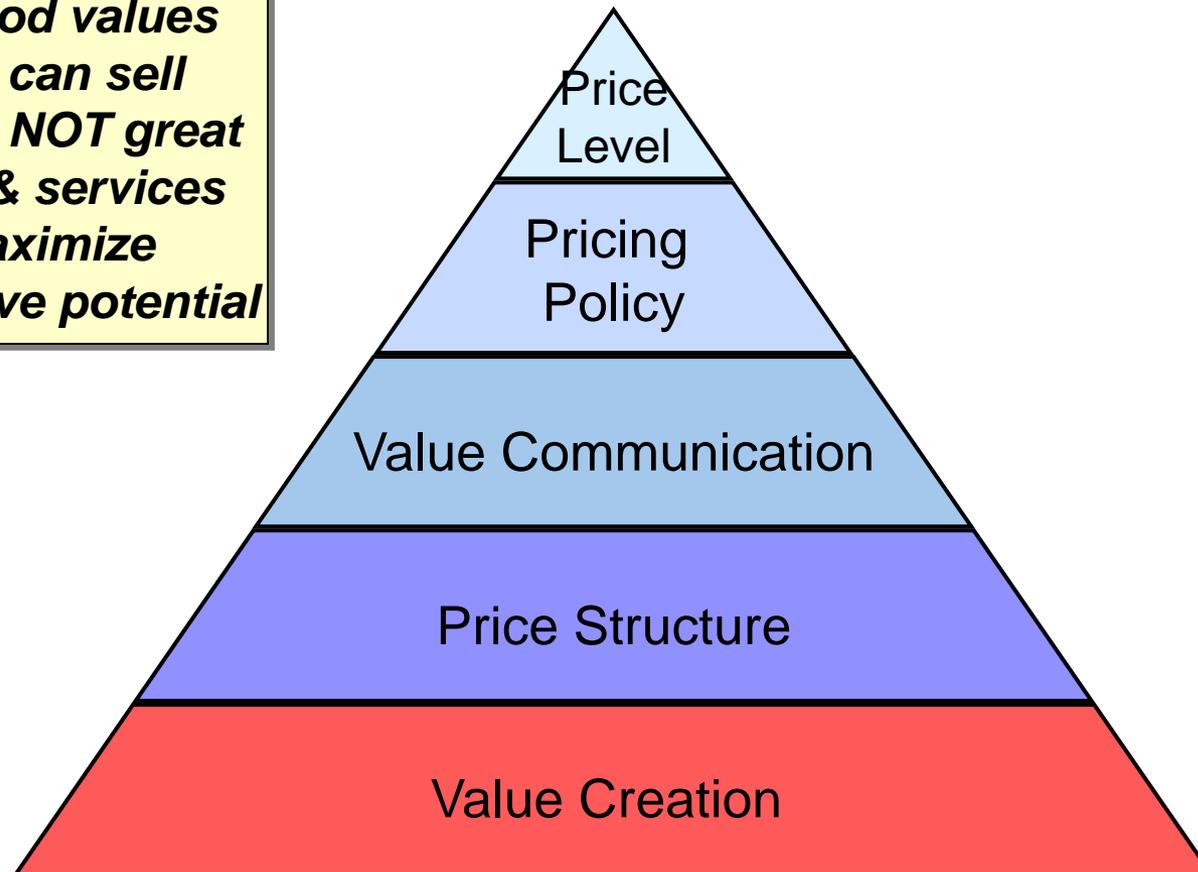
The Strategic Pricing Pyramid



**Price is just the “tip of the iceberg”
of a profitable pricing strategy**

The Pricing Strategy Pyramid

***Create good values
that you can sell
profitably, NOT great
products & services
that maximize
your creative potential***



Value creation



- Value creation requires
 - a deep understanding of customer needs and how it creates value for them
 - a clear understanding of which customer segments are high-value segments

