Knowledge for Decision Makers

vocatus:

Pricing studies – then what?

Many companies fail to earn the full value of their profits because their pricing strategy is not based on the actual decision-making process customers attribute to the product. Pricing studies can provide some help, but they are only the first step on the path to behavioral pricing.

A pricing study is only the beginning

Pricing studies are the first step toward consistently exploring all sources of price acceptance, and thus noticeably increasing profits.

Why is a probiotic yoghurt more expensive than a normal yoghurt? And why do wholesalers demand more money from a joiner than an electrician for exactly the same LED lamp?
Both pricing strategies have in common that they are guided by the diverse decision-making process experienced by the customer when choosing whether or not to buy a product: The probiotic yoghurt seems to be healthier, which changes the nature of the purchasing decision. And the joiner simply buys the LED lamp from the wholesaler where he buys everything else. After all, he doesn‘t often need this product, so he avoids the extra effort involved in making price comparisons. By contrast, the electrician chooses his wholesalers based on price comparisons of these kind of products, because he needs them often.

Nevertheless, many companies‘ pricing is still predominantly based on internal costs – and it costs just as much to produce a probiotic yoghurt as a normal one. The same applies to the LED lamp, and this means that one‘s own costs are of only limited relevance to achieving a profitable pricing strategy.

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It's a similar story when considering the notorious "gut feeling" so beloved by managers, or the cue taking by looking over the prices demanded by competitors. Competitors themselves often simply look over the shoulders of other companies, consider what their manufacturing costs are, or just trust their own instincts. If a company bases its pricing on what its rivals are asking, it runs the risk of merely replicating their mistakes. However, there's a much more crucial aspect: customers are often totally uninterested in the prices demanded by the competition, and are completely unaware of them too. This means it makes much more sense – and is far more profitable – to be predominantly guided by the relevant decision-making process and the resultant price acceptance (so-called behavioral pricing).

Costs, "gut feeling", or comparisons with the competition are of only limited relevance if one is to achieve a profitable pricing strategy.

A pricing study can be deployed to systematically and empirically ascertain price acceptance – if one takes account of customers' actual decision-making processes. This means that behavioral pricing goes one step further than the much-propagated concept of value-based pricing: Instead of just analyzing the perceived value of the pure product features, in behavioral pricing it is necessary to analyze all sources of product acceptance along the entire decision-making process.

In other words, price acceptance does not necessarily originate from product features, but can also result from a lack of price awareness. Nonetheless, many classic pricing research methods fall short of their mark, and must be duly extended and/or supplemented (see brochures devoted to "Behavioral Economics", "GAP: The Repair Kit for Conjoint Analyses" and "Behavioral Pricing").*

One can thereby validly illustrate customers' actual decision criteria and price acceptance, which duly influence their behavior. Experience demonstrates that this enables one to achieve noticeable increases in profits, while at the same time avoiding wrong (and costly) decisions.

* Download by going to www.vocatus.de/feedbacks

Time for a rethink

After a pricing study, many companies know they can ask considerably more for their products. However, they come to grief when they try to enforce these prices, because behavioral pricing challenges deep-seated ways of thinking.

Any profitable and professional pricing strategy focuses on the decision-making process that the customer undergoes, the aim being to exploit the resulting price acceptance to the fullest. However, different customer groups also accept different prices. For companies, this means that they have to analyze the origins of price acceptance in a segment-specific manner, and as a direct consequence of this, they will then have to set different price levels for the individual customer segments (as in the above-mentioned LED example).

This isn‘t a problem from the customers‘ perspective, so long as they‘re unaware of the price differentiation or feel it‘s fair and logical. Thus, for example, reduced-price magazine

Whoever wants to put a price on products which matches their price acceptance must also develop and sell them according to their price acceptance.

subscriptions for students or cheaper airline tickets for early bookers are generally accepted. However, the following usually applies: any discount on the reference price must be made obvious (and plausible) to customers. Indeed, large discounts or different prices for which there is no discernible justification may disconcert customers and make them feel this is unfair. Even worse: such measures undermine the product‘s perceived value, and thus – in the medium term – customers‘ price acceptance too. This means it‘s vital that the pricing study should not only examine individual price points, but also always shed light on the dynamic perception of the overall pricing structure in different customer segments.

When it comes to pricing, the path of least internal resistance is often the surest way to destroy margins.

