



# *Worth Noting*

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***Worth Noting is the fortnightly management journal of research and conferences company L21. It is focused on management strategy issues of relevance to senior executives.***

## **Pricing: Identifying Your Dilemma**

As regular readers of *Worth Noting* are aware, pricing is an issue which L21 regards as one of the most significant facing every business. Through our research work in this area and our *Pricing Tactics* conference, we continue to focus on this most critical aspect of corporate strategy. Because of its massive impact on profitability, pricing is the single most important issue in many industries, particularly for mature companies.

We won't spend a great deal of time fleshing out why pricing should be at the top of every company's agenda. The following analysis, extracted from Volume II of *Worth Noting*, should make the case.

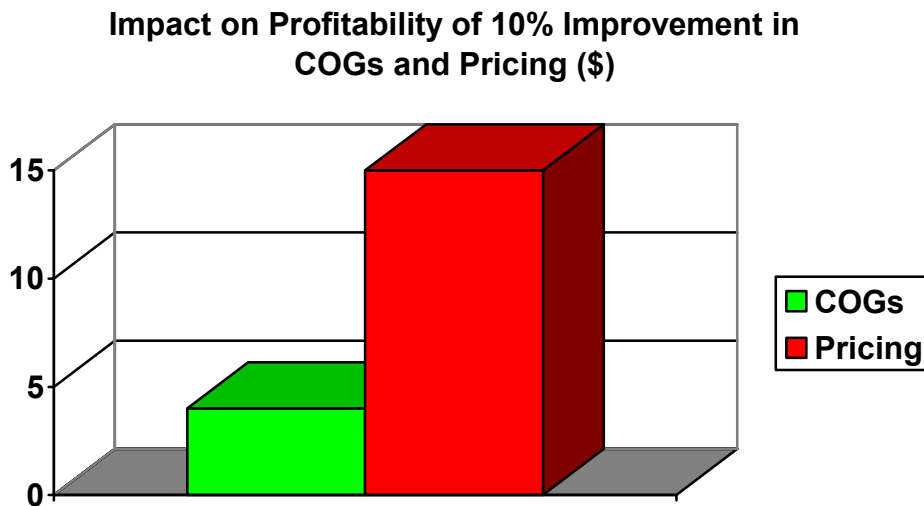
### ***Why it Matters***

*Let's look at a simplified example to demonstrate the benefits of sound pricing strategies.*

*Our example looks at the costs and revenues associated with a particular product and its standard pricing. Let's assume the product can be produced for a total cost of \$100. Of this amount, \$40 is Cost of Goods Sold (COGs), and the remaining \$60 accounts for the product's share of the fixed costs of operating the business. Further assume that the product is currently being sold for \$150, providing a contribution margin of \$50.*

*If we assume that the business is well run and operating costs are relatively fixed, then management has two devices at its disposal to improve profitability: variable costs and pricing.*

*The chart below shows the impact of a 10% improvement (ie reduction) in variable costs and the impact of a 10% improvement (ie increase) in price.*

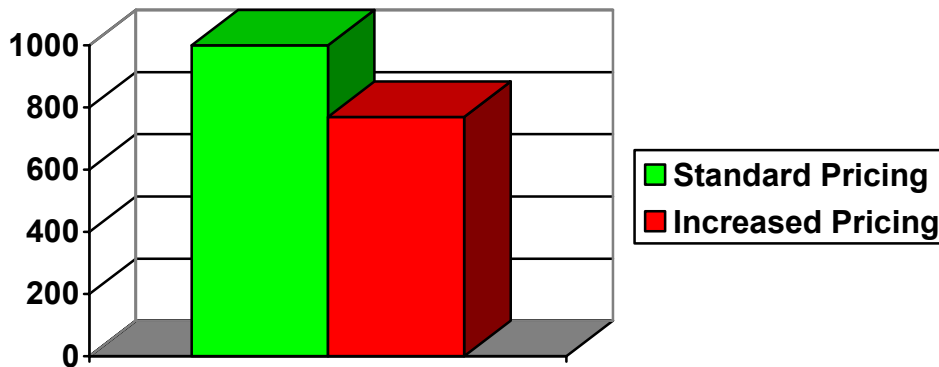


*Because COGs represent a substantially smaller line item than price, an equal percentage improvement does not stack up to the impact of improved pricing.*

*Of course, this example is over-simplified. If it was easy to increase prices by 10%, things would be very straightforward for senior managers. Conventional wisdom has it that increased prices mean decreased customers – and the conventional wisdom is usually right.*

*So the real value of a pricing change can only be determined by assessing the impact of the change on overall contribution to profitability. Sticking with the example above, let's assume that before prices were changed, there were 1,000 customers for the product, each with a contribution margin of \$50. Further assume that prices were increased by 10% while all costs remained the same. With the price increase, contribution margin per sale increases to \$65. The key question is: how many customers can we afford to lose, while still increasing profitability?*

