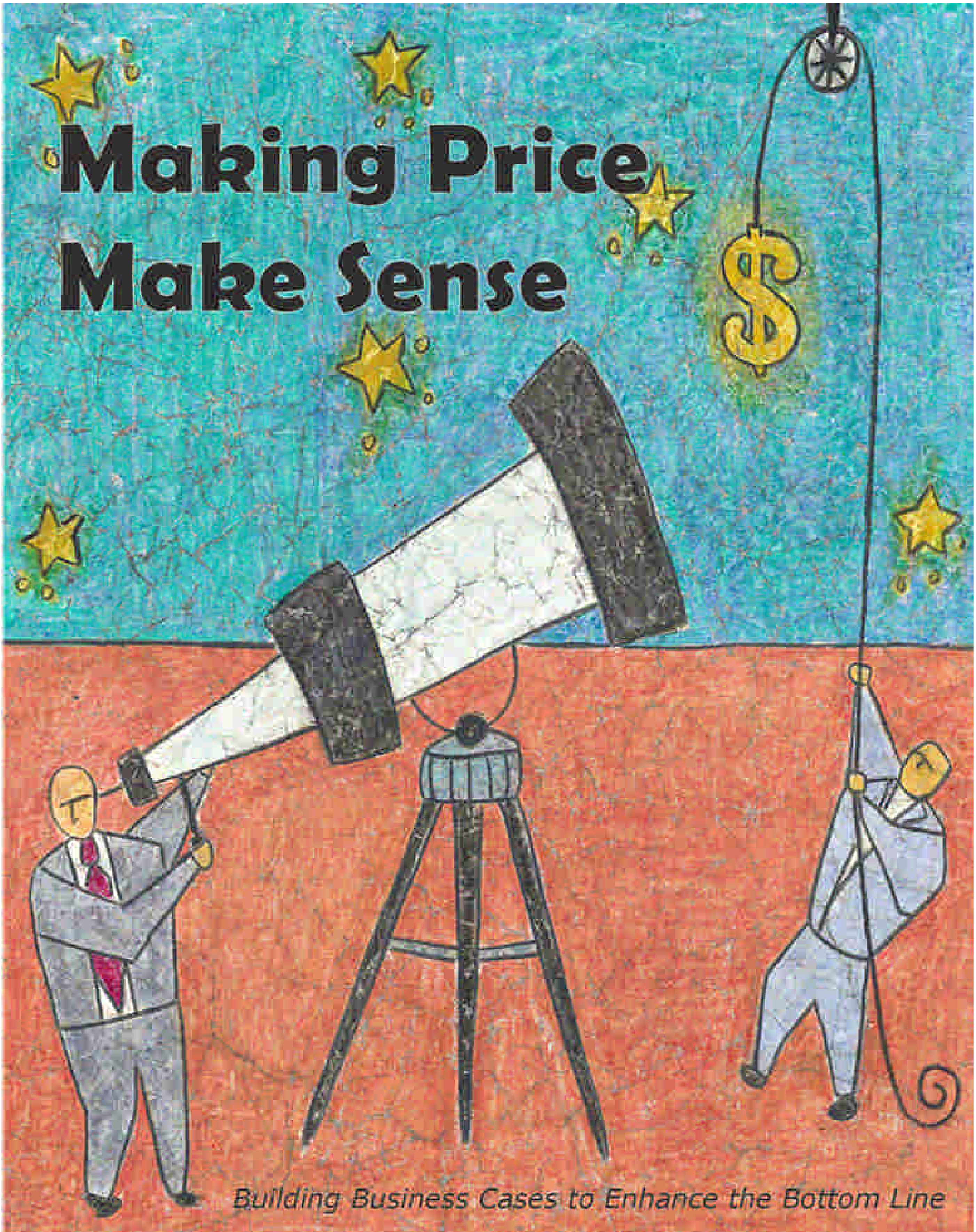
Making Price Make Sense



Building Business Cases to Enhance the Bottom Line

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Considering all the elements of the marketing mix, price has the most direct effect on profitability. Price is also the most easily controlled element of the marketing mix. Yet, properly setting prices and measuring their impact on the entire organization is seldom done strategically, or in a manner that optimizes long-term market share and profitability. Pricing strategy must focus on overall category profitability and consider the strategic implications of price changes on brand equity, product positioning, product cannibalization, and competitive response. In addition, the impact of price changes needs to be evaluated in the context of both return on marketing investment and impact on the remaining elements of the marketing mix.

