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Pricing for Profit

Strategy

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Question: *When does one percent equal 12.5 percent?*
Answer: *When a company increases its prices by one percent, profit soars 12.5 percent!*

That's just one example of how pricing can affect the bottom line. By practicing value-based pricing — pricing based on the perceived value of a company's product or service relative to that of its competitors — organizations can dramatically improve their profitability. In fact, research indicates that, by making improvements in pricing, the average company can increase its profitability by *25-60 percent!*

Unfortunately, many companies are not managing pricing, and therefore, are leaving large amounts of money on the table.

Best-Practice Pricing: Five ways in which successful pricers differentiate themselves

1. Develop a "1%" pricing mindset

Many managers not realizing that even a one-per-cent difference in pricing can have a dramatic impact on profit, think they can discount prices – even as much as fire or ten percent – without significantly affecting profitability. The example above shows how wrong they are. It is, therefore, crucial that everyone in the company understands the important of every one percent in pricing, and fights for it. "It's not about nickel-and-diming your customers," says Paul Hunt, president of Pricing Solutions. "It's about focusing on the value you deliver, so you don't have to compromise on price."

Take, for example, the case of company ABC, typical of many businesses. In its early days, the founder and CEO also acted as the de facto pricing manager. However, as the organization grew, so did the CEO's responsibilities and, consequently, the pricing function fell by the wayside. In the absence of a coordinated strategy, prices were all over the board — the finance department wanted prices to go up, sales wanted them to go down, and marketing was caught in the middle. As a result, profits suffered. It wasn't until the CEO crystallized the importance of developing a pricing policy, adjusting compensation, and assigning clear responsibility for pricing that he was able to reinstate the 1% pricing mindset in the organization leading to higher profits.

2. Consistently Deliver More Value

The most successful organizations consistently deliver more value to their customers and are able to capture enhanced margins as a result.

Best-practice-pricing organizations excel at the three key stages of value management: creation (product development, marketing), communication (selling), and delivery (execution, after-sales service). Each stage has a different pricing challenge.

In the product-development stage, best-practice organizations are more rigorous in their pricing assumptions. Consequently, they avoid developing products with lots of “bells and whistles” that are not valued by the customer. Compaq Computers, for example, implemented a “design to price” strategy. Realizing that its traditional high-end market was disappearing, the company set out to design the best computer it could for a price point under $2,000.

At the selling stage, salespeople of the more successful organizations communicate value to the customer, rather than selling on price. This can only be accomplished by knowing your customer’s desired end state (see newsletter *“Delivering Lasting Value,” Vol. 2, No. 3*)* and by establishing the ways in which your offering uniquely satisfies their needs. “To be able to do that effectively, you have to get inside your customer’s head. Getting close to your customer is the single most critical factor in value-based pricing,” says Hunt.

The moment of truth is when the customer uses the service or product offered (ie. the delivery/after-sales service stage). A satisfied customer is a profitable one. In researching its own customer base, accounting firm Arthur Andersen found that its most satisfied customers were also the most profitable ones, as they were willing to pay more for the firm’s offerings.

3. Price Strategically, Not Opportunistically

Companies that lower their prices to attract the price-conscious customer, or "cherry-picker," will pay the price in the long run.

The more an organization caters to a price-conscious customer in order to boost volume, the more it puts its core business at risk by pursuing customers who don't value the product or service more than the price.** Companies must define their core customers, and keep their pricing integrity for that market. For example, a company specializing in storing and distributing high-end pharmaceutical products, in an effort to grow, contemplated selling its services to a more price-sensitive segment of the market. However, offering lower prices to non-core customers could well lead to alienating the company's traditional customer base. Fortunately, before making this fateful decision, the company considered the implications and decided to reduce the level of service it would provide to the price sensitive segment. This enabled the company to look its core customers in the eye and tell them they were paying a fair price. "If you're going to sell to a price-reduced customer, you must alter your product accordingly — cut back on service, reduce your offering in some way," says Hunt.

In another example, a supplier was selling a large volume of product to a mass merchandiser, but at a bargain-basement price. Upon analyzing the situation, the supplier decided to "fire the customer," even though that customer represented 25 percent of the supplier's volume. But despite the loss of business, the supplier doubled its profitability within two years, because it attracted profitable business to replace the previous unprofitable volume.

4. Delve Deeply Into The Competition

When it comes to pricing, managers need to act like diplomats, rather than generals.

Diplomats avoid wars; generals fight them. No one wins in a price war. The foremost tool of a great diplomat is competitive intelligence — gathering and processing information about competitors. This ensures that your pricing strategy is driven by knowledge of your competitors, rather than fear of them (see newsletter *"How to Avoid a Price War," Vol. 1, No. 3*).

However, to reap the benefits of competitive intelligence, an organization must have a system in place to mine, manage, and disseminate the intelligence resident within it. One company, for example, has installed a toll-free telephone number for its salespeople to use to report competitive information, rather than asking them to write reports. It also has built in an incentive — the best tip of the month wins dinner for two. Salespeople are motivated to share the information they have, which creates a process for consolidating the knowledge — this has paid off handsomely for the company.

An organization can spend years building up value for its product or service, but if pricing is inadequate or inappropriate, it can squander profits in a matter of months. Good competitive pricing is critical to value-based pricing.

5. Make Pricing A Process

Pricing should be treated as a continual process, rather than a one-time event.

All too often companies gather together key employees to make pricing decisions in one fell swoop (Hail Mary pricing!). At one major consulting firm, every office had a different pricing process. In the absence of a good pricing process, managers reverted to ad hoc or “gut” pricing. “I’ve seen two people sell the same services and price them 100 percent differently,” says Hunt. “It’s because they don’t understand the value, don’t understand the customer, so they rely on their own perceptions of the world.” Active and coordinated pricing management is essential. This means establishing a pricing policy, using analytical tools, and training personnel.

In another pricing pitfall, many organizations pay their sales force on revenue, prompting salespeople to slash prices to generate volume. When that happens, margin suffers, since salespeople are not selling value. Companies should instead reward their salespeople on profitability, or margin. “I have seen many companies dramatically alter their profitability just by getting their compensation structured appropriately,” says Hunt.

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