### Number of Customers Required to Produce Gross Contribution of \$50,000



*Under the revised pricing, 770 customers would produce a total contribution margin of \$50,050. With the initial pricing, 1000 customers were required to produce a contribution margin of \$50,000.*

*In other words, a pricing increase of 10% could sustain a 23% loss of customers and still boost profitability. The numbers will vary based on the price and underlying margin of the product, but the point remains that pricing is a very big lever for management, and one which is worth substantial focus in all companies.*

#### **Three Pricing Scenarios**

In our experience, there are three particularly common scenarios facing pricing executives. Each of them has its own unique characteristics, and is worth examining separately.

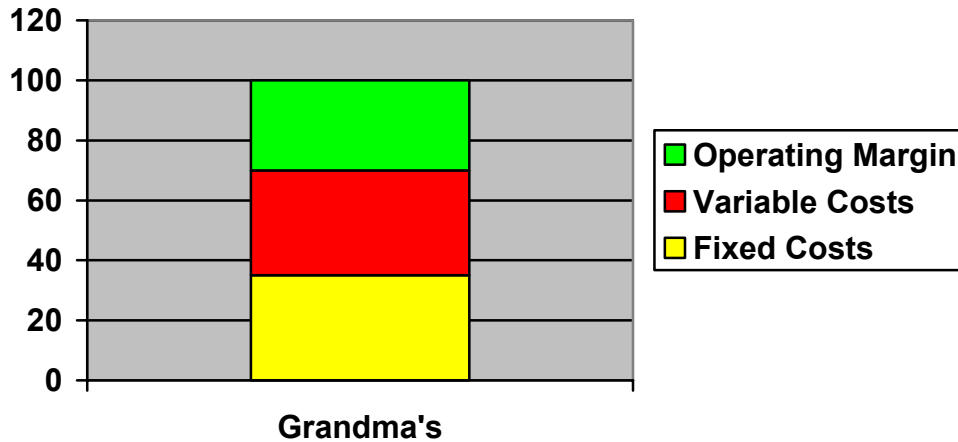
##### **(a) Value Products: Pushing the Envelope**

Marketers of what we call “value products” consistently make pricing mistakes. The basic error is to assume that products are more sensitive to upward movement in price than is in fact the case. It costs many companies dearly.

It is an understandable error. Grandma’s Cheap Pain Relief Tablets will never beat the market leader on quality – certainly not on customer perception of quality. If pricing gets too close to the market leader, the rational consumer will reject the lesser product. But how close is too close? And do marketers of market-following products test the waters enough?

Take the following theoretical example. The Grandma’s product and NoPain are the two biggest brands in the market – Grandma’s with 20% market share while NoPain holds 60%. Grandma’s product sells 20,000 units per week at \$1.50 while NoPain sells 60,000 units per week at \$3.00. Grandma’s has the following cost structure:

## Product Cost Structure (%)



Grandma's low variable costs largely reflect the lack of marketing support provided to its brands. As such, its executives in charge of pricing are hesitant to move its cost too close to NoPain.

Grandma's sells for 50% of the price of NoPain. The very simple question that Grandma's executives need to ask is: do we need to be this cheap? If we charged more, how many sales could we afford to lose while still improving profitability?

Currently, Grandma's is making an operating profit of \$6,000 ( $20,000 \times 1.5 \times 0.2$ ). Let's take a look at how many customers Grandma's could afford to lose and still make \$6,000 if it tried various price points:

New Price	Price Increase	Acceptable Customer Loss to Maintain Profitability
\$1.60	7%	25%
\$1.70	13%	40%
\$1.80	20%	50%
\$1.90	27%	57%
\$2.00	33%	63%
\$2.10	40%	67%
\$2.20	47%	70%

The table above underlines the potential of modest price increases in a particularly striking way. In the market we have described, a price increase of

13% would be very unlikely to lead to a 40% loss in sales. The degree to which the market-following product will lose sales as price increases comes down to a very simple matter: what is the extent of the perception of product quality difference?

In the example we have used, the follower sells for half the price of the leader. There is plenty of latitude to increase prices without getting too close to NoPain. Certainly, there is no excuse for not at least *testing* the elasticity of demand for Grandma's: a week's trial at around \$1.70 in one sample market would be a sound move.

### **(b) Avoiding Odious Comparisons**

Executives constantly tell us that their room to move on pricing is very limited. Particularly in commodity-type industries, the market sets (or at least expects) a price of \$x per item y, and there is not much a marketer can do to get away from that fact.

The root of this problem lies in the fact that the company is engaging in direct competition in a market for *absolutely comparable* products. Coal is coal; wheat is wheat; gold is gold. Selling these products in their raw form means accepting the market price.