Still, the real challenge presented by a differentiated and decision-oriented pricing strategy that's geared toward specific segments lies within the company itself. Often the very notion of behavioral pricing conflicts with the prevailing ways of thinking and existing organizational structures. A pricing study shortly before a product is launched may well be a start (and is the first step in the right direction), but if one is to consistently use and implement behavioral pricing, one must already consider customers, their needs, their decision-making process and the resulting price acceptance during the product development stage. Hence one doesn't start out with an existing product, analyze its costs, use them to calculate the retail price,

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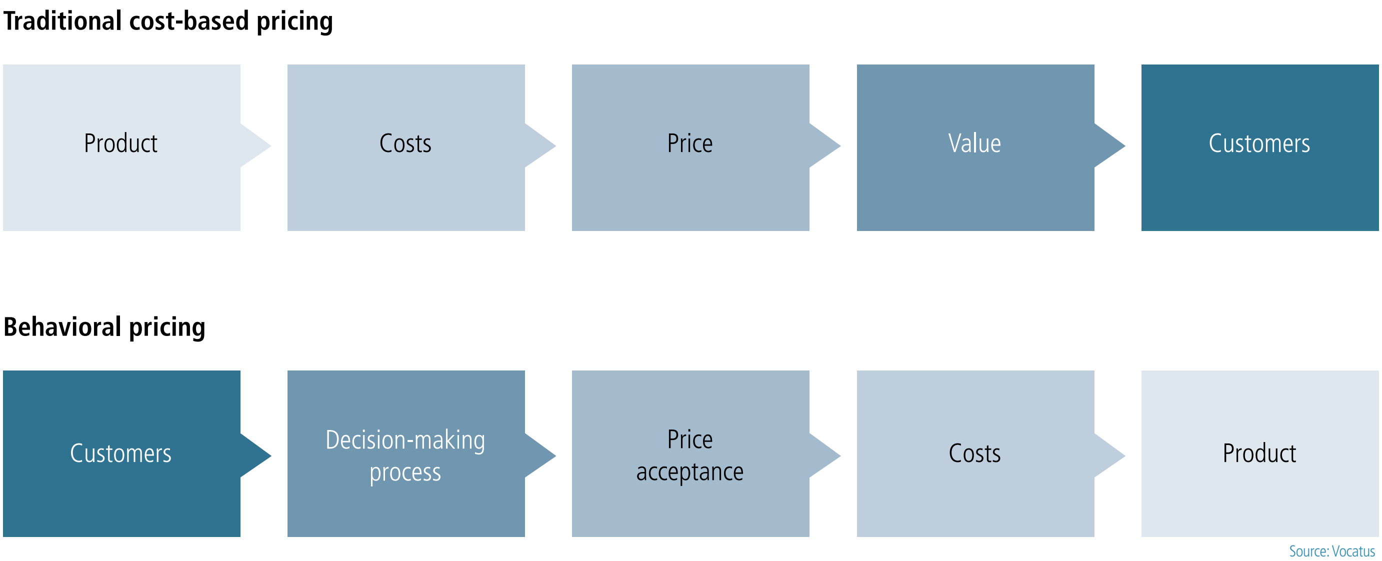
Chart 1:

When it comes to behavioral pricing, the decision-making process is the first – rather than the last – element to consider.



and then consider which values ought to be conveyed to the customer. Instead, one chooses precisely the opposite route (see Chart 1). In short: if one wants to price products in a decision-oriented way, one first has to develop them with that decision-making process in mind, and only then can they be sold. Behavioral pricing therefore heralds a paradigm shift, moving away from a focus on the product and from a purely subjective value and towards a comprehensive understanding of the decision-making process as a key factor.

Whether or not behavioral pricing can be enforced in a given company is thus often a matter of organizational development rather than acquiring a better understanding of price acceptance. As a rule, behavioral pricing also means one has to bid farewell to deep-seated habits and procedures: for example, it's customary for many companies to increase prices by 2% every year in order to keep pace with inflation. This kind of price optimization may be straightforward, and its successful passage through various boards and committees may be a matter of routine, but in some circumstances it can ignore customers' price acceptance and thus unnecessarily squander valuable margins. This demonstrates that – when it comes to pricing – the path of least internal resistance is often the surest way to destroy margins.

Alternatively, in order to use the considerable potential for profit which is offered by behavioral pricing and to implement it in the company, a gradual four-step model has proved to be successful (see next article).