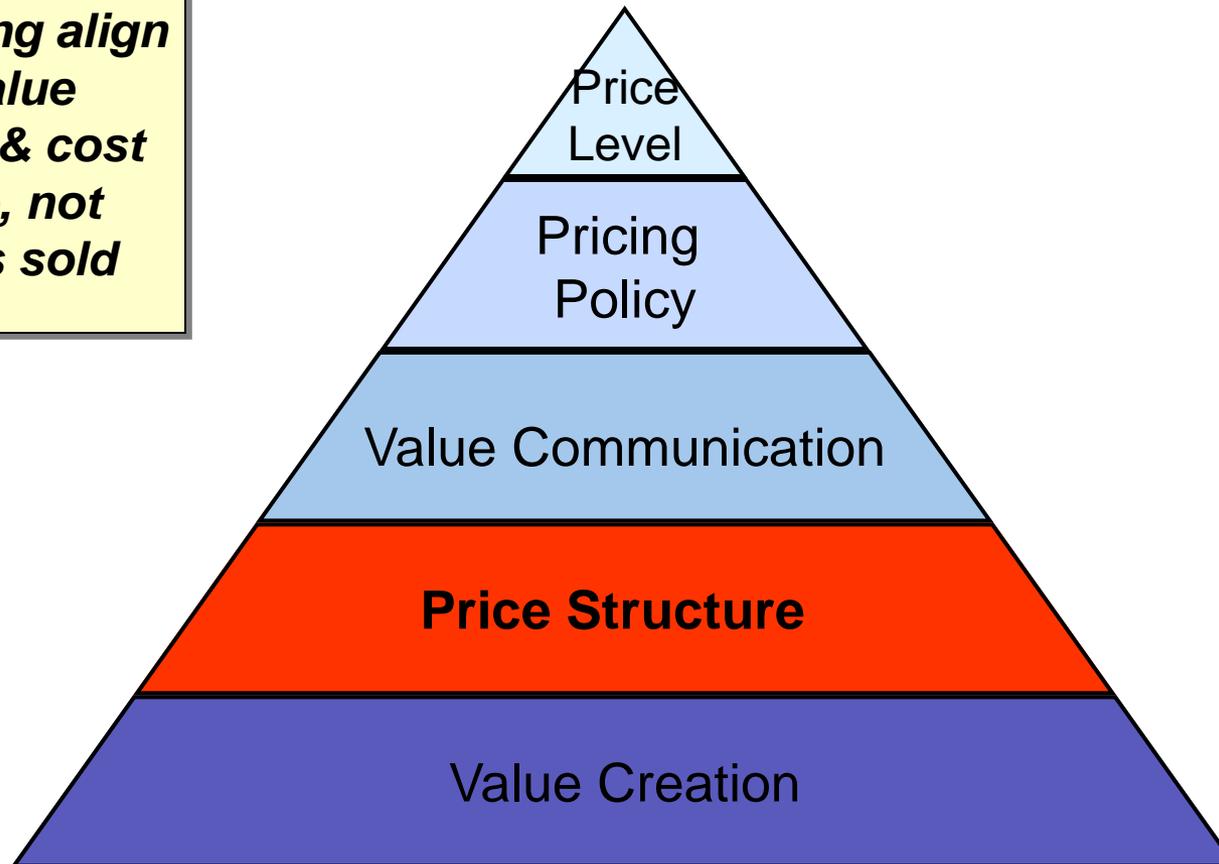


- Value creation is not the same as “creating great products” or “maximizing customer satisfaction”
 - Customer delight...
 - When price is factored into the decision, many customers are willing to give up some delight *in exchange* for lower prices



