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Everything You Want to Know about Raising Prices, but Are Afraid to Ask

A MANAGER'S GUIDE

With unprecedented volatility in input costs, energy prices, and increasing inflationary pressures, the urgency to manage pricing margins has never been greater.

Are you ready?

The mere idea of raising prices in an environment with spooked consumers, uneasy stock markets, and competitors waiting to pounce on mistakes has kept many pricing managers from getting a good night's rest.

Yet the ability to raise prices is a critical element to surviving—and even thriving—in this economy. Rarely before has there been more pressure to find incremental margin gains, given stagnant growth, and, increasingly, inflationary pressures affecting input costs. Discussions with some managers, however, reveal that their single most feared tactic in today's economic environment is the price increase.[1] While there is a need and a desire to increase margins, fear of potential consequences too often prevents managers from making decisions.

Management fears regarding price increases are not unfounded. There are many prominent examples of price increases gone wrong. As the recent example of Netflix, the innovative movie rental company demonstrates, there are effective and less effective ways to raise prices. A few years ago, in July 2011, when Netflix raised prices of its services by up to 60% and split its DVD and streaming businesses into two entities, the consumer outrage was immediate: Facing significantly higher prices and the need to use two channels for accessing content, movie watchers everywhere blogged, tweeted, emailed, unfriended, and even wrote old fashioned letters to any organization that would listen. The displeasure reached a crescendo when Netflix's CEO issued a public apology for the price increase. However the damage was done: Over 10,000 customers posted their displeasure on the company's blog, 1M subscribers had cancelled their service, and the company lost over 50% of its market value within two months of the price increase.[2]

By contrast, Netflix's most recent major price increase has been well-received. On May 12, 2014 Netflix implemented a 12.5% price increase, gained 1.7M new subscribers during the quarter in which the price increase took effect, and the impact is estimated to total $500M in incremental revenue by 2017.[3] What was different this time around? Netflix segmented their customer base between existing and new subscribers and only applied the increase to new customers. Since existing customers were not subject to the higher price, and new subscribers were opting in, consumers generally did not perceive a "loss" typically associated with a traditional price change. In addition, Netflix had announced its intent to raise prices, and offered guidance that the increase would "be in the $1-2 range." When the increase came in at the bottom of the range, affected consumers were likely relieved that it was not more.

Given the range of potential market reactions, it's no wonder that managers tend to treat price increases with trepidation.

So what separates success from failure? The managers who are successful at raising prices with positive results evaluate the impact and potential through six separate "lenses" that include:

- Clear understanding of the *value proposition* and whether it can support a price increase
- Evaluation of customer *price sensitivity* and the impact that price changes have on demand
- In-depth knowledge of the buyer's *psychology* and how customers interpret and evaluate price increases
- Clear understanding of the customer *buying process* and how it differs across segments, geographies, and purchase occasions
- Well-communicated *competitive position* and a history of following through on publicized intentions
- The ability to employ a *range of price and non-price actions* to manage cost increases

"Price is what you pay, value is what you get."

– WARREN BUFFET

Pricing Needs to be Grounded in Value

The first question that managers need to address is whether there is enough value in the offering to justify a higher price for at least one customer segment. Ultimately, customers may not care about costs or the financial goals of their suppliers—i.e., the internal needs of the seller. Instead they are interested in buying products that represent good value—both in an absolute sense as well as relative to competitors.

Can you convince at least some segment of customers that your offering is still a good deal in the face of a price change? And are there some portions of the markets served where there is a particularly large gap between the current price and value? The products, customer segments, and purchase occasions where the price-to-value gaps are greatest generally represent the best opportunities to increase prices.

Consider the most recent price increases in iTunes® music store application.[4] Under pressure to generate more revenues with music content, Apple® contemplated how to best raise prices. A uniform, across-the-board price increase was seen as too disruptive, especially given the well-established, one-size-fits-all $0.99 price point for all songs. When Apple® raised prices in 2009, it focused the increase on new releases and particularly popular songs—precisely the content that was most valuable and exhibited the greatest price-value gaps. And to lessen the potential for negative market reaction, Apple® lowered prices to $0.69 on thousands of less popular, "deep catalogue" songs where a lower price might rekindle interest in that content.

