Monitor Deloitte.

Growing profitability: Three principles of strategic pricing

This article was originally published in Chinese and appeared in *Harvard Business Review's* October 2015 China edition.

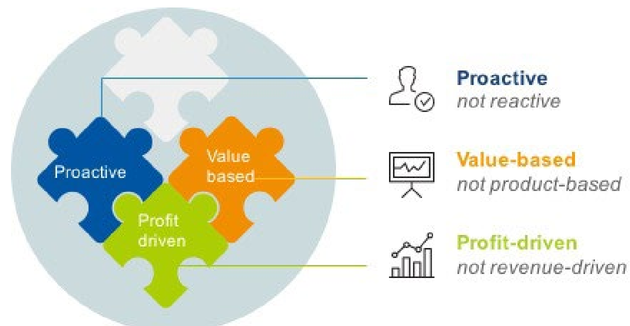
Chinese companies are facing new pricing challenges, as slower economic growth has become the "New Norm." Companies confronted with overcapacity and competitors willing to cut price need to find ways to compete without being drawn into price wars. Some companies have transformed and upgraded their manufacturing to target higher-end customers but still need to communicate the value of products and services more effectively in order to raise their pricing power. In both the industrial and consumer goods sectors, other companies have expanded overseas, hoping to build pricing strategies that will sustain growth in new markets. The emergence of E-commerce, "Internet+", and other communication technologies have changed trade and distribution channels and have made prices more transparent, raising new challenges to the common practice of pricing differently across markets.

Most companies have already begun efforts to improve the management of pricing. However, many still focus those efforts solely on price adjustment and optimization. By analyzing the price-volume tradeoff, they attempt to find the optimal price to maximize revenue. The drawback of this approach is that it treats customers' demand as a given and price as the only tactical variable, failing to consider the ways that a more effective pricing strategy can increase sales without reducing margins.

The purpose of strategic pricing is to price more profitably by capturing more value, which may or may not involve increasing sales. Some companies have adopted more strategic pricing approaches and been rewarded for it. These companies measure the success of strategic pricing not by how much it increases revenue, but by how much it increases the profits they earn. Strategic pricing gives these companies a competitive advantage that, over time, can lead to sustainable market leadership.

Although more than one strategy can achieve profitable results, nearly all successful pricing strategies embody three common principles. They are all *proactive*, not reactive; *value-based*, not product-based, and *profit-driven*, not revenue driven (figure 1).

Figure 1: Better pricing requires "three best practices"



Proactive

Proactive means that a company actively shapes its customers' understanding of value and their willingness to pay, rather than set prices in reaction to their customers' preexisting price expectations. Companies should anticipate what issues and challenges may arise under different market environments, business scenarios, or even disruptive events (negotiation with customers, a competitive threat, or a technological change), and develop pricing policies in advance to deal with them.

Reactive pricing lowers price expectations and undermines the ability to negotiate prices that reflect value. Consider the following scenario: A purchasing agent requests a better price after receiving an initial price quotation, claiming that his company does not value the added quality or service that is reflected in the seller's price. If the seller drops the price in reaction to this customer's price resistance, it may still win this sale profitably. Thereafter, however, the buyer will justifiably question the integrity of the seller's price quotations and, in response, adopt more aggressive negotiation tactics to ensure getting the best price. Such tactics may include researching how much other buyers pay, creating a “reverse auction” for its business, or splitting its business among multiple suppliers to increase competition among them. This may cause a seller to further discount the price reactively out of fear of losing sales, creating a destructive cycle in which the buyer has no incentive to acknowledge the value of what the seller offers.

Other companies may have price integrity but faulty policies which still create expectations that undermine the ability to charge prices that reflect value. For example, many B2B companies have a policy of not discounting except near the end of a quarter if necessary to achieve a quarterly sales goal. In that case, sales reps contact customers who were unwilling to buy earlier and offer them a more attractive price if they purchase before the end of the quarter. After the seller repeats such discounts a few times, buyers learn to delay their purchases within quarters whenever possible to take advantage of these end-of-quarter deals, and they may even buy more at the end of quarters in anticipation of needs in the next quarter. That behavior in turn increases the likelihood in the future that the seller's sales at regular prices will fall short of what is needed to meet the goal. This puts in vain the efforts of sales reps to sell more at regular prices and results in an increasing portion of sales being made at less profitable prices.

