New Thinking on Pricing Strategy - Raise Your Prices!

Face it: Most companies can't compete on price. And the good news is they don't have to.

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By now, we're all aware of the slash-your-prices scenario many companies take as a given these days: Your customers demand more and have online access to product comparisons from multiple sellers; you face global competition from rivals that have labor-cost advantages; and the financial crisis has accelerated the commoditization of more and more markets.

The solution? Cut your prices to gain volume and scale.

That definitely works for a few companies. But the reality is a very few—think Wal-Mart or Costco or Southwest Airlines. In fact, the very success of these business models makes it difficult for their competitors to duplicate—think Kmart or Sears, or any number of bankrupt budget airlines.

This article is for everybody else: those who choose not to compete on the basis of cost and low price. This article is for companies that can and should compete on the basis of performance, for which their customers willingly pay higher prices.

By competing on performance instead of price, you shift the battle to where your company's strengths lie—in the ability to deliver unique benefits. So-called performance pricers are adept at three core activities: identifying where they can do a superior job of meeting customers' needs and preferences; shaping their products and their business to dominate these segments; and managing cost and price in those areas to maximize profits.

If you can find these performance segments, manage them cost-effectively, and communicate to the customer the extra value being delivered, then as long as your offering is superior to the competition or other alternatives, you will be able to boost both prices and profits.

For an idea of how to become a master of performance pricing, let's consider a global chemical company we studied.

For years the company had a pretty typical sales rule: It would take any order at any acceptable price. That sounds familiar, no doubt. But by 2003, it had recognized this wouldn't generate acceptable shareholder returns or growth.

So the company switched to performance pricing, using a continuing four-step process that any company can duplicate: Identify value opportunities, choose which ones to prioritize, align their value and price, and constantly communicate to customers the value being provided. Here's a look at each of their four steps.

Identify Value Opportunities

The leaders of the company started out by repeatedly asking in meetings across functions: What can we do to help our customers succeed or be happier? Every product, service and benefit the company delivered to its customers was examined to better understand all of the ways in which it had some impact on the customer, and how the offering could be improved.

Questions to Ask Yourself

1. Does your company continuously focus on improving its products and services in ways that are important to customers and that allow you to raise prices and increase profits?

2. Do you communicate regularly with customers to find out how you can improve your offerings, and to make sure they're aware of any unique value you provide?

3. Do your salespeople speak to the right decision makers and others who care about these value benefits in the customer's organization?

4. Does your company involve every department in discussions about product development and pricing strategy in order to maximize efficiency, quality and profits?

5. Does your company consider pricing when it's still developing a new service or product instead of when the product or service is introduced to the market?

If you answered no to any of these questions, your company is probably not doing enough to maximize profits in line with products and services that customers want and are willing to pay more for. And if you lack a repeatable process for doing these things internally at your company, it is unlikely that you will effectively identify and communicate value externally with your customers: Like so many other important things in business, pricing and leadership begin at home.

For Further Reading

These related articles from MIT Sloan Management Review can be accessed online

- **The Myth of Commoditization**
  By Michael Schrage (Winter 2007)
  Executives, entrepreneurs and investors are too ready to believe that commodity is destiny. The result is a dulling of strategic focus and a narrowing of the business mind.
- **Why the Highest Price Isn't the Best Price**
  By James C. Anderson, Marc Wouters and Wouter van Rossum (Winter 2010)
  How to practice value-based pricing that boosts profits and promotes better relationships with customers.
- **The Seller's Hidden Advantage**
  By Niraj Dawar and Mark Vandenbosch (Winter 2004)
  Sellers have a view of their industry that their customers lack. But by sharing their unique knowledge, they can win loyalty and improve their pricing power.

Take a simple example: The company sells rubber stoppers to packagers of pharmaceuticals that use the stoppers to cap containers of injectable drugs. The company had long viewed the stoppers as a commodity. They're easy to make, perform a simple function and cost very little. But looking at them afresh, from the customers' perspective, it recognized that the stoppers could deliver multiple benefits to customers, and that these benefits could be quantified and ranked in terms of the value they produced for the customer.

The stoppers' low price was only the first benefit. Their design could be tweaked to improve customers' packaging-line speeds, lowering their operating costs. And because the customers used the stoppers to seal vials with different contents, making stoppers in different colors was recognized as a way to help hospitals and doctors reduce errors by making each vial more recognizable, and thus lower their insurance costs.

Set Priorities

After detailing the benefits, the company had to decide which products to develop further and how to invest its resources accordingly.

To be considered for performance pricing, an offering had to meet two basic tests. First, it had to have either a strong competitive position in its market or a highly ranked benefit to the customer (benefits were ranked, from low to high, in three groups: offering low acquisition price, helping reduce operating costs, and improving sales by enhancing quality). And second, the product had to be manufacturable at a cost that yielded attractive profit margins.

Thus, any product whose main benefit was its low sale price was likely to be rejected. But so were premium products if their costs were high and their projected total market too small. For example, the company had done well with a certain dental-filling product, but the total potential market was extremely limited and the investment costs would have included long, expensive testing of the product on people.

The stoppers, by comparison, looked promising. They offered highly valued benefits to customers, and could be produced at low cost.

Align Price and Value

The next step was to set higher prices in line with what the customer was willing to pay.

The key here is being able to document and quantify the precise nature of the benefits that your products offer, and to figure out what their tangible value is to the customer, in terms of acquisition cost, operating cost and added value to the end user. Once the supporting data are in hand, then you sit down with the customer to discuss what the new price should be.

In the case of the rubber stoppers, the company used the data to successfully argue to a customer that two products, while nearly identical in appearance, should be priced very differently because of the different ways they were used. One stopper sealed vials of a vaccine for chickens that the customer sold for less than $5 a vial; the other sealed vials of an anticancer medication that sold for more than $1,000.

While the stoppers looked alike, the higher-value application had tighter tolerances and came with significantly more technical assistance, service responsiveness and quality-control data, due to the difference in the costs and risks associated with the two stoppers. Indeed, failure of the seals on a few of the anticancer vials would have far greater impact on the customer's bottom line than a few ruined vials of the chicken vaccine. And, while both kinds of stoppers helped production—in terms of high packaging-line run efficiency and low scrap rates—higher efficiency for the anticancer vials, resulting from the technical assistance and tighter tolerances, translated into increased profits for the customer.

Thus the chemical company proposed a significantly higher price for the anticancer-vial stopper, and presented reams of data from the tracking system to support its argument. The customer later came back with figures of its own that painted a lesser impact than the company had suggested. But the customer's figures were in the ball park, the chemical company said. The two companies agreed on a new price for the anticancer stoppers that was a multiple of the price for the chicken-vaccine stoppers, and both parties felt like winners.

Get Cooperation

Such a system relies on a lot of help from the customer, and getting that cooperation takes work. The chemical company had to display a thorough understanding of all the issues the packager faced to win its case for the differently priced stoppers. After such increases are won, continuing efforts to communicate why higher prices are justified can bring other benefits as well.

By adopting performance pricing throughout the firm, over the next five years, the chemical company's profits grew 10% annually in a market growing less than 2% a year.

The approach also provided a strategy that allowed the company to weather the recession better than competitors: In 2009, industry volume declined more than 20%, compared with 14% for the company. But, despite lower volume, the company's return on sales increased by more than 40% due to its ability to identify value opportunities, prioritize requirements, align value and price, and communicate value to cost-conscious customers.

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