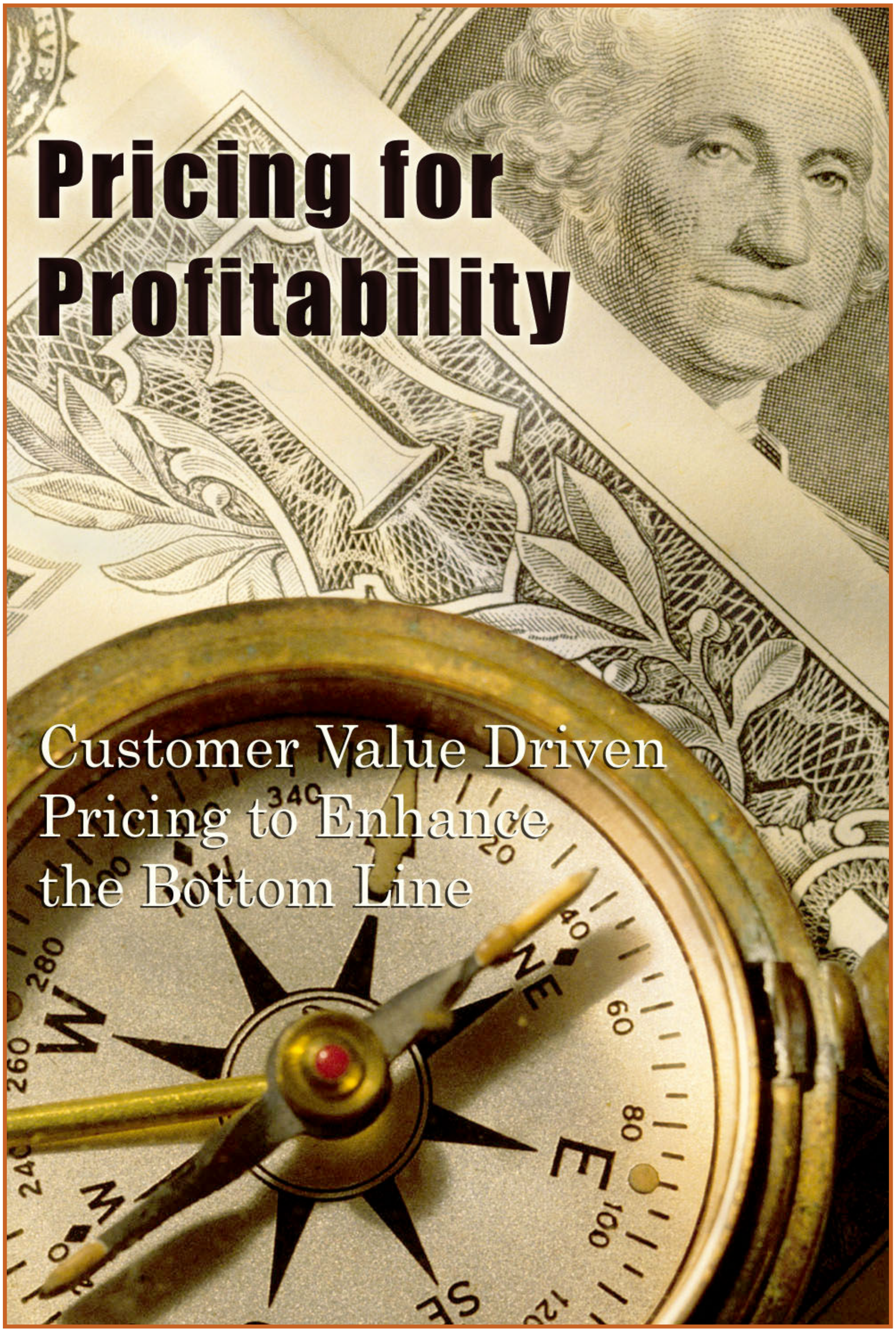

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Pricing for Profitability

Customer Value Driven Pricing to Enhance the Bottom Line

In business, information is king.

Having a detailed understanding of the needs and values of your customers in the context of the overall competitive marketplace allows you to develop effective marketing strategies, improve your competitive advantage, and increase your company profitability. Developing a system for collecting and analyzing marketplace intelligence is what Pricing for Profitability is all about.