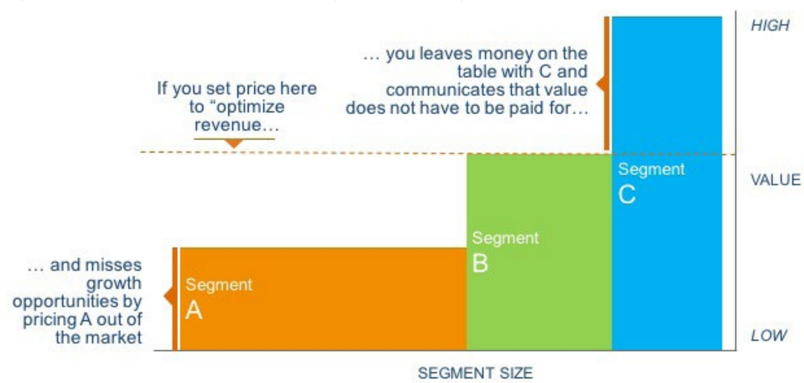
The solution is to stop making prices by exception, and make prices by policy. This doesn't mean that every customer has to pay the same price, or even that every customer has the option to pay only one price. But every time companies create a discount, they should think about the behaviors they are rewarding by doing so. They may proactively offer discounts to loyal customers and for behaviors that lower the costs (e.g., order online, order truckload quantities), as well as charge premiums for high-cost behaviors (e.g., rush orders). Such policies can better align pricing—both with value created for the customer and the cost to serve them.

Companies that practice strategic pricing control discounting by establishing policies that state clearly the conditions necessary for a discount, and proactively communicate those criteria to customers seeking lower prices. When customers are confronted with price-value tradeoffs, purchasing agents are forced to understand what is really important to their companies and to share that information with the seller in order to find the best value combination of price, product features, and services. They may even help the seller create new win-win policy options.

For example, by securing long-term contracts with customers and encouraging them to order in advance, companies in the chemicals industry have utilized assets more efficiently, achieved better sales and operations planning, and used operational and capital savings to maintain margins despite price incentives necessary to win those contracts. Formula pricing also enables suppliers and customers to share risks of price volatility due to feedstock cost and changes in downstream demand. Finally, empowering the sales organization with such options also frees up the sales force from frequent price renegotiations and thus increases sales effectiveness.

All of these are established benefits of well-designed price policies offered proactively while eschewing reactive price exceptions.

Figure 2. One-size-fits-all pricing cannot align with value



Value-based

Value-based means that differences in pricing across customers and changes in prices over time reflect differences or changes in the value to customers. Successful companies set prices that align with the value they deliver, which sometimes is associated with the number of units of product they sell, or the amount of services they provide—but not always. Value is not inherent in a product or service, but is determined by how customers use it. The key to value-based pricing is to align what the firm offers to different customer segments with what they value and are willing to pay for.

Value is the benefit that the customer gets from consuming the product or service. If customers are buying products for three different reasons or three different applications, then there are probably three different levels of value. This marks the intrinsic difficulty of value-based pricing. A "one-price-fits-all" pricing approach may be suitable for some customers, but it leaves money on the table for other high-value customers and communicates that value does not have to be paid for. At the same time, it misses growth opportunities of incremental volume by pricing more price sensitive customers out of the market (figure 2).

The solution to this dilemma is to create a segmented price structure that enables different prices for different market segments. A seller may aim to offer more value for some customers (Segment C in figure 2) by making some features and services available only at a higher bundled price.

On the other hand, the seller may create a "better value" offering by unbundling features and services (e.g., reduce product performance, quality warranty, and services) to better align with customers' expectation of ”value for money" (Segment A in figure 2).

Dow Corning is a leader in the silicone industry. Over a long period in history, the high-quality products that Dow Corning sold to its customers always came with rapid delivery, services, technical support and a high price. However, there were a lot of customers who wanted to buy high-quality silicone, but didn't want to pay for any additional services or technical support. As a result, Dow Corning created a subsidiary called "Xiameter" in 2002 to provide "no frills" commodity products to customers who understand the products well and could predict their needs in advance. All products were packaged in bulk, shipped in tank cars sold through online-only distribution channels, and delivered directly from the factory to the customers. By doing so, Xiameter increased Dow Corning’s silicone sales by bringing high-quality, reliable products at lower prices into the market while maintaining Dow’s profitable margins by cutting unnecessary costs.