Four steps to behavioral pricing

A step-by-step approach is preferable if one is to introduce behavioral pricing. However, these steps must go beyond pricing alone, and include the creation of the right organizational conditions.

If one is intent on deploying behavioral pricing, the most serious obstacles will be the beliefs and thought patterns that are deeply rooted within companies, and it will undoubtedly take a while to break them down. Experience suggests that the most effective way of accomplishing this is to conduct a pricing study which – from a sound empirical basis – initially calculates the potential of behavioral pricing by examining a core product. The only thing that‘s crucial here is the price acceptance of those people who must ultimately open their wallets: the customers.

> A single pricing study will not induce a company to adopt behavioral pricing.

This kind of study generally reveals a much greater price acceptance. Assuming that it identifies scope for price increases amounting to as much as 23 %, could there ever be a better argument in favor of behavioral pricing? Is there any better way of discrediting outdated dogmas, such as “we can‘t expect our customers to stomach more than a 5 % rise”? If one can demonstrate that this product (which sells two million units every year) can henceforth be sold for 5.90 euros instead of 4.80 euros (+23 %) without a slump in sales, one is suddenly faced with lost profits amounting to 2.2 million euros. Possible barriers rapidly crumble if one crunches the numbers for an actual product in a real-life market

Chart 2:
The four-step model to impl

Pricing

Roll-out: transferring
- Implementation of findings in relation to price level, pricing structure, price dynamics, and price communication
- Comparison of previous procedure and ROI calculation

Initial pricing study

Pricing execution

Roadshow: persuading
- A holistic understanding of the role of price from the customer’s perspective, plus demonstration of opportunities for behavioral pricing (internal, and among external sales partners)
- Correction of stereotypical hypotheses and beliefs
- Identification of barriers that will impede implementation, inclusion of relevant stakeholders and their concerns

environment, and internal as well as external stakeholders will be convinced by the added value offered by behavioral pricing.

It is already apparent that behavioral pricing can only be implemented by adopting a two-pronged approach whereby the two elements go hand in hand (see Chart 2): firstly, it's necessary to adjust pricing in its narrower sense, namely develop a comprehensive pricing strategy. Secondly, one nevertheless has to create the corresponding organizational conditions to execute this pricing strategy.

This is precisely where the initial pricing study provides some crucial back-up: for example, one can soon see which business units are involved in conducting and implementing the study. Who are the stakeholders? Where are the possible stumbling blocks? These hurdles differ from company to company. Sometimes the Sales department is wildly enthusiastic about selling on a customer-based basis in the future, whereas those in charge of finance and budgeting cling to their old habits. It can be precisely the reverse in other companies. The crunch point usually proves to be the extent to which one can prevent decision-makers from thinking in terms of "rational consumers" and at the management level create a common understanding of how customers actually deal

Pricing and its execution within the company go hand in hand.

with the topic of price. In order to achieve this, it can be helpful to calculate the Return on Investment derived from the pricing study. In other words: what concrete added value has already been gained as a result of the study?

Moving on to the second step, one can then build upon this to identify further products where an optimized pricing strategy promises the greatest success and the budget for a pricing study would be most sensibly invested. In addition to examining how products relate to one another in terms

lement behavioral pricing.

Portfolio: defining the strategy
- Identification of products with the greatest potential ("low-hanging fruit")
- Step-by-step definition of portfolio pricing strategy, from values to price relationships
- Definition of international channel and segment strategy

Methods: ensuring validity
- Definition of methodological standards and master designs related to conducting pricing studies
- Guidelines for the analysis and interpretation of pricing studies
- "Train the trainers" program
- Establishment of centralized knowledge management

Monitoring: doing the right thing
- Quality assurance with regard to external research partners
- ROI calculation for each study
- Long-term validation of forecast and elasticity models
- Feedback regarding ongoing optimization of methodological approaches

Organization: defining the structure
- Definition of who is responsible for prices and discounts and escalation processes
- Establishment of Pricing Board and Pricing Team
- Definition of pricing roadmap
- Definition of pricing process and gradual adaptation (centralized to decentralized)

Methods: ensuring implementation
- Sales: training sessions about decision-oriented selling, with examples of best practice; development of a "segmentation tool" and "battle cards"
- Documentation: strategic "pricing charter" and operational "pricing and discount guidelines"
- Communication: international "pricing excellence forums"

Monitoring: doing it right
- Agreed targets, with remuneration and incentive systems that are geared toward contributions to overall profits
- Development and implementation of evaluation routines relating to ongoing price analysis
- Management and "early warning" system
- Discount and contract management

Source: Vocatus

of price acceptance, one should also consider elements that are supposedly set in stone (such as product names), since they often mislead customers when they're trying to position products from the perspective of price. One can thus produce a long-term pricing roadmap – ranked according to priorities – within the context of a comprehensive portfolio pricing strategy.

