



PRICING OVER THE PRODUCT LIFECYCLE

Adapting Strategy in an Evolving Market

By John Hogan and Tom Nagle

STRATEGIC PRICING GROUP
A MEMBER OF MONITOR GROUP

Products, like people, typically pass through predictable phases. A product is conceived and eventually “born;” it “grows” as it gradually gains in buyer acceptance; eventually it “matures” as it attains full buyer acceptance; then it ultimately “dies” as it is discarded for something better. Although there are exceptions to this process (death sometimes comes prematurely, and youth sometimes extends inordinately), these typical phases present the opportunity to anticipate the future of most products. This understanding helps make up a firm’s long-run strategic plan with profitable pricing as the bottom line measure of that plan’s success. As a new product evolves through four phases—development, growth, maturity, and decline—one’s pricing strategy and tactics must vary if they are to remain appropriate.

Market Development

In this stage, buyers are price insensitive because they lack knowledge of the product’s benefits. Both production and promotional costs are high. Competitors are either nonexistent or few, and are not a threat since the potential gains from market development exceed those from competitive rivalry. Pricing strategy signals the product’s value to potential buyers, but buyer education remains the key to sales growth. Following are value communication approaches—other than price—that marketers should consider.

Communicating Value with Trial Promotions

Determining the actual price that first-time buyers should pay depends on the relative cost

of different methods for educating buyers about the product’s benefits. If the product is frequently purchased, has a low incremental production cost, and its benefits are obvious after just one use, the cheapest and most effective way to educate buyers may be to let them sample the product. Still, not all innovative products can be economically promoted by price-induced sampling, and many products will not immediately reveal their value when sampled just once. Many innovations (e.g., web-enabled cell phones) require that buyers learn skills before they can realize the product’s benefits. Without a marketing program to convince buyers that learning such skills is worth the effort, few buyers will sample at any price. In these cases, market development requires more direct education of buyers before they make their first purchases.

Communicating Value with Direct Sales

For innovations that involve a large dollar expenditure per purchase, education usually involves a direct sales force trained to evaluate buyers’ needs and to explain how the product will satisfy them. For example, in the early 1990s, enterprise software was considered a risky purchase due to the high degree of uncertainty about the ability to integrate the software into a company’s IT architecture. But rather than growing sales by pricing their product cheaply, SAP, a market leader in enterprise software, mitigated the uncertainty by providing new customers access to successful installations and by partnering with integration firms to ensure successful

implementations. This resulted in a ninefold increase in SAP's sales in the mid-90s.

Marketing Innovations through Distribution Channels

For innovative products sold through distribution channels, the innovator must convince the distributor to vigorously promote the product. One way to do this is by offering distributors a low wholesale price, leaving them with high margins, thereby giving them an incentive to promote the product with buyer education and service. However, when distribution channels are more competitive, that extra margin is often passed on in price discounts, thereby eliminating the promotional incentive. To avoid this situation, innovators may keep the margins at normal levels but pay incentive fees for stocking new products, co-op advertising, in-store displays, premium shelf space, and on-site service and demonstration.

Market Growth

During the market growth phase, buyers' concerns about a product's utility give way to concerns about the costs and benefits of the product. As buyers become more informed about product attributes, they are more responsive to lower prices. At this time competition emerges, and both the original innovator and later entrants begin to assume competitive positions. High rates of market growth enable industry-wide expansion, generally limiting price competition. The innovator and its competitors must decide whether their marketing strategies will be geared more toward a differentiated product strategy or a cost leadership strategy.

Pricing the Differentiated Product

A differentiated product may be tailored to a particular buyer segment or directed at multiple segments. If a differentiated strategy focuses on a particular segment, the company earns its rewards by skim pricing (capturing high margins at the expense of large sales volumes) to the segment that values the product most highly. Godiva, BMW, and Gucci use skim pricing to focus their differentiated product strategies. Conversely, if the strategy is more broadly aimed at multiple segments, companies should set neutral or penetration prices and earn rewards from the

sales volume that its product can attract. Kodak, Toyota, and Caterpillar use neutral pricing to sell their products to a large share of the market.

Pricing the Low-cost Product

A cost leadership strategy can also be aimed at a particular segment or multiple segments. For companies seeking industry-wide cost leadership, penetration pricing is often a component in the strategy implementation. When the source of a firm's anticipated cost advantage depends on selling a large volume, it may set low penetration prices during growth to gain a dominant market share, and later maintain those prices as a competitive deterrent while still earning profits. Wal-Mart uses this strategy successfully to achieve substantial cost economies in distribution and high sales per square foot.

Price Reductions in Growth

The best price for the growth stage, regardless of product strategy, is normally less than the price set during the market development stage. New competition in this stage gives buyers more alternatives from which to choose, and their growing familiarity with the product enables them to better evaluate those alternatives. Pricing in this stage is usually not cutthroat; generally, new firms can enter and existing ones expand without forcing competitors' sales to shrink. Sales of Apple's iPod continue to grow rapidly despite loss of some market share to new entrants.

Market Maturity

During this phase, most buyers are repeat purchasers who are familiar with the product. Increasing homogeneity enables them to better compare competing brands, so price sensitivity reaches its maximum in this phase. Competition begins to put downward pressure on prices since any firm can grow simply by taking sales from its competitors. Despite such competition, profitability depends on having achieved a defensible, competitive position through cost leadership or differentiation, and exploiting it effectively. Margins can be maintained by increasing pricing effectiveness through unbundling related products, improved demand estimation, improved control and utilization of costs, expansion of

the product line, and reevaluation of distribution channels.