There are a host of tools available to assess the value of a product or service; these include Economic Value Estimation (EVE), conjoint analytics to measure perceived value, or analysis of historical sales patterns and price premiums deemed successful as measured by market behaviors.

The Role of Price Sensitivity

In our estimation, managers tend to overestimate the level of customer price sensitivity. They constantly get feedback from the sales force that "prices are too high—customers keep asking for discounts," that "competitors are more aggressive than ever," or "we lost the deal because we were too expensive."[5] However a closer look often reveals that price plays a much smaller role in the customer's decision process—and the evidence is available in your transaction databases.

To the extent that the past is prologue, prior price increases often provide a rich set of insights into how sensitive customers really are to price changes. Unfortunately, when companies do not perform "post-game analyses" after instituting a price change, they miss the opportunity to measure its impact.

Additionally, in some cases the company's internal perspective may be clouded by the fact that the focal product represents a significant portion of a firm's revenue, yet for the buyer it is only small portion of their overall cost structure. Consider the example of a maker of color dyes for printing companies. The company had been so fearful of instituting a price increase that they had not raised prices in over eight years. The reason for the fear was that any loss of volume could have severe negative consequences given their high fixed costs. Yet, after eight years they had exhausted all avenues of cost savings and needed a price increase to offset inflationary pressures. And because they had waited for so many years, the price increase was not small—it was raised by 45%. What they had not considered was that their product only represented a small input cost for their customers. A few days later their largest customer called with the comment: "We've been wondering when you would finally raise prices!"

Of course, many markets are highly price-sensitive. These are often mature markets that are marked by suppliers that sell nearly identical products, have excess capacity, high fixed costs and a stagnant climate of innovation. In these situations, competitive prices (and especially any price decreases) are quickly matched and customers become accustomed to carefully shopping for the best price. When raising prices in this type of environment, companies have often concentrated their price increases on non-product related factors. The airline industry, for example, uses alternate pricing structures such as fees for baggage handling, premium seating, and other services to generate additional revenues in an effort to shield the more publicly visible ticket price from a price increase; these fees have increased by an estimated 1,200% since 2007 to $31.5B in 2013.[6]

Understanding Buyer Psychology

It is well established in behavioral psychology literature that customers are more sensitive to losses (such as from a price increase) than they are to gains, which only elevates the need to understand the psychological implications of a price increase.[7] All price increases are seen, and acted upon, by people, irrespective of whether it is a B2C or B2B environment. And these individuals all bring their own biases and decision heuristics into the consideration of a price increase.

The literature on behavioral psychology is extensive and growing, and catalogs the list of human behavioral patterns and how they translate into economic decisions. For the purpose of evaluating the impact of a price increase, key psychological factors include:

- Are there "price points that matter?" In a recent Deloitte project in the apparel industry, retailers commonly assorted their categories to cover key price points. For example, in outerwear jackets retailers wanted products that retailed at $99, $149, and $199 as they felt that consumers looked for these key price points.

- Community-held norms of fairness have a significant impact on consumer willingness to absorb a price increase. For example, behavioral economics literature has established that consumers generally code a price increase as being fair when it is due to a commensurate cost increase.[8] Conversely, consumers tend to view as unfair any price increases that are the result of market power—such as when a car dealer adds a premium above the MSRP to a popular model that is in short supply. For this reason, many companies—especially monopolies—will emphasize the roles of costs when announcing price increases.

- Price increases are sometimes not noticed by consumers, especially if the amount is too small to impact the budget. For example, in a study by Bergen et al. that investigated price patterns in a large mid-western grocery store chain, price increases tended to be small and frequent while price decreases tended to be large and noticeable, although less frequent.[9] The study showed that this retailer would disaggregate manufacturer cost changes into many small incremental changes to make them "barely noticeable" to the consumer. For this reason, it is important to not delay a price increase. Too often companies put off a price increase, only to be forced to pass through large, highly visible, increases at inopportune times.