The Pricing Strategy Pyramid

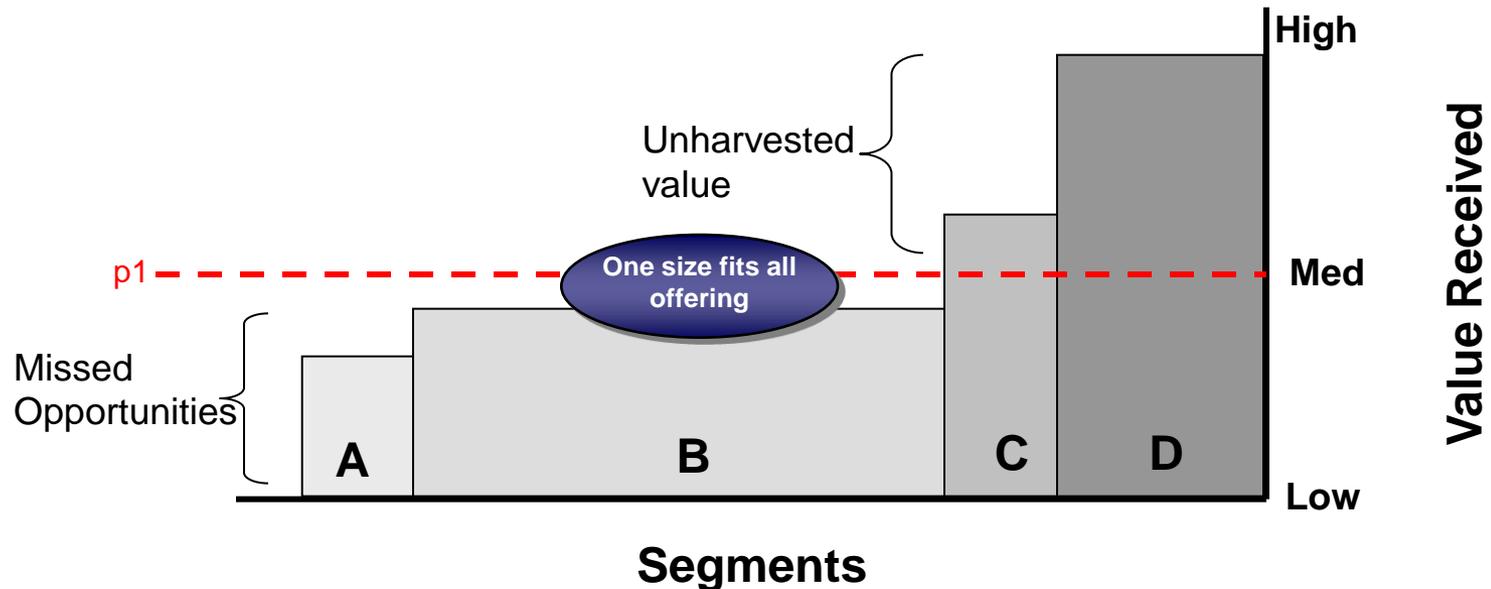
*Make pricing align
with value
delivered & cost
to serve, not
products sold*



Price Menu

- Provide opportunities to trade up *or* down to different levels of value received for different prices
- Price Menu is the centre of effective price structures
- **Fences**
 - The rules and policies that enforce boundaries between price segments
 - E.g. non-refundable tickets, requiring a weekend stay, eat before six o'clock, ocean view or not...
- **Metrics**
 - The terms of exchange, the units in which the customer receives value and pays for that value
 - E.g. per haircut, per 10 min solarium, pr 100 gr