Another way to align price with value is to alter the metrics by which price is applied to a product or service. A great example of this lies within the airline industry. In the beginning of the last decade, Rolls-Royce and GE started to make a new type of aircraft engine based on composite materials that are much lighter and more fuel efficient.

But the value is different depending on flight routes. For long distance flights, requiring that the plane be loaded with a lot of fuel before a flight begins, these more fuel-efficient engines save an enormous amount of fuel and makes non-stop flights over for longer distances possible. For short haul flights, however, the value of fuel saving isn't nearly as big; since it is possible to refuel at every stop, much less fuel needs to be lifted aloft during any takeoff.

The problem encountered by aircraft engine manufacturers is that the airlines don't want to have some engines for the longer flights, and other engines for the shorter flights since that would require training mechanics on two types of engines and require two sets of inventory for parts.

How Rolls-Royce and GE overcame this problem is now well-known. They radically changed their business models from selling aircraft engines to charging airlines by the hour for engine use.

Although paying the same price per hour, airlines with different flying requirements or the same airline with different flight routes paid different amounts for engines on long-haul planes because they fly more hours each day than short haul planes that spend much more time at gates. Airlines welcomed this new price metric, since it is well aligned with the timing and amount of savings they earned from fuel efficiency. Moreover, since flying time of aircraft engines is already recorded routinely for proper maintenance, "Power by the Hour™" was easily measurable and enforceable.

A third way to align price with value and cost-to-serve is with a price “fence.” Price fences are criteria that customers must meet to qualify for a lower price: a tactic widely employed by global and Chinese airlines.

Segmented by customer age (adult, senior, child), profile (corporate, individual), point of purchase (official website, mobile app, agent), time of purchase (days in advance, day/night promotion), and restrictions (change and cancellation fees, stops over time), the price for the same cabin on the same flight varies significantly. Some budget airlines have taken this approach to a remarkable level and earned remarkably high profitability as a result. When companies are able to enforce the fences so that customers who get high value cannot get over the fence to buy at a lower price, price fences can increase sales and profitability even when the products and the price metric are exactly the same.

Profit-driven

Unfortunately, the fallacy that market share drives profitability is still alive among many managers. It seems intuitive that winning more volume, even through low pricing, will pay off in greater profit due to better asset utilization. What they forget is that, if competitors can as easily match lower prices, price-based competition is more likely to trigger price wars that drain cash flow than drive share gains that improve it. If high market share or even high volume of sales per product really drove higher profitability, General Motors should clearly have been the world's most profitable automobile company and Philips the most profitable manufacturer of electrical and electronic products. Yet neither has been the case for decades.

Although there is a high correlation between market share and profitability, it is superior margins that drive profitable growth, not the other way around. Superior margins can fund product development, marketing, and capital investments that enable companies to create "good value" that wins new customers. In contrasts, volume that is generated by cutting margins is not "won;" it is simply rented until a competitor comes along that is willing to accept even less.

Take the automotive industry for example. Automaker Ford did not go after market share. It even divested Jaguar and Land Rover to improve its profitability and so was the only American car manufacturer to avoid bankruptcy. Toyota did not have the best quality of cars in the early days, but they did have a superior way of manufacturing them that enabled the company to earn more per car than most other manufacturers. Rather than cut its prices to grow, which it could easily have afforded, Toyota used its high incremental profit per car to invest in R&D to improve quality, making its cars attractive to more of the market. It also invested in brand promotion and in a dealer network that offered great service. Ultimately, as General Motors market share declined despite lots of costly promotional pricing, Toyota's market share grew, despite what ultimately became premium prices, and its profits grew to exceed by far those of its much larger competitor.

Apple and Walmart have similar histories as companies that began by pursuing higher margin business models even when they had small market shares, then leveraging those high margins into growth by reinvesting to attract even more customers.

There are Chinese company success stories as well. In the high-tech medical devices sector, Mindray is a leading domestic manufacturer. Mindray focused on the patient monitoring product segment during its early development. Although its patient monitoring product was priced 30 percent lower than similar products from multinational competitors, Mindray could still achieve higher margins with optimized cost structure that stripped out features not relevant to price-sensitive customers. Mindray continuously invested 10 percent of annual sales in R&D, acquiring market share and establishing a leading position in this segment as well as expanding into higher value segments of invitro diagnostics and medical imaging devices. Today, Mindray's R&D footprint spans more than 10 cities in China, US and Sweden with over 1,400 global patents. Leveraging its higher profitability, Mindray also expanded through a series of overseas M&A activities. In 2013, Mindray had 55 percent of its revenue coming from overseas markets, and was well established as an industry leading player with globalized operations.