This paper will explain Pricing for Profitability and show examples of marketing issues that the procedure can address. Types of information that are provided by this approach will be shown, along with how this information is used to develop marketing strategies. The last section enumerates some items that will need to be addressed when undertaking a Pricing for Profitability analysis.

What is Pricing for Profitability

Pricing for Profitability uses information collected from customers and prospects to drive models that predict the business impact of potential pricing decisions. Through the use of integrating company's cost structure, the modeling focuses on profitability rather then sales.

Maybe the best way to explain Pricing for Profitability is to list some specific marketing issues that this technique addresses. What follows are examples of questions that Pricing for Profitability is designed to answer:

- How do I insure that my pricing decisions will support the overall long-term positioning of my product?
- For a specific offering in a category, at what price will I maximize the overall profitability for the entire company offering in the category?
- When introducing a new product, or an extension of an existing product, what will be the impact on existing products?
- How can I develop and price bundles of products/services to enhance overall profitability?

- How do I tailor pricing and bundle offerings to meet the unique needs of my most valuable customers?

- For branded products, how can I effectively compete with value/generic offerings?

- How do I determine the specific benefits that customers are willing to pay more for?

- What will be the impact of competitive responses to my new offerings and how would that change my optimal offering/price?

- If market constraints force downward pressure on prices, how do I price my offerings to minimize the impact on overall positioning and long-term profitability?

Answers to these questions will give your company the kind of marketplace intelligence that can be used to develop marketing strategies that will increase your bottom line.

Many companies use historical data -- either internal databases or scanner-type data sources -- to determine the impact that price has on volume. While these databases produce very accurate share numbers, their ability to isolate the impact of price on sales is limited. Problems arise when trying to control items such as availability, consistent pricing in all locations, and competitive counter-pricing and promotions. In addition, you can only test currently available products. Finally, it is not a good idea to use the marketplace to test changes to prices. Price not only controls the amount the customer has to pay for your service, but also price effects the value customer's place on your services. By changing prices in the marketplace, even in limited markets, you can weaken the value customer place on your products/services.

In the Pricing for Profitability procedure, historical data is used to calibrate the models so that they reflect current market conditions, but primary customer information is used to actually model changes to price and choice of new product/service offerings.

COMPONENTS OF PRICING FOR PROFITABILITY

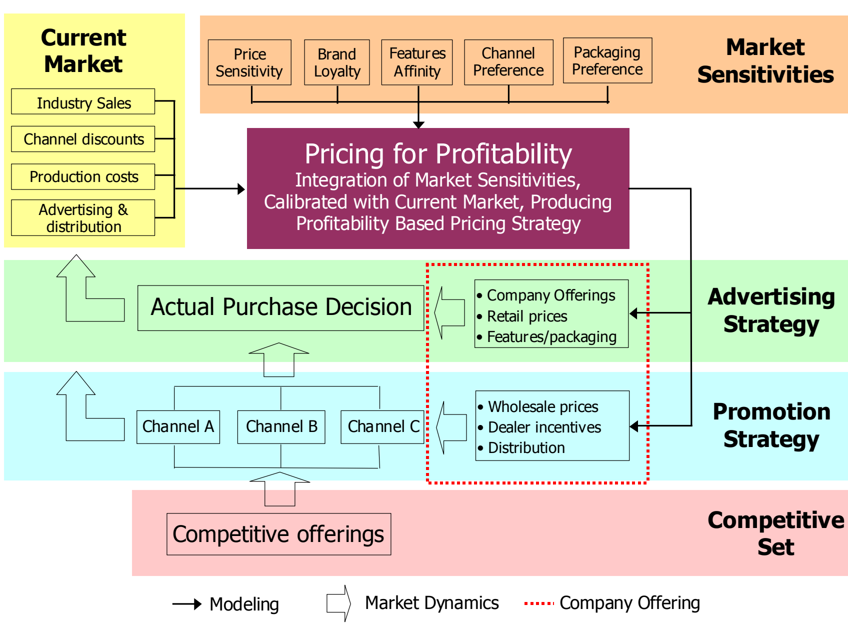
A Pricing for Profitability study involves being able to integrate (1) how the market will react to changes in your marketing mix, price, offering, and so forth (2) current market conditions, and (3) your company's cost structure. Combining and integrating this information will allow your company to develop marketing strategies that satisfy the needs of the marketplace and enhance your firm's overall profitability. In a Pricing for Profitability study the following items will need to be considered:

- How the market will react to changes in price, brand, product/service features, channel and packaging
- Current industry sales and competitor shares
- Company and competitive offerings, including both new and existing offerings with specific pricing
- The impact that any new offering will have on your existing company portfolio
- Company variable costs for all offerings
- Channel margins
- Current and proposed levels of advertising and distribution

To show how these pieces of information come together, consider the components of Pricing for Profitability shown in Figure 1. The key to this approach is to collect and analyze market sensitivities. These sensitivities measure how the marketplace values the current offerings and how they would react to changes in offerings and prices. The collection of market sensitivities is typically done through conducting primary research. In such a research study, a controlled experiment is designed and administered to potential customers. Through the controlled experiment, questions are asked in such a way as to be able to predict how customers would react to changes in your offering as well as competitive offerings. It is very important when collecting the market sensitivities that you do so in a way that parallels the way customers normally purchase. This insures that the results can be linked up to existing market shares and sales and will allow you to build a financial model to help optimize your bottom line.

FIGURE **1**

COMPONENTS OF PRICING FOR PROFITABILITY



Once the market sensitivities are researched and analyzed, they are integrated with current market conditions to insure that forecasts are grounded in current market sizes. In addition, variable costs are integrated into the forecasts so all outcomes are reported in terms of contribution (unit sales – unit costs). The remainder of the analysis is accomplished through testing different market scenarios, based on certain competitive offerings and prices and your company's level of advertising and distribution. The user interface for this procedure is referred to as a market response simulator. This tool allows the user to see the impact on profitability associated with:

- changes in price for a new or existing company or competitive offering, or
- the introduction or removal of a new company or competitive offering or packaging.

The number of combinations of changes to price and offerings is typically very large; therefore, the market response simulator needs to have both graphing and optimization capabilities to aid in pattern recognition. The simulator graphs shown in the next section are typical of the types of information that can be helpful in optimizing your offering.

What do You Learn from Pricing for Profitability

To help you better understand how Pricing for Profitability can improve your marketing strategy, let's consider a simple case where a company is launching a new offering and wants to know the optimal price. The optimal price is the price for the new offering that provides the highest contribution for the entire company offering. After collecting and analyzing the market sensitivities, the model first produces market shares based on only existing products and current prices. These shares are calibrated against known market shares to adjust for any sample bias and to insure that any projections are based on current market shares and sizes.

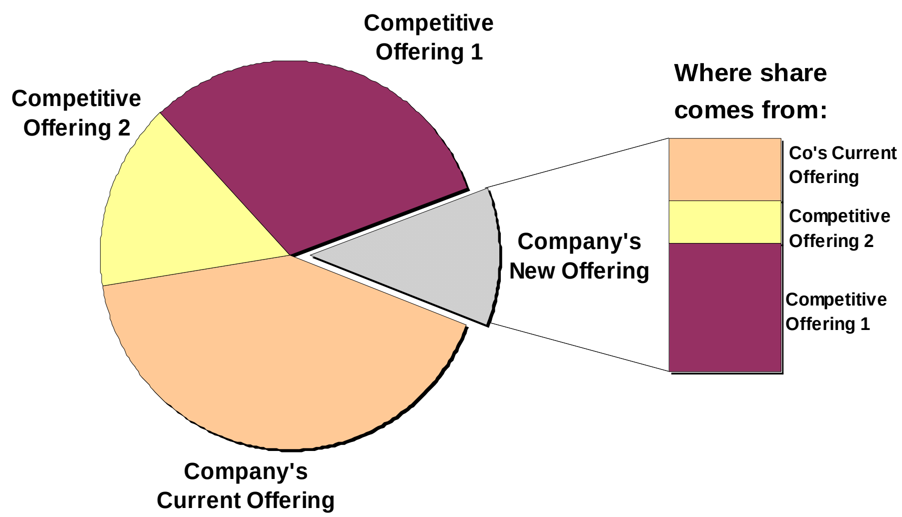
Next, using the simulator, we introduce the new offering at a specific price. Based on the market sensitivities, the model will produce updated market share numbers.