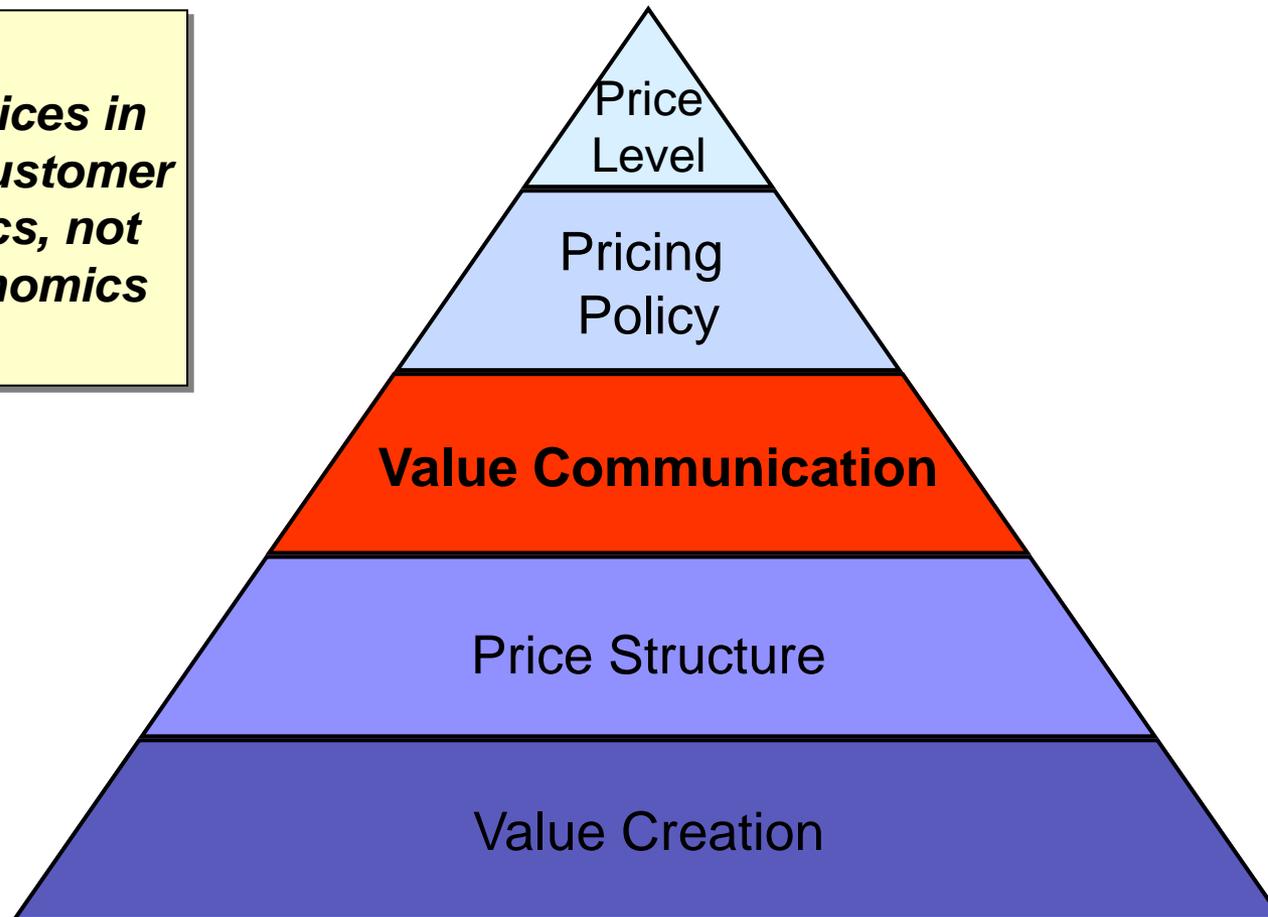
Bundled offerings miss opportunities



The same product can deliver different value depending on the customer. An average price will result in over-pricing for some and leaving money on the table for other segments!