To institute effective strategic pricing, companies should reject the fallacy that market share drives profitability. Growth opportunities should be prioritized not based upon the potential for volume growth, but on the potential to earn high margins relative to competitors. No company that wants to grow should consider low pricing as the means to acquire new customers unless it has a variable cost advantage that exceeds the price advantage necessary to win sales. Companies can usually make more money winning market share by offering "good value" than by selling "cheap," because product and service differentiations are more difficult for competitors to match than are low prices.

Implementing strategic pricing

Since these three principles do not seem complicated, why do many companies struggle to execute and sustain effective pricing strategies? There are three main reasons. First, the development and implementation of a successful pricing strategy crosses disciplines within a firm that do not share information necessary to make good decisions. For example, sales reps and even marketers are often unware of the costs to the firm of different customer behaviors or different service options. Second, those different functional areas often have conflicting interests and performance measures that are misaligned with a common strategy. Third, even when incentives are aligned, managers who are making pricing decisions often lack the knowledge and tools to determine in advance what strategic choices need to be made and which are likely to be the most profitable.

To begin making a company's pricing more strategic, we offer three recommendations:

1. **Align the organization to seek superior profit contribution before market share.** Implementing a pricing strategy proactively is difficult because it requires input and coordination across many different functional areas: marketing, sales, R&D, manufacturing, procurement, and finance. Profit-driven pricing requires coordinating decisions about which customers to target, what product features and services to offer, what information to communicate to the customer, what costs to incur to improve quality and service, how to structure discounts and premium charges, as well what levels of price to set. Proper metrics should be in place to motivate managers to seek cross-functional information and engage in behaviors that drive profit, not just functional goals. Measuring and rewarding sales force performance on revenue alone, for example, encourages reactive, undisciplined discounts. An incentive system should be designed to promote more profit-driven behaviors instead.

2. **Manage the margins, not just the price and cost separately.** Most companies have sales and marketing departments in charge of sales, operation departments in charge of overhead costs, and purchasing departments in charge of variable costs. But which department is in charge of profits? Believing that managing revenue and cost separately will address profit is a flawed perception, because increases in sales and decreases in cost are not independent results. For example, accepting "rush orders" to grow sales will increase cost, while a reduction in product variety may reduce cost but undermine sales and the ability to charge different prices to different customer segments. Strategic pricing requires fostering coordination among decision makers to ensure that the impact of strategic choices on profit, not just revenue or cost, is fully understood.

3. **Centralize strategy and measurement, and decentralize execution.** Given the strategic importance of pricing, it is surprising how many firms continue to organize their pricing activities so that pricing decisions are made by lower-level managers lacking the skills, data, and authority to implement coordinated strategies. Poor pricing decisions are more often the result of poor organization than the result of an individual making a poor decision. In most instances, it is neither desirable nor necessary for a company to have a large, centralized organization to make every pricing and discounting decision. But companies should centralize the development of pricing policies and value communication protocols to ensure consistency both across functional areas within the firm and across customers externally. Sales managers and even sales reps can then be empowered with the flexibility to make individual pricing decisions within the constraints of those policies and protocols.

The net result is that customers will learn that they can expect to be treated fairly, and that abusive purchase tactics will not be rewarded with discounts. Sales reps will learn to close deals based upon the value created for the customer and the sell rather than by using price as a tactical lever to close a deal. Finance will learn to look beyond cost as a determinant of price to better understand the trade-offs among price, cost, and market response. These changes constitute the essential ideas of strategic pricing that enable a company to realize growth that is more profitable and sustainable.

About the authors

Dr. Thomas Nagle is a senior advisor of Deloitte Consulting LLP in the US Strategy Service Line, Monitor Deloitte. He is the founder of the Strategic Pricing Group (now part of Monitor Deloitte).

Jiaming Li is a director of Monitor Deloitte based in the Shanghai office. He leads the Pricing and Profitability Management service offering for Monitor Deloitte in China.