IS THE PRICE RIGHT? PRICING FOR LONG TERM PROFITABILITY

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"The more you can slice and dice your prices and offerings without affecting your brand, the more you can sustain profitability."
Eric Mitchell, Professional Pricing Society

Abstract:
The way how we choose our pricing strategy has a significant impact on company's success. Nowadays companies more and more adopt a new way of thinking in pricing, namely pricing for a long term period in order to bring higher profitability, to build an efficient pricing strategy. Marketers have only recently begun to focus seriously on effective pricing. These companies are the so called progressive companies. They have begun doing more than just worrying about pricing. To increase profitability many are abandoning traditional reactive pricing procedures in favor of proactive pricing, making explicit corporate decisions to change their focus to growth in top-line sales to growth in profitability. The long-term implications of price strategies are still under-researched, and managers should be aware of shifts in customer reactions that may result from frequent adoption of certain strategies. The company pricing strategy should be seen in relation to developments in the company variables, internal ones (capital strength, competencies, organizational conditions, efficiency of the work force etc.) as well as external ones (customers, competitors, the technological development etc.), adopting strategic pricing. In this paper I will present the most effective pricing strategies leading to long term profitability, and also suggest practical conditions for pricing strategies to maximize profit in the long run.

Keywords: strategic pricing, offensive pricing

Introduction

For marketers pricing strategies for long-term profitability had become a priority, especially in industries with an intense competition, combined with measures to generate more short-term effects, continues to be the management top priority.

Inappropriate pricing strategy can shrink profitability, warp customer relationships, and destroy even a well known brand [10]. Therefore, companies have to focus on value creation over the long-term by honoring the needs of customers. For customers the benefit of a product or service versus the price of the product or service is what matters most in the purchasing decision.

Taking this fact into consideration companies have to set their price in order to capitalize on the perceived value of customers. Besides setting the price level, companies have the opportunity to build innovative pricing models that better meet the needs of the firm and its customers.

Unfortunately pricing decisions often have to be made quickly, without testing, as they are left to the last minute and are often a compromise between the goal of volume and market share versus profitability and financial return. Companies increasingly need to make pricing decisions more and more rapidly in order to respond to competitive actions, market changes or their own inventory situations. They no longer have the time to perform market analyses or extended studies every time a pricing change needs to be considered. The premium in profitability is on speed, on the proactive pricing strategies. While nowadays has been a general acceleration of business in all fields, the impact on pricing and revenue optimization has been particularly notable [3]. Companies seek to maximize long-term profits by increasing market share and lowering costs through economy of scale.

Pricing and revenue optimization incorporates costs, customer demand (or willingness to pay) and the competitive environment to determine the prices that maximize expected net contribution [9]. Other approaches to pricing tend to weigh one of these three aspects more than the others, as shown in the table 1.

Table 1

Alternative approaches to pricing

Approach	Based on	Ignores	Liked by
Cost- plus	Costs	Competition, customers	Finance
Market based	Competition	Cost, customers	Sales
Value based	Customers	Cost, competition	Marketing

Source: Robert L. Phillips [2005]: Pricing and revenue optimization, Standfords Business Books.

As does not exist a single right way to determine the pricing strategy, fortunately there are some guidelines that will help marketers with their decision.

Depending on overall market strategy, pricing should depend on the economic value to the purchaser. Accordingly effective pricing should vary according to the customer's price sensitivity. Measuring price elasticity and the comparative profitability of various pricing scheme is becoming more and more important to strategic pricing as the more traditional model of 'one price fits all' of the mass merchandising economy goes by the wayside.

Break-even analysis- a starting point for long term profitability

First of all in establishing a well based pricing strategy companies have to establish a minimum baseline, a bottom line to find the price point where anything less, will terminate their business. The goal should be not to merely break-even every time, rather companies should priorities the activity of turning profit into a long-run.

Nowadays, profitability is a highly debated subject, when a company is profitable or not? Evidently to be profitable does not mean to overcharge your customers. Profit has to be a sort of reward of a well functioning business, creating value to customers.

In the light of globalization and with the spread of information technology companies have the opportunity of an insight in other company's results comparing their results with of other companies functioning in the same filed. Thus, companies interpret profitability in different ways, taking into consideration factors like competition, surrounding environment, considering their business not profitable if the performing indicators are less then for their competitors.