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Marketing departments traditionally provide insights into market acceptance of new offerings and prices but have limited impact on building business cases for changing prices. At the 2004 AMA Research Conference, Sally Dancer, Senior Practice Expert, McKinsey & Company indicated that CEO's want marketing to become full business partners. She went on to challenge marketing to be more of an integrator to better develop business cases that directly link marketing initiatives with profits.

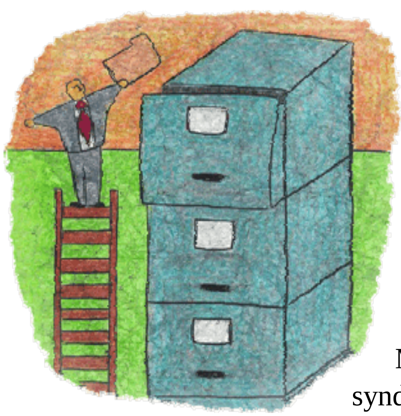
Based on what Ms. Dancer and others are saying, there is a big incentive for marketing departments to expand their traditional role of providing insights and become a more active partner in building more of a financial model, especially for developing pricing strategy. In order for marketing departments to make the transition from simply providing business insights to developing full-blown business cases, they need to redesign their research studies to reflect actual marketplace behavior, incorporating inputs for all marketing mix items.

CURRENT PARADIGMS

"To develop a meaningful pricing strategy, marketers must integrate customer input on a complete competitive marketplace with all the other business variables that impact pricing decisions."

Traditionally, marketing's role in developing pricing strategy has been to understand market acceptance of price changes to new and existing products and services. Through the use of conjoint experiments, researchers have learned about the trade-offs between brand, price, features, and channels, in order to leverage customer value propositions to develop pricing strategies. While this is valuable information, this type of research approach does not do a good job of replicating the complexity of current marketplaces and extracting the real impact of price and price sensitivity. For example, conjoint creates an artificial marketplace that forces competitive offerings to contain similar features and prices, when, in reality, for many product and service categories competitive offerings have features and prices that are unique to a single brand. In addition, conjoint experiments typically underestimate the impact of price and they do not provide price sensitivity estimates by individual brand, but rather only in aggregate.

Pricing research typically focuses on a customer's preference for specific offerings and reports findings in terms of percentages. Given the lack of a complete set of competitive offerings and prices in the marketplace, it is difficult, if not impossible, to align preference measures with current market conditions and then accurately project the marketplace impact of changes in the marketing mix, especially in financial terms. Furthermore, this procedure tends to lower the value of research because management can only make decisions on a relative "percentage" basis, rather than on an absolute "profit" basis. To develop a meaningful pricing strategy, marketers must integrate customer input on a complete competitive marketplace with all the other business variables that impact pricing decisions.



Many organizations make pricing decisions based on secondary or syndicated data sources, internal costs, or competitive factors. While each of these items needs to be considered, profit potential and brand equity can erode significantly with strategies based on these items alone. Some companies get input on customer's willingness to pay from measurements based on observed marketplace behavior. Such measurements are limited because they only reflect existing product and service characteristics. In addition, observational data doesn't involve controls, so it can be difficult to separate the trends and sensitivities in the observed data from external items such as product availability, promotion and advertising for both the company and competitors.