Unbundling Related Products and Services

As a market moves toward maturity, competitors can more closely imitate the differentiating aspects of products in the leading company's bundle, which makes it easier for someone to develop just one superior part while allowing buyers to purchase other parts from the leading company's other competitors. If buyers are forced to purchase from the leading company only as a bundle, the more knowledgeable ones will often abandon it altogether to purchase individual pieces from innovative competitors. In this situation it is better to sell many buyers most of the products they need for a benefit rather than selling the entire bundle to fewer of them.

Improved Estimation of Price Sensitivity

It is easier to estimate buyers' price sensitivity in the maturity stage than the growth stage. In maturity, when the source of demand is repeat buyers and competition remains more stable, one may better gauge the incremental revenue from a price change and discover that a little fine tuning can significantly improve profits. Conditions for measurement of price sensitivity can be either controlled or uncontrolled. For example, in an uncontrolled measurement, marketing researchers might collect data on consumer purchases of laundry detergent in a grocery store, but the prices and other variables that influence those purchases are beyond their control. In a controlled measurement of the same behavior, the researchers would select the prices, advertising and shelf placement of various brands to make the data more useful. Generally, controlled research produces more accurate estimates of price sensitivity, but it is often costly to implement a "real world" setting to obtain such results.

Improved Control and Utilization of Costs

In the growth stage, new customers and new products initially require technical, sales, and managerial support that is reasonably allocated to overhead during growth. In the transition to maturity, a more accurate allocation of incremental costs to sales may reveal opportunities to significantly increase profit.

For example, one may find that sales at certain times of the year require capacity that is underutilized during other times. Sales at these times should be priced higher to reflect the cost of capacity. A careful cost analysis will identify those products and customers that are simply not carrying their weight. If some products in the line require a disproportionate sales effort, that should be reflected in the incremental cost of their sales and in their prices.

Expansion of the Product Line

Despite increased competition and buyer sophistication in the maturity phase, the firm may be able to leverage its position (as a differentiated or low-cost producer) to sell peripheral goods or services that it can price more profitably. When Novartis, a Swiss pharmaceutical maker, recognized the need for broader and more flexible product lines to meet the needs of smaller market niches in 2004, it committed to investing \$60 million in new packaging and production capabilities to support them. The flexibility not only reduced inventory costs, but also enabled the drug-maker to better execute a segmented pricing strategy in an increasingly fragmented market.

Reevaluation of Distribution Channels

In the transition to maturity, most manufacturers begin to reevaluate their wholesale prices with an eye to reducing dealer margins. There is no need in maturity to pay dealers to promote the product to new buyers. Repeat purchasers know what they want and are more likely to consider cost when purchasing than the advice and promotion of the distributor or retailer. Nor is there a need to restrict the kind of retailers with whom one deals – the exclusive distribution networks for Apple, Compaq and IBM have given way to low-service, low-margin distributors like discount computer chains, office supply houses, and warehouse clubs.

Market Decline

Reduced buyer demand and excess capacity characterize this phase. If costs are largely variable or if capital can be easily reallocated to more promising markets, prices need fall only slightly to induce some firms to cut capacity. If costs are largely fixed and sunk,

average costs soar due to reduced capacity utilization, while price competition increases as firms attempt to increase their capacity utilization by capturing a larger share of a declining market. Three options are available to deal with this challenge: *retrench* to one's strongest product lines and price to defend one's share in them, *harvest* one's entire business by pricing for maximum cash flow, or *consolidate* one's position by price-cutting to drive out weak competitors and capture their markets.

Retrenchment

A retrenchment strategy involves either partial or complete capitulation of some market segments to refocus resources on others where the firm has a stronger position. The firm deliberately forgoes market share but positions itself to be more profitable with the share it retains. Retrenchment is a carefully planned and executed strategy to put the firm in a more viable competitive position, not an immediate necessity to stave off collapse.

Harvesting

A harvesting strategy is a phased withdrawal from an industry. It begins like retrenchment with abandonment of the weakest links, but the goal of harvesting is a departure rather than a reallocation of resources. The harvesting firm does not price to defend its remaining market share but rather to maximize its income. The harvesting firm may make short-term investments in the industry to keep its position from deteriorating too rapidly, but it avoids fundamental long-term investments, preferring instead to treat its competitive position in the declining market as a "cash cow" for funding more promising ventures in other markets.

Consolidation

A consolidation strategy is an attempt to gain a stronger position in a declining industry. It is viable only for a firm that begins the decline in a strong financial position, enabling it to weather the storm that forces its competitors to flee. A successful consolidation leaves a firm poised to profit after a shakeout, with a larger market share in a restructured, less-competitive industry.

In Summary

The factors that influence pricing strategy change over the life of a product concept. The market defined by a product concept passes through four phases, Development, Growth, Maturity, and Decline. While it is critical to look at each situation uniquely, the rules of thumb outlined above are appropriate to use as a starting point before making any significant pricing decision.



Tom Nagle and John Hogan are Group Leaders in the Cambridge office of Strategic Pricing Group, a member of Monitor Group. They can be reached at tom_nagle@monitor.com and john_hogan@monitor.com.

SPG *Insights* is a quarterly publication of Strategic Pricing Group, a member of Monitor Group. In each issue, we take an in-depth look at current value-based marketing challenges and provide practical solutions and insights for executives in marketing, sales and management. To register to receive SPG *Insights*, visit our website at www.strategicpricinggroup.com.