However, this new strategy must also be firmly established among the relevant areas of responsibility within the organization, and the best way of accomplishing this is to adopt a step-by-step approach which is visibly endorsed by senior management. The prerequisite for this is a "Pricing Board" filled with top-quality appointees. In addition to formal areas of responsibility for prices and discounts, one should in this context also define possible escalation levels for the authorization of extraordinary terms and conditions. This guarantees flexibility, although it should only be used very sparingly.

Behavioral pricing isn't always a "quick win", but it's definitely a "big win".

The third step then ensures that the methods required for the long-term implementation of behavioral pricing are being correctly applied throughout the organization. This is firstly about defining the fundamental procedure to follow for pricing studies, which necessitates the corresponding corporate units or skill centers so that pricing studies can be conducted independently. Within these units, proprietary pricing research methods are then developed and documented, and employees are trained to use these tools. One should always include those employees who have already made a significant contribution to the initial pricing study. To complement this, a "train the trainers" program ensures that employees will be able to advance behavioral pricing in the future without any outside assistance.

However, it's vital that the Sales department and sales partners should play their part too: to this end, one can for example develop so-called "battle cards" in order to support consistent price enforcement. This is accompanied by training sessions which look at decision-oriented selling, and they can encompass anything from a strategic "pricing charter" through to purely operational guidelines. Finally, regular company-wide forums ensure that individuals can exchange views and experiences, thereby breathing life into the formal documentation and helping to further develop the system.

The fourth step ultimately aims at constantly monitoring and ensuring that behavioral pricing is genuinely being adopted within the company. In terms of actual pricing, the main task here is to validate the simulations and sensitivity models and further refine the methodology.

In the organization itself, especially the Sales department, it's important to secure price enforcement in the longer term through the corresponding agreed targets and incentive schemes. This is where a radical rethink is often required, since it's frequently the case that the Sales department is not only responsible for discounts, but at the same time is incentivized according to sales/turnover. This must be corrected if a company wants to stop destroying its margins. At the end of the day, no Sales employee can be accused of having previously depended on discounts to sell goods so long as they are incentivized according to sales/turnover and can define the discounts themselves. Nevertheless, it's just as important to develop and introduce ongoing price analysis routines. When combined with relevant figures, this produces an optimal management and "early warning" system.

Experience demonstrates that behavioral pricing is best introduced via small, incremental steps. If one is to achieve long-term success, it's crucial to think beyond pricing alone. Instead, this strategy must be firmly anchored within the organization, and with the corresponding framework conditions, otherwise the new pricing strategy will lack a solid foundation and remain nothing more than a theoretical exercise. It's also evident that a single pricing study will not induce a company to adopt behavioral pricing. Nevertheless, many companies have already made a good start, and must by no means start from scratch. This sort of process should be a "no-brainer", yet it isn't. Even if value-based pricing isn't always a "quick win", it's definitely a "big win".

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Tina Terras & Michael Walter

The central subjects of their photography are people and water: "We love the lightness and freedom under water, to portray people floating in water and amaze the viewer." Indeed attention is always drawn back to their pictures – an effect that, especially for ad campaigns, can't be dismissed.

It is remarkable how their pictures tell their own story. When they were still living in Southern France, Tina Terras stumbled across pictures of Sylt on the internet which she thought were her own – the beaches of Sylt look very similar to those of the South Atlantic Coast. But these were the pictures of the Sylt native Michael Walter, who in turn had been attracted to her pictures and thought they were his own.

That the contact had been established without either one knowing that the other already knew was simultaneously revealed by a fortune-teller on the French side, and by a soothsayer from Flensburg on the German side, who said that the two were not only professionally intended for one another. And so it came to be. Since 2009 Tina Terras & Michael Walter work as freelance photographers in Kiel.

Website: www.1000literfotos.de
Email: info@1000literfotos.de
Facebook: www.facebook.com/1000literfotos

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