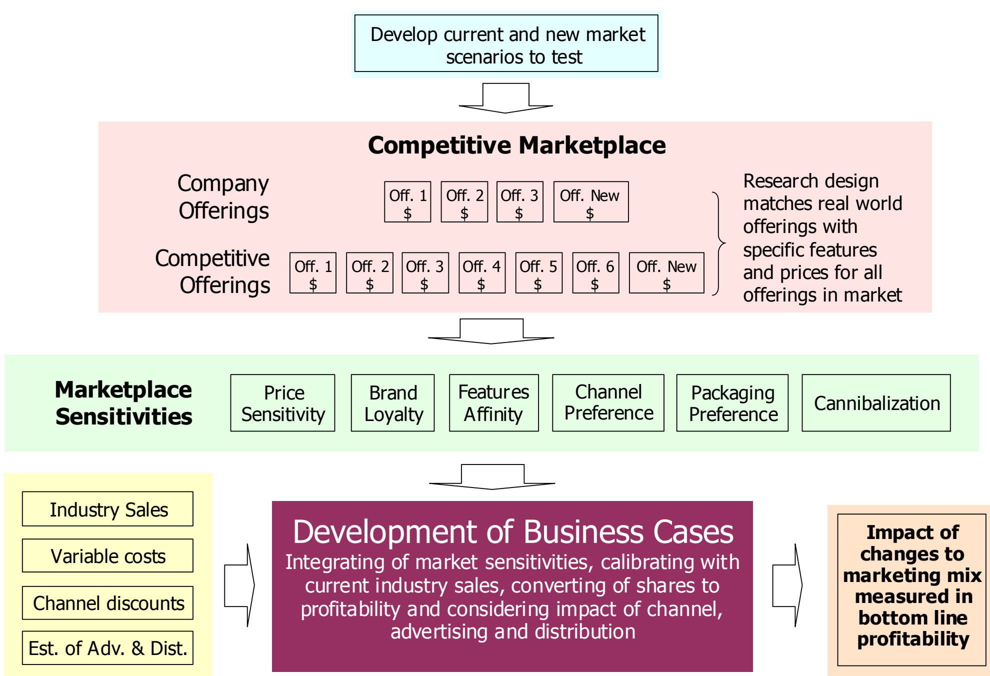
"It is unwise to develop a pricing strategy based on a reaction to customers leveraging one supplier over another to get the best possible price."

While internal costs have a major impact on profitability, not linking them to market input on competitive pricing and customer willingness to pay can dramatically impact profits. It is unwise to develop a pricing strategy based on a reaction to customers leveraging one supplier over another to get the best possible price. It is equally unwise to develop a pricing strategy in reaction to competitive price changes, internal sales goals, or inventory levels. These factors need to be considered in developing pricing strategies. However, basing pricing strategies only on these inputs can hurt long-term profitability and product equity. Pricing strategy must also take into account long term market response and impact on sales channels and profitability.

Developing Business Cases from Market Insight

Consider the diagram in Figure 1. Here a comprehensive approach to developing a financial model from market insight is shown. The key is to be able to report the information collected from current and potential customers in the context of overall profitability.

Figure 1 - Developing Business Cases from Market Insight



There are four key components to this approach;

- Determining the strategic and tactical issues to support the business case
- Developing of competitive marketplace
- Determining marketplace sensitivities
- Determining the impact of changes to the marketing mix in terms of bottom line profitability

Determining the Strategic and Tactical Issues

The critical first step for marketing is to first understand the key issues. There is nothing more frustrating than to present the results of a study and for someone to say "did you consider…" It is therefore extremely important to be able to review with senior management all relevant marketing issues that impact costs and profitability before designing the study. Listed below are examples of the types of questions that need to be considered when reviewing key issues with senior management. Note that most of the examples are more strategic and need to be considered in order to keep a strategic focus on developing business cases in concert with the myriad of tactical issues that tend to overwhelm the planning process.

- 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 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?

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- 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?

Development of Competitive Marketplace

Once the tactical and strategic issues are defined and prioritized, the research study needs to be carefully designed. When focusing on pricing strategy, it is extremely important that the survey instrument include actual market offerings and prices. The reason for this is two-fold. First, it is very important to be able to model what the respondents are currently purchasing based on current prices. This base case will be used to calibrate the model and to aid in determining cannibalization. Second, whenever new offerings or prices are considered, the respondent needs to react to them in the context of all the current options that will be available to them. Here is where a lot of research studies miss the mark in that they try to measure response to new offerings and prices independent of the other alternatives available to them. By including all company and competitive offerings, the respondent's task of selecting new offerings or prices is much more accurate and less subject to survey bias.