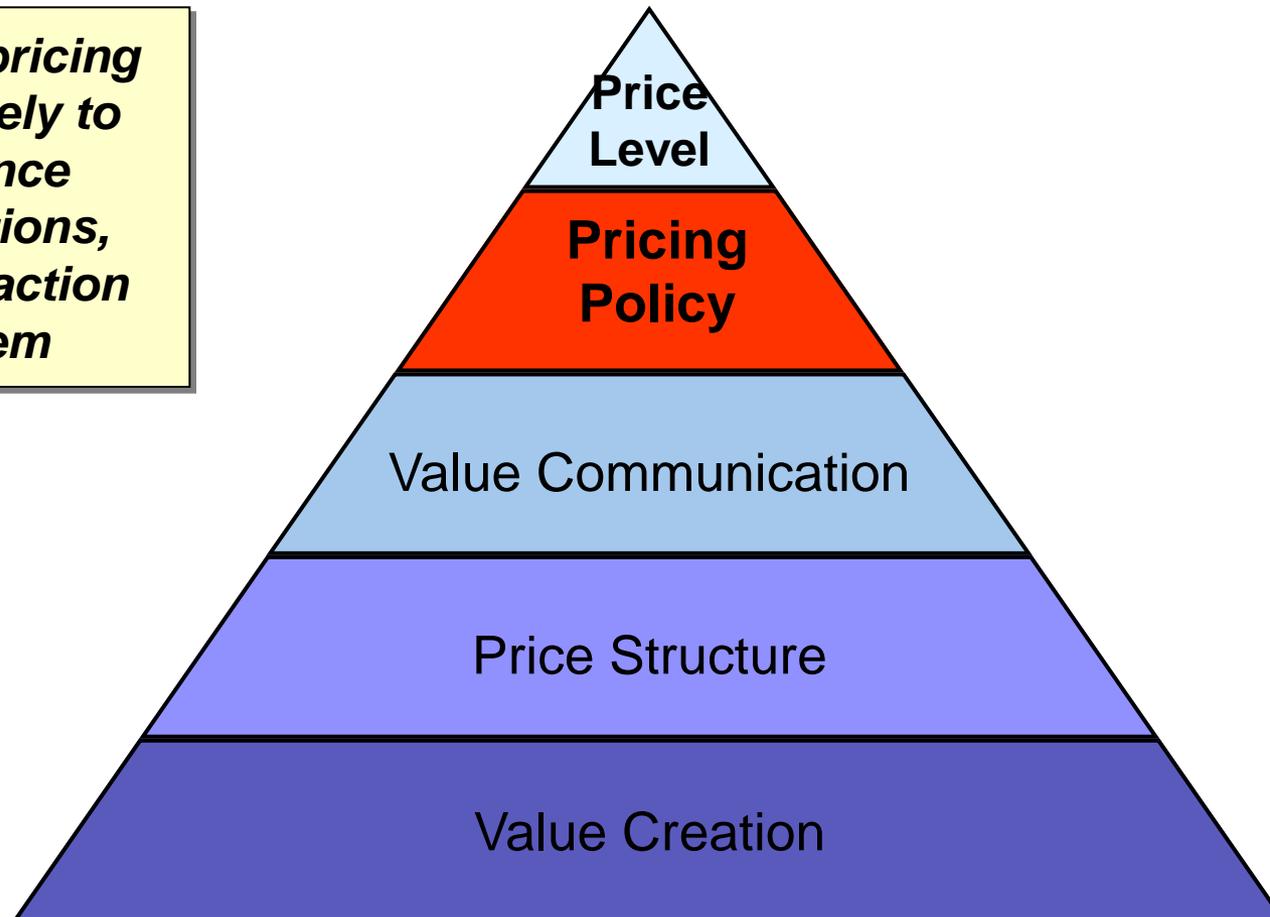
The Pricing Strategy Pyramid

Justify prices in terms of customer economics, not your economics



The Pricing Strategy Pyramid

Manage pricing proactively to influence expectations, not in reaction to them



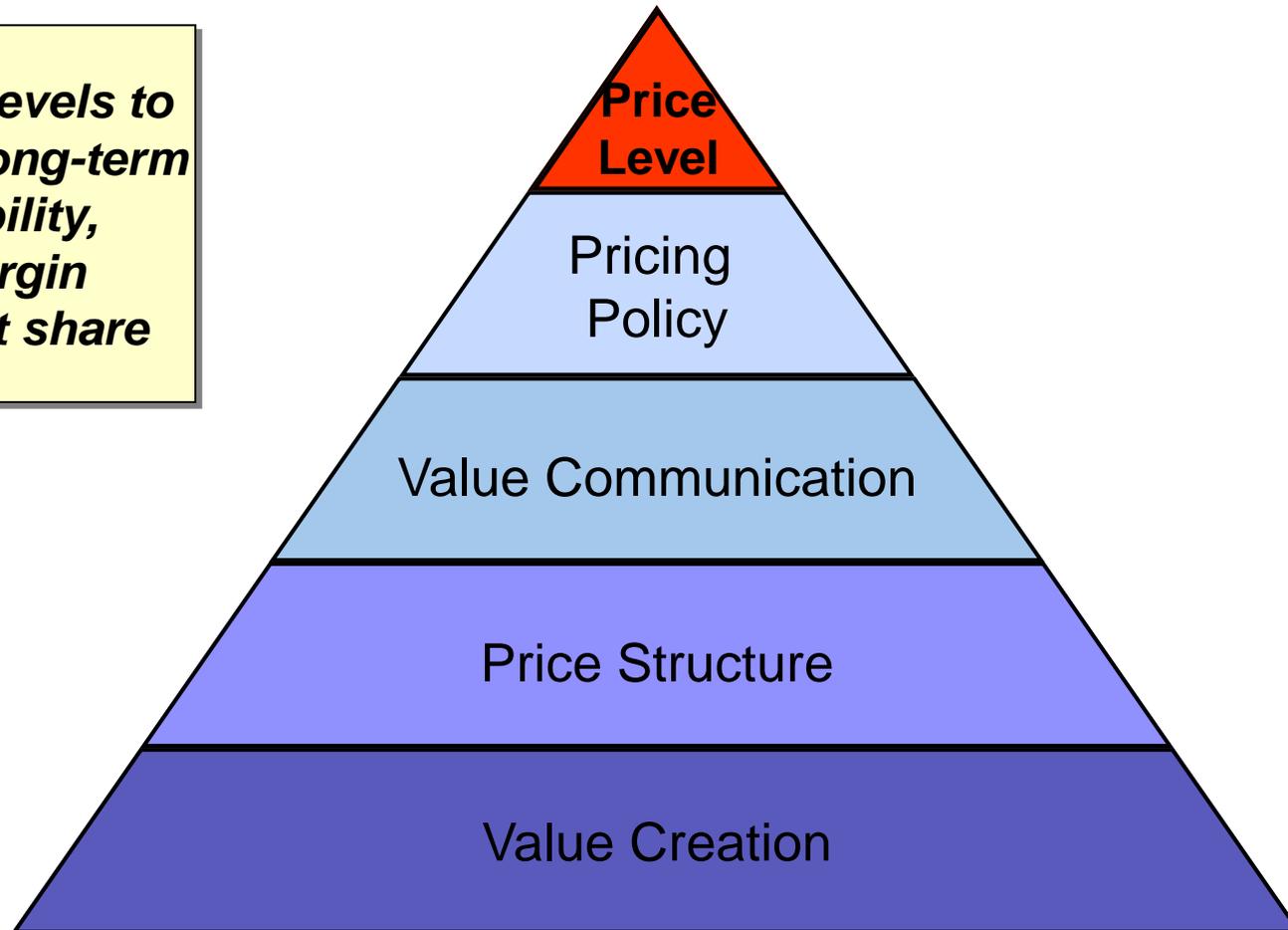
Diagnostic tools

- **Price banding**
 - tracks the variability in pricing across e.g. products or customer accounts
 - identifies outliers according to pricing policy
 - helps manage the variability of overall prices

- **Price waterfalls**
 - tracks the types and depth of *discounts* accounts typically receive
 - identifies pockets of money leak from pricing policy

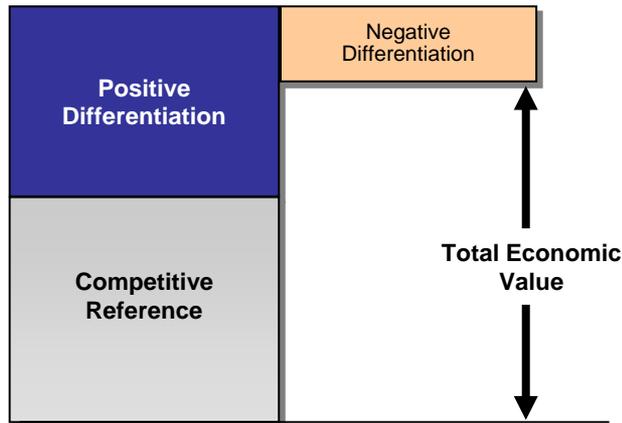
The Pricing Strategy Pyramid

Set price levels to maximize long-term profitability, not margin or market share



The Price Setting Objective

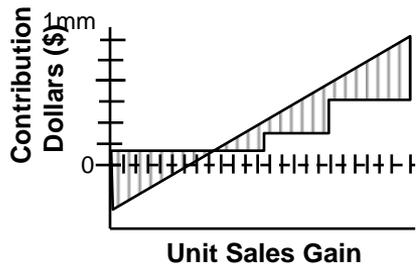
Value Estimation



Price Sensitivity Factors

1. The Fairness Effect
2. The Perceived Risk Effect
3. The Switching Cost Effect
4. The Difficult Comparison Effect
5. The Price-Quality Effect
6. The Expenditure Effect
7. The End-Benefit Effect
8. The Shared-Cost Effect
9. The Reference Effect
10. The Framing Effect

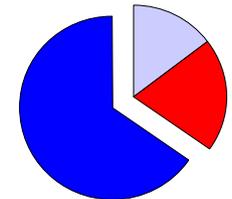
Breakeven Sales Analysis



Key Question:

How to determine the price that will capture the value of our offering and maximize profitability?

Strategic Objectives



- Segment Penetration
- Total market share
- Cost advantages

Important information for next time

For lecture 2, please read:

- Nagle et al., Ch. 2 (The Role of Value in Pricing & How to Estimate Economic Value)
- Nagle et al., Ch. 4 (Value Communication)
- Anderson & Narus (1998) (provided in Stud.IP)
 - Special attention p. 53-60