But for every marketer that is genuinely constrained by a commodity market, there are two or three who could avoid commoditisation were they to think more creatively. There are a great deal of products that were perceived as commodity-type items only a decade or two ago but are now characterised by sophisticated markets with high levels of differentiation. For examples of this look no further than two of the most basic of products: bread and water.

For executives charged with pricing responsibility, the question becomes: *how do I make my product less price comparable?* The imperative is to get out of the destructive situation where a customer can look at a number of identical products and make a decision based on price. In such an environment, products will always be constrained by industry-standard economics, and achieving margin growth will be extremely difficult. The challenge for marketers is not to win in this game, but to play a different one.

There are three main ways for executives to increase pricing flexibility in this situation:

#### **(i) Non-Standard Product Presentation**

If four companies sell 500g packs of Corn Flakes, the pricing executive is on the back foot. But if one company moves to sell an 800g pack, its pricing latitude increases. The price increase will not need to be proportionate to the size of the pack increase, given the limited proportion of total costs made up by product

content. The customer is presented with a new proposition – one which can genuinely provide increased value both to the buyer and the seller.

Bundling is also relevant in this context. Combining one commodity-type item (say monthly telephone line rental) with a series of other products, options, and special offers creates uniqueness in the consumer's mind. It is difficult to compare pricing when an offer is not matched elsewhere in the market, allowing the marketing executive to calibrate pricing in such a way as to maximise profitability.

***(ii) Make a Different Product***

Take the Corn Flakes example again. Why market an undifferentiated competitor when there is the opportunity to innovate? Maybe there is an opportunity to develop a related, but unique product – in this instance perhaps a new flavour of corn flakes. Underlying costs are likely to be comparable to marketing the generic product but pricing flexibility is substantially increased.

***(iii) Attack the Quality of Competitors' Products***

This is the most difficult and least recommended differentiation strategy, but can work in the right circumstances. It is probably more commonly attempted than either (i) or (ii) above, as it reflects the market reality of the sales person's task.

If the customer no longer perceives the competitive offerings as comparable, then clearly there will be more pricing latitude for the products which come out on top in buyer perception. If your product has earned "the right to brand" over its competitors, then it makes sense to attempt to do so. But most attempts to shake up customer perceptions in staid markets fail. And perceptions can quickly change – a campaign might produce some perceived differentiation for 12 months, but not sustain pricing thereafter. Sustainable pricing advantage is much more likely to come from (i) or (ii) above than by changing customer perceptions in a commodity-type environment.

***(c) Standing Firm***

Your product is the market leader, or close to it, with a strong brand and consumers perceive that its quality is superior to competitors. But in the last couple of years, other companies have worked out a lot of what used to make your product unique. They haven't quite got the formula right yet, but there is no doubt that your quality lead over the market has been reduced in recent times.

The increased competition is reflected in your financials. You haven't felt comfortable raising prices for the past couple of years, because you didn't want to give your customers any reason to try the new competitors out. So far, your product's costs have been held stable, so you have not seen margins contract. But costs are due to go up substantially next year and without a price increase you will see significant margin reduction. Volumes have been flat, and it looks like they might reduce a little in the current quarter.

There is a real concern that things are about to get very difficult.

Sound familiar? This is probably one of the most common scenarios in the economy today, where the mystical power of brands is being reduced by widespread quality improvements brought about by increasing levels of technology and education. As the market leader, can you price your way out of trouble?

The short answer is probably not. The temptation to reduce prices should be resisted, nine times out of ten. In this scenario, the time to price aggressively (if at all) would have been at an earlier stage, where the competitors lacked traction and the quality gap was largest. Now that the quality gap has narrowed, a price decrease will be perceived by the market as bracketing the leader with the also-rans – something that should be avoided. It is probably too late to kill off the competitors with a predatory price reduction, and going down the discounting path is rarely a pleasant experience.

Holding prices constant isn't particularly viable either. Margins will continue to contract, and as the quality of competitive goods continues to increase, their market share is likely to rise.

For pricing and marketing executives, the most important role here is one of advocacy. The bottom line is that if the product's quality does not continue to increase, its economics are shot. The days of strong margins and consistent pricing growth will be over. The only strategy that makes sense is the existing strategy – to be the best, and to price to be the best. No matter how good the product's marketers are, quality always counts in the end. Pricing executives need to hold firm in this environment and ensure that the product's historical quality advantages remain, so as to maintain keen pricing. All other roads lead to oblivion.

Pricing is little understood, widely overlooked, and massively important. It occupies a unique place in business – a space that is part technical, part marketing. Understanding the dynamics of pricing intimately should be a high priority for senior executives. Simply put, pricing is the biggest profit lever in industry – a fact that is certainly worth noting.