> Obviously, knowing how much potential this new product has is very important, but just as important is that the model can also tell us where that business will come from.

The interaction that the new offering has with the rest of the company's offering is critical in the determination of the new offering's optimal price. The pie charts in Figure 2 show an example of how much share the new offering might get, but also indicates the other critical information that is needed, where this share will come from. In the example shown in Figure 2, the current company offering is the market leader, but their proposed new offering would get most of its business from competitive offering 1, which allows a lot of flexibility in pricing for the company's new offering.

FIGURE **2**

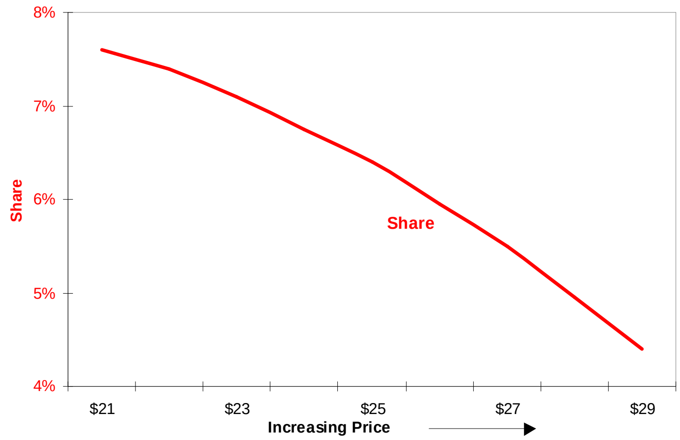
UNDERSTANDING WHERE SHARE COMES FROM



In these types of studies, multiple price points are tested for the new offering as well as certain other offerings in the marketplace. Using these multiple price points, the model develops price elasticity curves that show the expected share at different price points. The chart in Figure 3 shows that at $21, projected share is 7.5%, and if price were raised to $29, share would drop to 4.5%. Does this tell us the optimal price? Clearly it does not, it only indicates that the lowest price provides the highest share.

FIGURE **3**

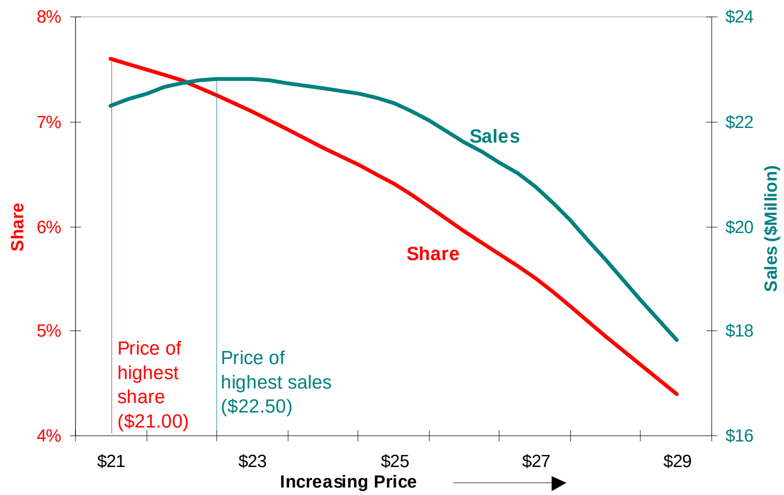
PRICE ELASTICITY CURVE



Given forecasted share, along with specific selling prices, a curve can be developed which shows potential sales at different prices. The chart in Figure 4 shows such a sales curve. It indicates that the selling price for the new offering that maximizes sales is $22.50. Is this the optimal price for the new offering? No it's not, because this does not factor in the impact of the margin for the new offering.