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In order to accommodate these types of pricing studies a custom designed discrete choice experiment is highly recommended. A discrete choice designed experiment provides the best analytical methodology for developing pricing strategy. When properly executed, it allows the researcher to present a complete portfolio of products and services that parallels current marketplace offerings. In addition, combinations of new and existing products and services can be tested in and out of the current marketplace, as well as changing prices and specific features for any offering in the marketplace.

"Offerings are tested in and out of the marketplace to determine which offerings will lose share when a new product or service is added and which offerings will gain share when a product or service is no longer in the market"

In general, the key components of a discrete choice design involve multiple price levels for the company's and key competitor offerings, along with testing of availability for certain offerings in the marketplace. Offerings are tested in and out of the marketplace to determine which offerings will lose share when a new product or service is added and which offerings will gain share when a product or service is no longer in the market. Prices can be different for all products and services being tested and should reflect current market prices. The ranges of prices to be tested must be wide enough to allow proper sensitivity testing and future use of the market response tool.

It is important to understand how the market values the different components of an offering. For certain studies, part of the design needs to include options for de-bundling an offering, as well as combining multiple products and services into a package offering. In both cases, multiple levels of price would need to be tested for each de-bundling and package offering. Another consideration for the design is allowing respondent choices to be recorded in a way that matches how customers would normally purchase products and services. In addition, respondents should not only indicate which offering they would chose, but also indicate some volumetric measure such as "how many" or "how often."

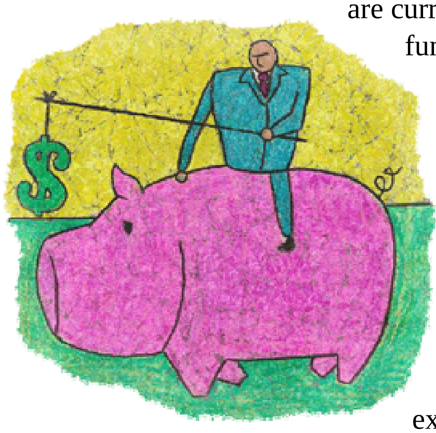
Determining Marketplace Sensitivities

Once the survey has been properly designed and executed, market sensitivities need to be derived from customer input. The modeling of market input must analyze the choices the respondents gave to specific market conditions and convert them into measures of price sensitivity, brand loyalty, feature affinity, channel and packaging preference and cannibalization. In addition to deriving these sensitivities, having detailed respondent level choice data will also allow development of segments. Grouping together segments of respondents who exhibit similar market sensitivities will provide a better understanding of the unique needs of target segments. As an example, a segment may be defined as customers who prefer a certain brand, feature, channel or package option or have similar price sensitivity.

With these market sensitivities, market share estimates can be produced for new and existing offerings and the impact of changing prices can also be used to update market share estimates. Before this market sensitivities can be used to build a financial model there are some necessary calibrations, conversions and adjustments that need to be made.

Determining the Impact of Changes to Marketing Mix

The first step in building a profitability model is to be able to link survey results to current market size and shares. When linking to current market a base case needs to be developed. The base case is defined as only those offerings which are currently in the marketplace, all at current prices. There are two functions to the base case; one is to replicate known market shares and the other is to size the overall market in terms of total units sold. The linking is done by calibrating the model's base case with known market shares and market sizes at the same prices and availabilities.



Developing a base case is a very important step in bridging the richness of a research experiment with the accuracy of known market information. No matter how good the sampling and however realistic the survey matches the actual buying experience, this step ensures all projections are based on an agreed-upon starting point. The key for the survey is to derive sensitivities from market input and then to put this information into a context that management can understand and then use to develop an effective pricing strategy.

"Developing a base case is a very important step in bridging the richness of a research experiment with the accuracy of known market information."

