



THE TOP MYTHS OF STRATEGIC PRICING

Mistakes Someone In Your Organization Is Making Today That You'll Need to Correct!

By John E. Hogan and Joe Zale

STRATEGIC PRICING GROUP
A MEMBER OF MONITOR GROUP

Pricing Strategy Run Amuck

The devil really is in the details. You've heard that "old saw" before, but when it comes to strategic pricing, Satan is also sneaking around your strategy. Over and over again, we see companies making fundamental blunders in their pricing strategy, actually thinking they're making sound business decisions. Their typical problem: basing pricing decisions on conventional wisdom, rules of thumb, and sometimes over-relying on "scientific" data analysis. Across the board, managers have absorbed these "worst practices" and unknowingly make poor decisions that undermine their businesses. A common reason for poor decision making lies in taking these rules and techniques and carrying them from one competitive environment to another. Are you buying into any of the following myths?

Myth – You Can't Raise Prices and Volume at the Same Time

In many companies, executives believe that demand curves (i.e. price and volume) are fixed. This leads to the trap of thinking that optimizing price and volume is the only hope in driving profit. However, price optimization is only a small piece of the answer. It's actually possible to hit multiple points on a demand curve with one product that will drive both volume and price simultaneously. This can be accomplished

by creating tiered offerings that break products and services into different bundles that attract different customer segments. Instead of a one-size-fits-all product offering

and price, multiple product offerings and price points can be created. The result is higher prices for premium offerings and higher volume for the standard offerings. The net effect, if orchestrated properly, is significantly higher overall profits.

A recent client of SPG, a Fortune 500 distributor with razor thin margins, was struggling with this exact problem. They believed they had to choose between becoming either the low cost producer or stake out higher ground as the premier solutions provider. What they didn't realize was a tiered offering could hit multiple segments of the market, driving both volume and price. After working with SPG to create an entirely new go-to-market strategy, our client achieved 20%+ incremental gains in both revenue and volume - a significant achievement in an industry where minor changes in revenue and margin are measured in basis points (i.e. hundredths of a percent). *For more information, view the article on our website entitled [The Price Menu](#).*

Myth – Pricing More Profitably Means Having to Raise Prices

Structuring prices to incent cost avoidance is also a way to price more profitably, without actually raising prices. In our experience, there are big opportunities to improve profits by looking in areas not often considered in the realm of pricing. By that, we mean service features that often get wrapped into a company's offering, such as rush orders, financial terms, warehousing, and technical support. Instead of bundling services into a product offering like an "all you can eat" buffet, positioning them as a la carte upgrades can help improve profits through cost avoidance. Customers will think twice about paying for services they don't actually value. The net effect is to lower cost-to-serve and increase share from customers who forgo services, and increase revenue from those who value these services. When you add it all together, this approach can yield big dollars in profit improvement.

One of our clients, a leader in the transportation industry, did just that and took millions out of its cost structure. Their a la carte strategy wasn't designed to raise incremental revenue, but position their offerings to prevent service abusers from dragging down overall company profitability. A by-product of the strategy was in the area of customer satisfaction. This approach actually created higher levels of customer satisfaction because service abusers were no longer creating bottlenecks in the system and our client's customer support personnel were able to react much faster to customer needs.

Myth – Prices Should Be Set to Cover Total Cost Plus Some Target Margin

The goal of pricing is not to cover total costs. Our clients often struggle with this challenge because the concept is counter-intuitive and the mistake so pervasive in companies. Instead, the goal of pricing is to maximize total contribution (i.e. unit price minus unit variable costs). Why? Because the portion of price that affects profitability is contribution margin. Whether that contribution exceeds or falls short of profit objectives is not a pricing issue. In other words, allocating fixed costs within the price does not help make better pricing decisions

because those costs are not actually incurred when making additional sales.

For example, one of our large clients in the chemicals industry had a decade's long practice of cost-plus pricing, where they took fully loaded costs and added on a small margin to set prices. By teaching them to break out variable costs more explicitly and to segment those costs based on different customer profiles, they were able to add millions to their contribution margin in a few short years.

Myth – Drive Volume in a High Fixed Cost Business

On the surface, this statement is true; however, there is a trap. We see many high fixed cost businesses becoming more variable over time, and yet they are not adjusting their management thinking to reflect this change. For example, take a large manufacturer we have worked with, whose business has moved from a 35% variable cost structure to close to 55% variable in just two years. This change is being driven by three important factors that are impacting many industries:

- internal business functions are being aggressively outsourced,
- raw material costs are dramatically rising,
- treating "hard to measure" variable costs as if they are fixed (e.g. customer service)

All of these factors are having a fundamental effect on the cost structure of companies, and many executives aren't paying attention to it. In these businesses, the historical focus has been to drive volume and market share. And now, this drive for volume is not having the effect it did in years past. In some companies, the problem is being made worse by reducing prices even further, thinking the incremental volume will help cure profit problems. They haven't yet realized that this focus on volume will never achieve the desired profits.

Myth – The Prices You Can Charge are Proportional to Increases in Product Performance (e.g., Quality, Speed, Costs)

Companies often make this pricing mistake when trying to estimate the value of their products. It's best explained by a recent conversation we had with a company launching a new extension to their product line. This highly regarded Fortune 500 Company had developed a new industrial product that improved manufacturing efficiency for its clients by 10% (proven in many beta tests). After years of development and significant costs, they mistakenly believed this new product should be priced 10% higher than the old product because it was 10% more effective. What they didn't realize, or bother to quantify, was that this performance improvement actually translated into 40% cost savings for clients. While it sounds simple, many people fail to remember that product improvements are not proportional to the value they deliver. Superior performance can command superior pricing. Product managers often get fixated on a customer's willingness to pay and worry too much about a product's pricing history. In particular, we find market researcher guilty of this mistake, providing recommendations that leave significant value on the table for their clients.

Wrapping it Up

The critical point to remember is that pricing requires the application of strategy and tactics appropriate for the business environment in which you compete. Rules of thumb and conventional wisdom can get companies in trouble. Careful examination of costs, customers, and competition are essential to ensure the right strategy is executed for the right environment.



John Hogan and Joe Zale are Partners in the Cambridge office of Strategic Pricing Group, a member of Monitor Group. They can be reached at john_hogan@monitor.com and joe_zale@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.