- When the purchase price is shared with another party, such as an insurance provider in the case of health care, customers generally will be less sensitive to price increases. In many cases customers are able to share cost increases with downstream customers, and anyone contemplating a price increase should think of ways in which they can help their customers share the pain. Consumer products companies, for example, will often engage in a brand building campaign to reinforce the value proposition and build demand, and thereby help retailers pass on higher product prices.

- In some cases there may be price-quality effects that lessen the impact of price increases. For example, luxury goods manufacturers sometimes see demand rise with a price increase, as part of the prestige factor in these types of products is the commensurately high price. In many surgical product lines, high prices are expected given the need for high quality and careful management of failure risk—real or perceived.

- Another customer dimension to consider is the relative size of expenditure the transaction represents for a customer. There is often significant asymmetry between sellers and buyers regarding the importance that price plays, and companies sometimes overestimate the impact of a cost increase on their customers.

- Finally, price increases can sometimes be framed in more favorable terms by considering the pricing of the overall portfolio. By augmenting the product portfolio with a high-priced offering, or by instituting a large price increase on a low-volume offering, manufacturers can often reframe the magnitude of a price increase. For example, when Volkswagen introduced the Phaeton to the U.S. market in 2004, at a price in excess of $60,000, or nearly three times the cost of the next most expensive car in its lineup, VW did not expect to sell very many units.[10] Indeed it did not, finding only 1,433 buyers that year. However, by placing a $60,000 car in showrooms, VW expanded consumer's price expectations for the brand and allowed the $40,000 price tag of its new upscale SUV, the Touareg, to not seem out of the ordinary.

Leveraging the Buying Process to Manage Price Increases

Evaluation of price increases should be done in the context of how customers make their purchase decisions and the role price plays in that decision. In the economic downturn, auto sales fell by 21.2% in the U.S. in 2009.[11] As the financial system tightened, rising costs of capital impacted lenders who helped finance car purchases. While many manufacturers with captive financing arms absorbed the cost increase—or even further subsidized bank costs with below-market interest rates—one company stood out by carefully evaluating buying behaviors, adjusted their offer to better meet customer needs, and was able to absorb the fluctuations in capital costs. That company was Hyundai.

Hyundai realized that the reason many consumers were holding off on a car purchase was not so much the price of the car; rather, some were holding off due to the uncertainty of their job situation and fear of disruption to their household income stream. In response, Hyundai introduced the "Hyundai Assurance" program whereby cars were sold in their conventional form via leases and bank loans, but with the stipulation that Hyundai was willing to take back the car and cancel the bank note, in the event the purchaser lost their job. The program was very effective; enabling Hyundai to register a 14% sales increase while the rest of the industry saw a 30% decline.[12]

The Role of Lifetime Value

Many customer relationships have a "shadow of the future" that should be considered when raising prices. Customer relationships are valuable; the owner of a neighborhood bike shop wrote an article in which he estimated that his customers spent an average of $12,500 over the course of their relationship with his store. For this reason he was willing to invest in maintaining customer relationships, even going so far as to accept damaged merchandise returns in an effort to win future business.[13] And winning back a customer who has left is expensive. The cell phone industry is an example of a sector that has high customer acquisition costs; in 2008 Vonage estimated its customer acquisition costs at $309 per new customer.[14]

Extending the notions of price elasticity, fairness, and consumer psychology, the impact of a price change should consider not only the impact on the next customer transaction, but also on all future customer transactions. Companies have deployed an array of tactics to manage the customer relationship, such as notifying customers in advance of an impending price increase, and thus allowing customers to plan for and potentially stock up before the price increase takes effect. Festool, a German manufacturer of high-end power tools usually provides one or two months' notice to its dealers and customers,[15] perhaps using the impending price increase to provide additional reason for any fence sitter to make their next tool purchase quickly.