Once the model has been calibrated and can produce share estimates for alternative scenarios, it needs to report results in profit or contribution. This is done through integrating variable costs and any relevant channel discounts. In most cases the retail selling price less the unit cost is all that is necessary to indicate the profit. Sometimes when a product or service is sold through different channels, a component of the business case is to look at the retail selling price less unit costs along with channel discounts. In this case it is important to break out the channel discounts so assumptions on different channel discounts and their impact on channel volumes can be considered.

Before testing the financial impact of the various market scenarios the modeling of market insight needs to be adjusted. The two main areas where adjustments need to be made are in the level of advertising and distribution. While there is a big advantage to collecting survey data from a carefully designed controlled experiment, there are biases associated with it. By nature of being survey driven, these types of market insights make the assumption that the entire marketplace has complete knowledge about new offerings and changes to prices as well as 100% availability of any products or services being offered. To adjust for this, the marketing departments, working with other departments, need to set up a range of awareness levels and their associated advertising costs as well as a range of expected distribution levels. Typically these assumptions follow an "S" curve distribution as they track over time. It is therefore quite useful to allow the financial model that is used to build the business case to have a time element to them so assumptions for awareness and distribution levels can be tracked over a specified time period. Paralleling these awareness and distribution levels, estimated costs to achieve these levels should also be included in the model.

WHAT DO YOU LEARN FROM PRICING FOR PROFITABILITY

To 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.

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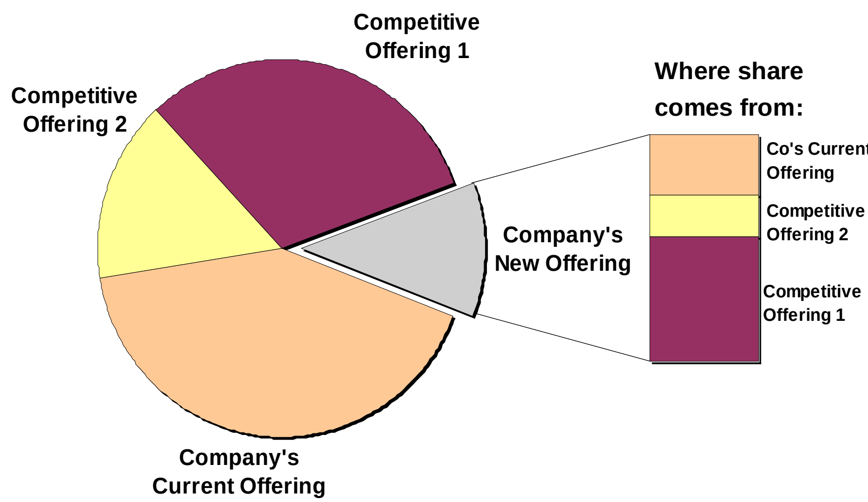
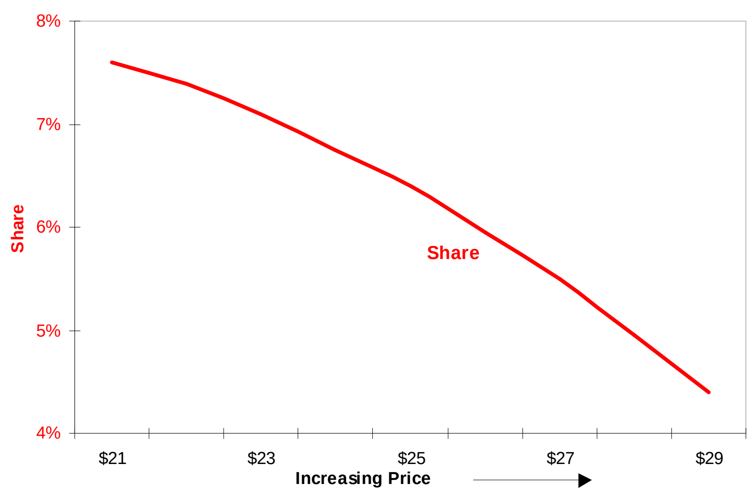
Figure 2 - Understanding Where Share Comes From