Additionally we can consider that profitability is different to everybody.

To increase profitability even long term-run companies may ask the well known question: what pricing model should I use? Often we can be witness of a tendency when companies under-price their offerings. Probably because several companies have no idea what they should charge, or they are too concerned with existing and potential competitors. Therefore they judge that lowering the price is the best practice. More often the reason of this mistake is that companies have not assessed their baseline, the profit they would like to make, and the working hours needed to complete it.

Approaching the subject from a skeptical point of view, different authors say that there's no right answer for the question: how do you get the price right, moreover we won't get it right the first time they affirm.

Pricing strategies

When developing their marketing strategies companies often turn a blind eye to the importance of pricing, instead they tend to focus on promotions and advertising. Forgetting that fact that pricing can have a huge impact on the company's result.

There are many ways to price a product, thus, companies have the possibility to choose between a variety of pricing strategies. In order to make wise decisions and adopt the most efficient pricing strategy all required is to understand the best strategy in various situations. Some of the things companies have to consider for the best pricing strategy are: costs, taking into consideration both short term and long term sales and profit goals, competitor's pricing strategies, and last but not least customer lifetime value.

A traditional approach to pricing is the *cost-plus pricing*. Probably is the oldest one and still the most popular one. It is wide used among marketers due to the fact that gives a feeling of financial prudence. It is characterized by a compelling simplicity, adding a surcharge to the calculated cost. This extra amount of money added to the cost can be calculated often to reflect an allocation of fixed costs and a required return on capital. Despite of the simplicity this pricing strategy has some major drawbacks which are recognized by everybody: firstly, it is an inward focused pricing practice that has nothing to do with the market. Furthermore, the "cost-plus-premium" model does take into account costs, but seldom the right ones.

Cost-plus price-setters either use fully loaded costs (fixed and variable) or draw the line between fixed and variable costs in the wrong place. For this reason a thorough activity-based analysis is needed to define cost structures accurately [8]. Cost plus pricing strategy fails to take into consideration the consumer side of equation, what is the consumer willing to pay for the offering in comparison to substitute products or services in the market. The other problem with cost plus is that it ignores experience theory for the product. The experience theory was introduced for strategic marketing by Bruce Henderson and the Boston Consulting Group, and is based on the empirical observation that as accumulated experience in production grows, costs decline. What was observed in the empirical study is that with every doubling of accumulated production volume (from 1 to 2 to 4 to 8 to 16…) there is a percentage decline in average unit cost of production that ranges from 5 to 15 percent [3].

The implication of experience theory for cost based pricing is that if volume can be increased, costs can be lowered. If a company can lower cost, then should incorporate projected costs in its pricing decision. This means that gathering cost data for pricing decisions we must look forward, not backward.

Calculating prices without any reference to what customer might (or might not) be willing to pay for our product is an obvious folly. It does not support price differentiation, the ability to charge different prices to different customer segments, which is at the heart of pricing and revenue optimization [9].

Another pricing strategy is the *market based pricing,* which is different from the cost based pricing putting things in a different context. It is commonly applied for commodity products, and by smaller players on the market. Adopting this pricing strategy companies slavishly follow competitor's prices, in this way they can fall into the trap that they do not capitalize on the changing value perception of customers. Furthermore companies will not be able to take advantage of the differential perception that customers hold of versus the competition, neglecting the possibility that they should charge a higher price to customers who value their offering more highly.

Monitoring the competition prices and making sure that a realistic pricing relationship exist with the key competitors is extremely important, but companies also need to adjust their position in order to reflect current market conditions if they want to maximize long term profitability.

Moreover, to build an efficient pricing strategy, maximizing revenue pricing should relate to customer value, adopting a value-based pricing strategy. By definition the customer buys the satisfaction of a want. They buy value, thus pricing has to start from customers considerations.

Price has no relevance in isolation, in itself is useless. For instance the price of a car cannot be converted into value judgment unless a few characteristics are known for instance: the model, the age and manufacturer of the car. Generally speaking, price translates offerings into propositions that can be valued, and value is an equation relating quality to price. The well known equation of value can be written as follows:

Actual or perceived quality x Price = Value

This equation can be detailed in a Value Map, which compares various quality/price alternatives. Here quality is defined as the consumer judgment on product/service proposition relative to competition. In the below presented Value Map both quality and price are compared to competitors. The ranking in the boxes are value ranking (figure 1).

