Price: The Longest Lever

Grow volume, control cost, or optimize price. These are the most common tools a company has in its search for profitability. Most companies choose volume improvements first. They “go for share” by lowering price and packing in the volume to boost revenues. To support the lowered prices, they often redouble efforts to control costs. Optimizing price is the least chosen strategy even though it is often far more effective.

Two recent, well executed studies of the effects of price optimization\(^1\) found remarkable results. Improvements in price typically have three to four times the effect on profitability than do similar improvements in either cost or volume. One study found that a 1% improvement in price increased operating profit by more than 12%.

So why are business leaders so enamored with volume and cost? Possibly because their customers have taken control of their prices. That control was largely ceded during the hyper-inflation of the 1980s when price lists became starting points for negotiations and sales forces were “empowered” to make pricing decisions. Despite an extraordinary change in economic circumstances since then, including the creation of on-line trading communities and auctions, pricing power has essentially remained with customers.

Wrestling for pricing power with your customers is not for the faint of heart. And especially so when there are two other tools out there that look much more inviting: cost control and volume growth. But neither actually works as well. They just get better press. And have more spin.

The Spin of In

Controlling cost is not a bad thing. Cost is on the inside where we can do something about it. When a company gives its Controllers all the control, costs are cut. But far too often, so is the company’s value proposition. We cut travel expenses, lay off personnel, reduce hours and eliminate less profitable products. The bottom line improves but not one of those moves provides value to a customer.

And profitability with diminished customer value is not a recipe for growth.

Your Finance leaders are not paid to worry about differentiation techniques, segmentation, market share or competitive position. They are paid to be your company’s staunchest advocate for the “inside-out” view. So, is the argument that you should let the Marketers, your “outside-in” team, grow you to profitability?

**Spin it Out**

Profitable companies often have substantial market shares. So, if we want to be profitable, we need market share, right? Quick, get the Marketing guys on the phone.

While market share and profitability are, indeed, often highly correlated, neither has a causal relationship with the other. Instead, both are symptoms of underlying business success. Sustained competitive advantage most often produces both. If your Marketing (or Sales) crowd is crying out to buy market share—tell them to turn down the volume and get to work building value for your customers.

**Building Customer Value**

*Value* is the key to sustained competitive advantage. No big revelation there. Except many business leaders are confused about what *value* really is. And no, you probably won’t know it when you see it.

Value is not what the market will bear, or what customers are willing to pay or some cost-plus calculation. And it isn’t ROI, brand identity, close rates or time-to-market. To be sure, these all have value; just not to your customers.

Value is an outside-in perspective. It can’t be viewed from your board room or your staff meetings. And it isn’t lying around in your Marketing department just waiting to be printed up into a brochure. So, what is it?

*Value is the monetary worth of the benefits your customers receive from using your product versus somebody else’s.*

Yes, this is the economist’s definition of value. The same guys who, if all laid end-to-end, would point in every direction. But it is the only definition that will lead to profitability and increased market share. And it’s not as hard to operationalize as you think.

**Nothing and Everything to Do with Price**

Right off the bat, this definition looks hard because the stuff that has to be measured either lies with the customer or the competitor. But the hard work of understanding what to measure and how to do it effectively can mean the difference between profit and loss. This is particularly the case in business-to-business commerce where the measurement of customer value is often clearly visible. Let’s look at a simplified example.
Macrohard makes a software package for colleges that registers students for classes. It has a price of $1,000. Macrohard came up with that price by taking the number of person-years it took to write the software, multiplying by the cost of one average person-year, adding 10% profit and dividing the result by the number of expected purchasers over the product's expected three year life on the market. If they sell a copy to each one of the company’s expected purchasers, the company thinks it will make money.

Macrohard’s brochure for its product talks about the company’s long and vibrant history, its impressive customer list and the product’s features and functions. It says that the product can have more simultaneous users than any competitive product and that its mean time to failure is the best in the industry. It also points out that an independent industry testing organization gave it a four-star rating.

That’s great, but most customers base their decisions to buy on entirely different criteria. One typical customer figured out how long it took—without Macrohard’s product—to register students and how satisfactory the results were to students, professors and administrative staff. And these were translated into hard dollars. The college found that a student had to wait in at least 3 lines for a total of about 4 hours to register for all of his or her classes. And there was a 20% chance that one or more of the classes desired were unavailable. The resultant student (and parental) complaints cost the college at least two matriculations per semester. Each was worth $18,000 over the course of the year it took to replace those students. With the Macrohard product, this could be cut by 45%. The savings would be $16,200.

Further, last minute additions to the teaching schedules cost another $25,000 per semester in additional hires. And finally, the administrative staff needed to move all the paperwork around came to another $7,000. Macrohard’s product looked like it may reduce this by 45% also. Another $14,400.

The value of Macrohard’s product to the college is $30,600 ($16,200 + $14,400) less the time spent by an IT employee to learn and maintain the product and the hardware and facilities to run it. Let’s say this is $5,000, making the total value to the college about $25,000—each semester. The product has a reasonable life of three years. That’s $150,000 in value to the college. Macrohard’s price of $1,000 asked the college for only a .0067% share of the value the product generated. Quite likely, the college would have paid more.

Understanding value from a customer’s vantage point will often open up avenues of opportunity for price optimization. Setting price to reflect some reasonable sharing of the value created, like the example above, is only one.

Welcome to The Price is Right!—Smart Pricing™ Practices

Smart pricing doesn’t have to mean price hikes. Not even the sneaky kind much favored these days by consumer food product producers. Did they really think we wouldn’t notice those two missing ounces of yogurt?
Smart pricing more accurately aligns your product prices with the value expressions of your customers. How many different kinds of customers do you have? And in how many ways do they use your products? In the answers to these questions you will find opportunities for price optimization.

**The 12 Steps to Price Rehabilitation**

1. segment your customers (and prospects) into groups with similar uses for your products
2. understand exactly how each segment uses your products
3. estimate the value to them (remember: it is better to be roughly correct than precisely wrong.)
4. dig into the structure of your pricing; do your “scorekeeping” units make sense to your customers?
5. look over the level(s) of your pricing for, say, volume discounts that have gotten out of whack with reality
6. look for opportunities to bundle; particularly in new segments
7. look for opportunities to unbundle; particularly with customers who claim not to be persuaded by “value”
8. think through your competition’s reactions to changes you are considering
9. then think through your customer’s reactions to both your changes and those that competitors might make in response to yours
10. think through the implications for your brand
11. remember that there can be only one “lowest cost” supplier, but several “best value” suppliers
12. listen to your customers…and your not-yet customers

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**Dog-Gone Value**

A guy is driving around and he sees a sign in front of a house: “Talking Dog for Sale.” He rings the bell, and the owner shows him the dog.

“You talk?” he asks.

“Yes,” the dog replies.

“So, what’s your story?”

The dog looks up and says, "Well, I discovered that I could talk when I was pretty young, so I told the CIA about my gift, and in no time they had me jetting all over, sitting in rooms with spies and world leaders, because no one figured a dog would be eavesdropping.

But the jetting around really tired me out, so I signed up for a security job at the airport wandering near suspicious characters and listening in. I uncovered some incredible dealings and was awarded a batch of medals. Now I'm just retired."

The guy is amazed and asks the owner what he wants for the dog.

"Ten dollars."

The guy says, "Why on earth are you selling him so cheap?"

"Because he's a liar. He didn't do any of that stuff."

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