FIGURE **4**

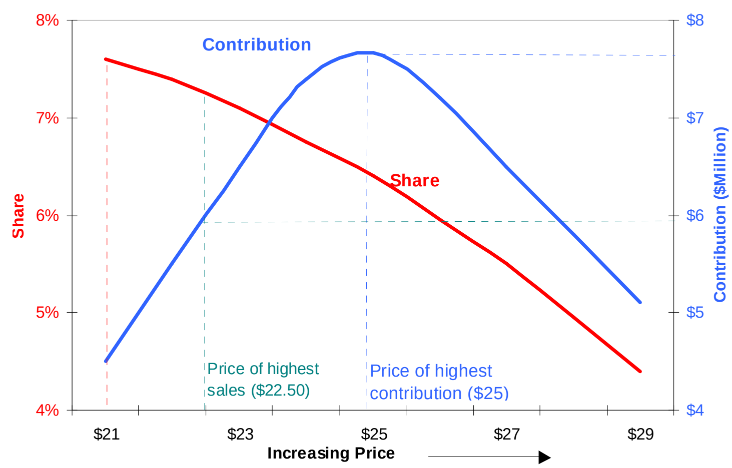
Optimum Price Based on Sales



The chart in Figure 5 shows a contribution curve (selling price less unit cost). This shows that the optimum price to maximize contribution for the new offering is $25.

FIGURE **5**

Optimum Price Based on Contribution

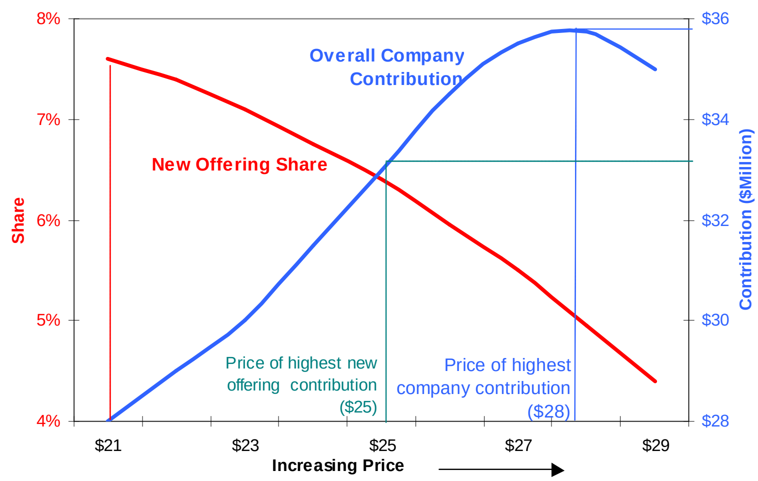


It's interesting to note that even though share drops from 7.5% to 6.5% when price is raised from $21 to $25, contribution increased from $4.5 million to over $7.5 million. So, is this the optimal price for the new offering? No, we must still consider the impact of the new offering on the overall company contribution.

One final chart should be developed which allows the new offering's price to change, but this time show the impact on the overall company contribution. Figure 6 shows what the total company contribution will be at various price levels for the new offering. This chart indicates that the optimal selling price for the new offering should be at a higher price of $28. At this price cannibalization is minimized with the current offering and company contribution is maximized.

FIGURE **6**

OPTIMUM PRICE BASED ON OVERALL COMPANY CONTRIBUTION



Just to review, in the above example a company was planning to launch a new offering and wanted to know the optimal price. Using the market sensitivities, a price elasticity curve was developed for the new company offering which indicated expected sales at different selling prices.

The key findings indicated that the company would be better off raising the price and lowering their sales potential for the new offering in order to maximize the company contribution and minimize the cannibalization with their market leading current offering

WHAT ELSE CAN I DO WITH PRICING FOR PROFITABILITY?

This initial example is typical of how Pricing for Profitability can help companies strategically set prices in a way that optimizes the overall company portfolio. The real power of this approach is that it allows you to do scenario testing on a complete category and forecast the financial impact on your entire offering. Besides optimizing price changes for new and existing offerings, this technique can be used for a host of other strategic marketing issues. Below are a few of these issues, along with how Pricing for Profitability can help your company address them.

- **Positioning** – New product/service introductions are essential to a company's on-going offering in a category. However, it is vitally important that the new offerings target the right segments and draw more business from competitive offerings. Using Pricing for Profitability to set prices and to determine necessary features for all of your offerings will help you rationalize your product portfolio and maintain the proper positioning for all of your products/services and maximize your overall contribution.