PRICE

Quality

	Higher	**Parity**	**Lower**
Superior	Good value	Very good	Excellent
Parity	Poor value	Acceptable	Very good
Worse	Terrible value	Poor	May be acceptable

Figure1. Value Map

Source: Davidson, Hugh ; Keegan, Warren J. [2004]: Offensive Marketing An Action Guide to Gaining Competitive Advantage, Oxford : Butterworth-Heinemann.

Once established the Value Map companies can put it to good use to define their value delivery and to check the robustness of their overall strategy. This map should be changed regularly as competitor's position change on the marketplace [3].

The value-based pricing strategy in different situations it is called one to one pricing, due to the fact that to each customer is quoted a different price based on the value perceived for the offering [9]. In this case customer value should be the driver of the price.

Ultimately, prices must reflect customers' willingness to pay, and managers can change willingness to pay by manipulating the pricing environment.

Segmentation strategy forms the base of value-based pricing practice. Introducing segmentation fences companies define a criteria that customers must meet to qualify for discounts. When the segmentation criteria are verifiable, such as the buyer's age, the customer legal status (consumer or business, non-profit or for-profit) or location of purchase segmentation fences are also used with success. They can quickly break down, when the segmentation criteria aren't easily verifiable, or when the product could be purchased by a buyer who qualified for a discount. In most cases, where fences alone prove inadequate to segment markets, successful prices must develop metrics to track value [7]. Airline companies are the ones that recognize customer segments, and strive for "first-class," "business-class," and "economy" pricing. First-class customers receive extra value with minimal discounting, whereas economy customers get minimum value. Such segmentation based on price sensitivity creates sales opportunities that can offset losses in other areas, especially since there is often little difference in production costs among the offerings.

In addition, companies can segment customers not only on the base of value but also on the base of time (peak and off-peak purchasing), location, and purchased quantity. Dynamic pricing represents an extension of such a segmented pricing strategy, adopted by airline companies, where prices shift instantaneously in response to changes in supply and demand. Although the practice doesn't suit every company, early testers of dynamic pricing software have been pleasantly surprised to discover how much more they can charge without affecting sales volume. [10]

Considering the above presented pricing strategies we can state that is difficult to find a company where a pure form of these strategies is applied. These strategies cannot stand alone and what is most important cannot lead to profitability if they are considered isolated.

Vacillating among pricing approaches is actually better states Robert Phillips, than strict devotion to one approach. Any company that sticks tenaciously to any one of the three pure pricing strategies would likely find itself in deep trouble. What could be advisable to use pieces of all three methods supplemented by a considerable amount of improvisation, even though the result is a pricing confusion [9].

In order to have a pricing strategy driving for long term profitability companies should take into consideration a highly debated subject in research papers, namely who should be titled to manage pricing decisions in the company. We can find different opinions regarding this subject, but at the end all of them arrive at the same conclusion. To have an efficient pricing process, maximizing profits an individual or a team have to be held accountable for core pricing functions.

In many businesses there exist no clear lines of authority for the pricing function and this could be a barrier to profitability.

To solve this problem companies either bring in consultants to assess their pricing strategy or hire a full-time pricing professional. It's unlikely that, without strong executive support, any person or organization would be able to effect enough support in sales, marketing and finance to empower any one individual or group of individuals with the core pricing function [2]. Michael Calogridis affirms that it is highly unlikely that any company will have a steadily working pricing function without someone who carries the title 'pricing expert'.

It is time for companies to recognize that if they are serious about pricing commensurate with the value they create, they need to establish a core group of enthusiastic pricers in order to make pricing a core competency within the firm [1]. Baker is a strong advocate of this statement, presenting in his book a new position, the Chief Value Officer (CVO), who takes a stand for customer value. The CVO implicitly and explicitly understand that the company's prices are the language in which they strategically communicate value to customers. Furthermore, Baker suggests the formation of a pricing cartel, a committee under the Chief Value Officer who develops pricing policies in alignment with the company's overall strategy. The committee should be in charge of comprehending, communicating and capturing value.

Efficient pricing leading to profitability

Davidson Hugh and Keegan Warren suggest several principles for an efficient pricing which leads to increase in profitability.