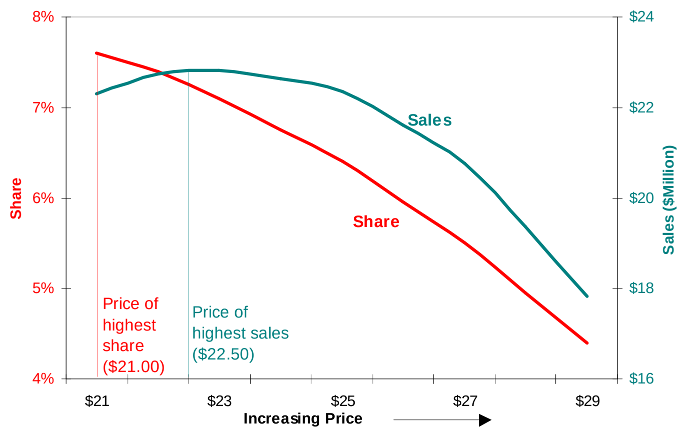
In these types of studies, multiple price points are tested for the new offering as well as certain other offerings in the marketplace. Using these multiple price points, the model develops price elasticity curves that show the expected share at different price points. The chart in Figure 3 shows that 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 – New Offering



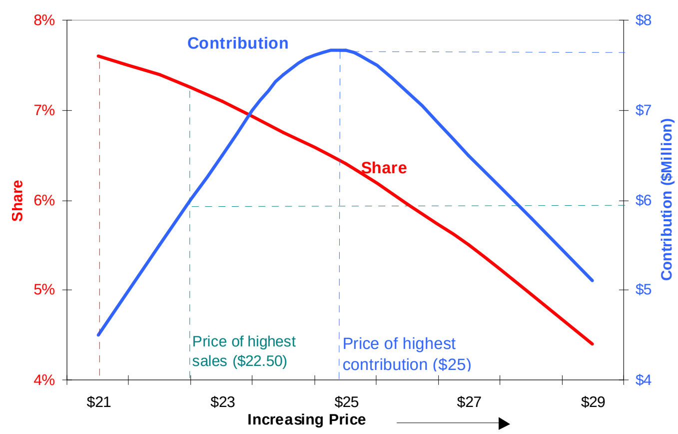
Given forecasted share, along with specific selling prices, a curve can be developed which shows potential sales at different prices. The chart in Figure 4 shows such a sales curve. It indicates that the selling price for the new offering that maximizes sales is $22.50. Is this the optimal price for 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 – New Offering



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

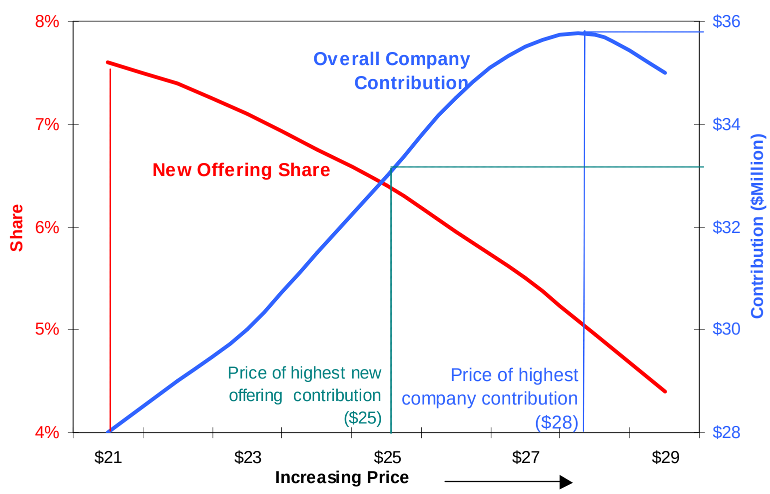
Figure 5 - Optimum Price Based on Contribution – New Offering



It is 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



..."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."

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.

CONCLUSIONS

In terms of developing pricing strategy, marketing departments have a real opportunity to elevate themselves and become full business partners with the rest of the organization. This can be accomplished by enhancing their traditional marketing insights into complete business cases. The key for research is to talk about profitability and to link their pricing studies to business issues in the context of the relevant strategic environment. And success with pricing can only elevate research's positioning in the organization.

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