- **Package offerings** – In many cases, new offerings are not really new, but rather an existing product or service that has been re-packaged. Combining multiple product/service offerings can expand your customer base and significantly increase revenue and contribution. Debundling offerings allows your company to effectively compete on price without eroding product positioning and driving up costs. Pricing for Profitability allows you to test different packaging and debundling scenarios. It evaluates bundles of features based on consumer needs and willingness to pay, and forecasts where the packaging business will come from and how much additional contribution it will generate.

- **Target Segments** - Since different customers exhibit different behavior (some tend to be price sensitive, others more brand loyal and still others have specific feature or channel affinities), it is critical to develop targeted strategies designed to meet the unique needs of your most valuable customers. For example, customers with very specific feature affinities might not be that price-sensitive, whereas high volume customers may be more price-sensitive. Pricing for Profitability addresses this by individually modeling loyal and high volume customers and developing market sensitivities around them; thus, the scenarios tested use these very target market sensitivities to develop the optimal pricing strategies.

- **Value offerings** –When competitors drop their prices and your sales department is pushing for a similar response by your company, how do you respond? You know from prior experience that lowering prices can lead to a spiral of lower margins for everyone in the industry. Pricing for Profitability can help by allowing you to test potential market scenarios that leverage packaging/debundling options or test different discounts or incentives that maintain the product/service's base price while addressing short-term competitive pricing.

Successful Pricing for Profitability Studies

To help your company get the most out of a Pricing for Profitability study, the following key items need to be considered:

- **Studies Needs to Involve Senior Management and Key Stakeholders**

  Successful studies link corporate strategy and tactics. It is essential to have full senior management support and their close involvement in the development process. In any type of pricing study, it is also essential to have strong buy-in from key stakeholders from marketing, finance, production, and distribution. In addition, you must insure that the channel is open to implementing any proposed changes to price.

- **Critical Step in Modeling is the Design**

  Without properly designing the research, the results will not be able to answer the key questions. A very important step in completing a Pricing for Profitability study is to review with management all possible scenarios to be considered. These scenarios include:
  - which new offerings should be considered,
  - what price ranges and possible incentives or promotions for new and existing offerings should be considered,
  - which products/services should be considered for removal from the market, and
  - packaging and debundling options.

- **Using the Right Research Technique Is Important**

  There are different research methodologies used in pricing research. Some work better than others. The key to setting up a research survey for a Pricing for Profitability study is to insure that the questions are asked in a way that matches the actual customer purchasing experience. Typically, a custom-designed discrete choice study works best. This technique allows all the major offerings in a category to be available and have their own unique features and prices. It is critically important for you to be able to test a complete competitive set -- allowing all of the major offerings in a category to be available -- in order to link the survey results into a financial model capable of doing scenario testing and market simulation.

- **Survey Instrument is a Balance Between Research Objectives and Respondent Task**

  While it is very important to compile all the possible marketing scenarios that should be tested, trying to ask too many scenarios may be confusing to the survey participant. In order to get actionable information, the survey participants must be able to fully understand what is being asked of them. In addition, the survey exercise needs to parallel their regular purchasing behavior and allow choices to be made as they would normally be made in the marketplace.

- **Survey Results Need to be Adjusted for Level of Advertising and Distribution**

  Advertising and distribution must be considered when developing marketing strategies. In a research study, survey participants have complete knowledge of all the offerings and prices in the marketplace, since the survey presents all this information to them. In the actual marketplace, all consumers do not have this complete knowledge and products/services may not be universally available. Therefore, it is important that the forecasts be adjusted to reflect current and proposed levels of advertising and distribution. In most cases, these levels are not simple percents, but rather are detailed estimates by channel and market and need to be phased in over time.

Conclusions

Using primary research to develop measures of price sensitivity, Pricing for Profitability integrates the control and flexibility of a research survey with the accuracy of current market shares and combines these into a financial analysis tool that can evaluate alternative market scenarios. This approach is based on sound economic theory and provides the necessary information needed to make strategic pricing decisions. Strategic pricing decisions are those that focus on a company's overall bottom line enhancement.