Other tactics include using a cost index to signal to customers that the price increase will be in place only so long as costs remain high—and that prices will decline in the future should costs decline. Shipping companies and airlines, for example, may create fuel surcharges that are indexed to a commodity index to create a "shadow of the future" that holds out hope for customers that prices may decline.

Employing Non-Price Levers

Companies should also consider whether cost increases can be passed through using non-price mechanisms that make the increase less apparent more acceptable to customers.

When faced with a sluggish economy or supply cost increases, we've seen manufacturers turn to non-price mechanisms such as reducing packaging sizes, and therefore, product content, to save money. The change is barely perceptible, as packaging typically looks the same, and the familiar price point that consumers are accustomed to remains intact.

Other non-price mechanisms include:

- Offering a lower-cost brand to provide a ready alternative for price-sensitive consumers who are sufficiently impacted by the price increase to switch.
- Incentivizing low cost behaviors such as online ordering in the airline industry
- Changing product formulations: As cotton prices rise, many clothing manufacturers are reconsidering the fiber content in their garments and substituting synthetic materials as a way to manage the cost increase.
- Driving better capacity utilization by incentivizing off-peak usage at health clubs

Putting it all together

As an example of a company that leveraged these filters effectively, consider the example of a food ingredient manufacturer that was facing patent expiration on a consumer branded food ingredient. Understandably, there was significant concern that the entry of a generic product—a product that shared the same molecular structure—would lead to price-based competition with buyers always choosing the lowest-priced supplier. However, a price elasticity study revealed that customers—food manufacturers—had rarely substituted suppliers in the face of better pricing from another supplier. Deeper analysis revealed that most customers did not consider price nearly as important as key value drivers including having a trusted supplier, high levels of product consistency, and special services such as custom packaging, technical support and ingredient traceability.[16] The fact that there was a very high switching cost associated with qualifying a new supplier and addressing the inevitable consumer concerns when product formulation changed further cemented customer loyalty. And these considerations were most important for customers that had large, branded products for whom any change in product consistency would lead to potential negative publicity. For most purchasers of this food ingredient, a price premium relative to a generic alternative, while inconvenient, was not as important as maintaining a relationship with a trusted supplier. When this food ingredient manufacturer instituted a price increase to cover the cost of inflation, they saw minimal losses in sales, even in the face of generic entry and a looming recession. And the losses that they did experience came from customers who themselves had little brand reputation at risk, generally were smaller buyers, and would likely have defected to the generic alternative anyway.

Through careful consideration of the multiple lenses on the market, the food ingredient company was able to build the preponderance of evidence that provided the management team with the conviction to raise prices in a difficult competitive environment and drive profitable margin growth to fund future innovation and differentiation.

The Time to Plan for Price Increases is Now

It takes time and preparation to effectively implement a price increase. The recession and recent volatility in commodity costs has caught many companies off-guard and exposed weak or simply missing pricing strategies. The result has been a scramble to action, hastily planned pricing moves, and in the worst cases, outbreaks of price wars because competitors viewed pricing actions through a different lens.

However with some forethought and care, price increases can be managed effectively, responsibly, and profitably. Addressing cost volatility is part and parcel of managing any business. At some point most enterprises experience cost increases in at least a portion of their business, whether it is directly product-related or occurring in ancillary services like delivery or financing.

It takes courage to raise prices, especially when markets are fickle and the economy is still in recovery mode. However, many companies manage to do exactly that, with positive results. The goal should be to determine how and where opportunities exist to pass through the increases, and when discretion is advised. The most successful firms are also the most profitable, and they remain profitable by carefully managing pricing margins.

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[4] Dawn Chmielewski, "Hottest tracks to cost $1.29 at ITunes starting April 7", Los Angeles Times, March 26 2009, http://articles.latimes.com/2009/mar/26/business/fi-cotown-itunes26.

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[16] Monitor Deloitte research performed on behalf of a client.

About the Author

Georg Müller joined Deloitte through the acquisition of Monitor Group in 2013 and is a leader of Deloitte's Pricing and Profitability Management practice. He specializes in helping firms develop and implement top-line margin improvement strategies across consumer and industrial markets.

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