The first principle they propose, the most important one to consider, is to know the price dynamics of the market in which our company operates. In order to realize a deep analysis about the market companies should have a look on the following indicators:

- Frequency of purchase, having a major influence on the sensitivity of individual products or services to price changes.
- Degree of necessity
- Degree of comparability
- Degree of fashion or status
- Unit price: high priced items tend to be a subject to long deliberation and considerable price-consciousness.

Secondly, companies should choose the price segment. Every market is segmented by price brackets. Therefore, it is important to establish a price sector strategy.

Furthermore, another principle is to achieve clarity of pricing. Companies have to be consistent in their pricing strategy, adopting a logical and not confusing communication, thus customers have to understand their pricing system. Pricing is often regarded as a somewhat mechanical aspect of marketing, but in fact it provides plenty of opportunities for creativity. Price is only one part of the marketing mix, and the profitability of a change in price should be compared with all the other viable alternatives. It is important to remember that the marketing mix is truly in fact a mix of factors that adds up to the value perceived by the customer.

Another principle is to target the price changes. The marketers need to have advanced knowledge of the differing price elasticities of her customers, and to understand the role pricing plays in the value equation. The objective of the marketer should be to get as many consumers as possible to the point where they acknowledge their brand experience as superior and become regular users. Price should be targeted to reach this objective.

In order to increase profit another suggestion from the authors is to guard against product cannibalization when pricing new products. This is a usual mistake for companies launching new products. Last but not least companies have to be flexible if they make a mistake on pricing, they have to admit it and remedy fast. Anyone can make a mistake on pricing, but the important thing is to face up to it and correct it fast [3].

In order to achieve a successful pricing strategy companies have to consider the following five steps, describe in the figure 2.

Consumer or end-user analysis	Price elasticity Market research Perceived product or service quality Consumer value
Channel or distributor analysis	Channel or account price strategy Channel margins, discounts Channel value delivered
Competitors pricing analysis	Elasticity Perceived performance and value Current price/value strategy Future strategy
Economic and capacity analysis	Quality cost breakdowns Sensitivity analysis Value improvement opportunities Alternate scenarios review
Developing pricing objectives and strategies	Relate to overall marketing strategy Value and profit improvement

Figure 2. Five- Step Process for Offensive Pricing

Source: Davidson, Hugh ; Keegan, Warren J. [2004]: Offensive Marketing An Action Guide to Gaining Competitive Advantage, Oxford : Butterworth-Heinemann.

If the company has a number of identifiable customers types or different buying occasions it is advisable to develop a view of relative price elasticity of each. Moreover, companies should check the perceived quality of the offering proposition versus competition. Asking customers about the company relative quality is better, equal or worse as the competitor's is always a good starting point.

Furthermore, identifying the margin, discount and consumer pricing strategies of each channel and major account and recognizing the changes in future is an important step to the efficient pricing strategy. The company major competitors have to be put through the same process as in the first step establishing price elasticity, relative quality and relative value. Then analyze each competitor past behavior.

At step number four establishing the cost breakdown, and explaining to the finance department their role in the pricing procedure.

Finally the last step capitalizes on the analysis done in the four previous steps and transforms them into proper action. Here the marketer leads the organization to a holistic strategy, focused on the customer.

Concluding remarks

Pricing holds a central position in the corporate affairs of a company because pricing decisions are a major factor in determining the volume of business the company will achieve, its positioning the market compared to competitors and its total sales, revenue and profit. There are two reasons why companies put a price on something, they want to sell it and they want to make a profit [4].

Pricing has to follow the following simple rules to assure profitability:

- the pricing strategy has to reflect transparency, if customers miss a sale they have to feel comfortable buying at another time at full price;
- clarity;
- Simplicity, prices have to be expressed in whole amounts. Companies have to forget the ninety-nine gimmick, because customers can round up;
- trust has to be build in order to strengthen the relationship with customers.

Summing up the conditions for effective pricing decisions we do not have to forget that an essential factor contributing to the success is strategic pricing. It is essential that the formulated pricing strategy supports the company's general goals and strategies and contains an inbuilt flexibility, which makes it possible to make immediate adaptations and react to changes in the market, competitive behavior [6]. Pricing strategies have to be made with reference to the company broad strategic choice; pricing has to be linked to strategy.

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