VLERICK BUSINESS SCHOOL

WHAT IS THE RIGHT PRICE?

6 PATHS OF VALUE CREATION THAT CAN LEAD TOWARD HIGHER PRICING

BY PROF DR KOEN TACKX

Pricing matters. It's one of the most critical drivers of profit in any company. Yet it is one of the least understood. And as a business skill, the capacity to set prices strategically is also one of the most undervalued.
Too often, business managers rely on gut feeling, on assumptions, past experience, experiments or simple cost-plus models to set prices.

THE RESULT?
You don't capture the full value you are creating for your customer and you leave money on the table. Worse still, you increase prices without a clear strategy or rationale. And you end up losing customers.

WHY PRICING MATTERS

Let's say your business has two key objectives[1]:

1. **CREATING VALUE FOR YOUR CUSTOMERS**
2. **CAPTURING PART OF THAT VALUE FOR YOUR SHAREHOLDERS AND OTHER STAKEHOLDERS**

Your full value chain from creating value – innovation to development, production to marketing and sales – needs to balance with capturing value through the price.

Get your pricing strategy wrong and you lose that balance. Either you fail to capture the value that you create by charging prices that are too low, or you risk losing customers by charging too much. Get it right, and the impact on your bottom line will be positive and significant.

Think of it like a sport. An athlete or a team needs to prepare adequately for the competition. Sufficient preparation determines whether they are rewarded by a prize (price!) or not. The impact of the price on your profit can be huge.

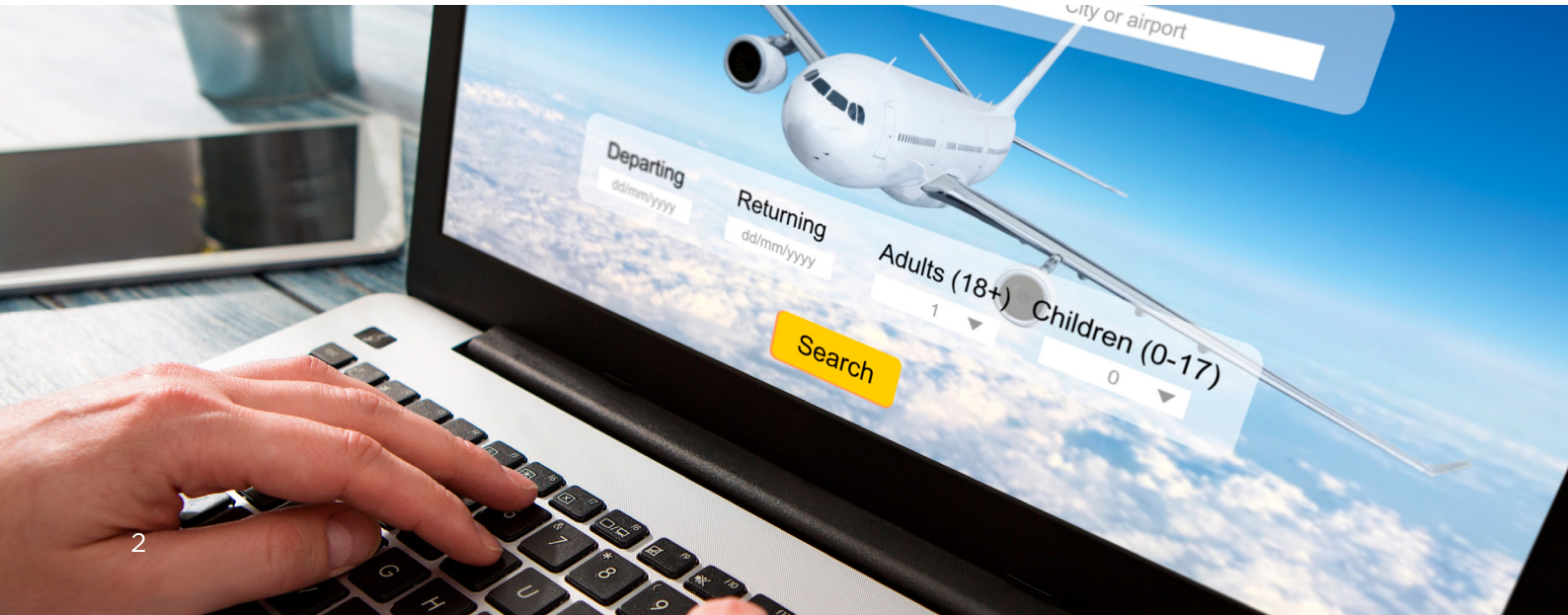
Take Brussels Airlines. In 2018, they made a net profit of €12.7 million on more than €1.5 billion in revenues[2]. This means that an increase of just 1% in ticket prices could more than double the profit, provided the number of passengers stays the same.

The ability to charge higher prices than the competition is not only a technical "pricing" matter. It starts earlier, at the point where you define how to offer higher value to the customer. Look at the example of Netflix. A company that began selling DVDs has evolved into the world's premier streaming service and, more recently, a producer of its own content.

Netflix operates a kind of *innovation loop*. They innovate, create new products, market and price them, capture the value and then start innovating all over again. Now Netflix has a track record of increasing prices regularly, and substantially. In May 2014, the price of a standard Netflix subscription in the USA was raised from $7,99 to $8,99. Two further $1 price increases followed in October 2015 and 2017 respectively. The price increase in January 2019 added $2, leading to $12,99 – a 60%+ price increase in less than 5 years[3].

Yet every time they increase their prices, they increase revenue and profit which they can then invest in more content to create more value, winning more customers. It's a flying wheel of sales, innovation and pricing and it keeps competitors at a distance.

So how can other companies reap these benefits of higher prices?



THE VALUE PRICING PYRAMID

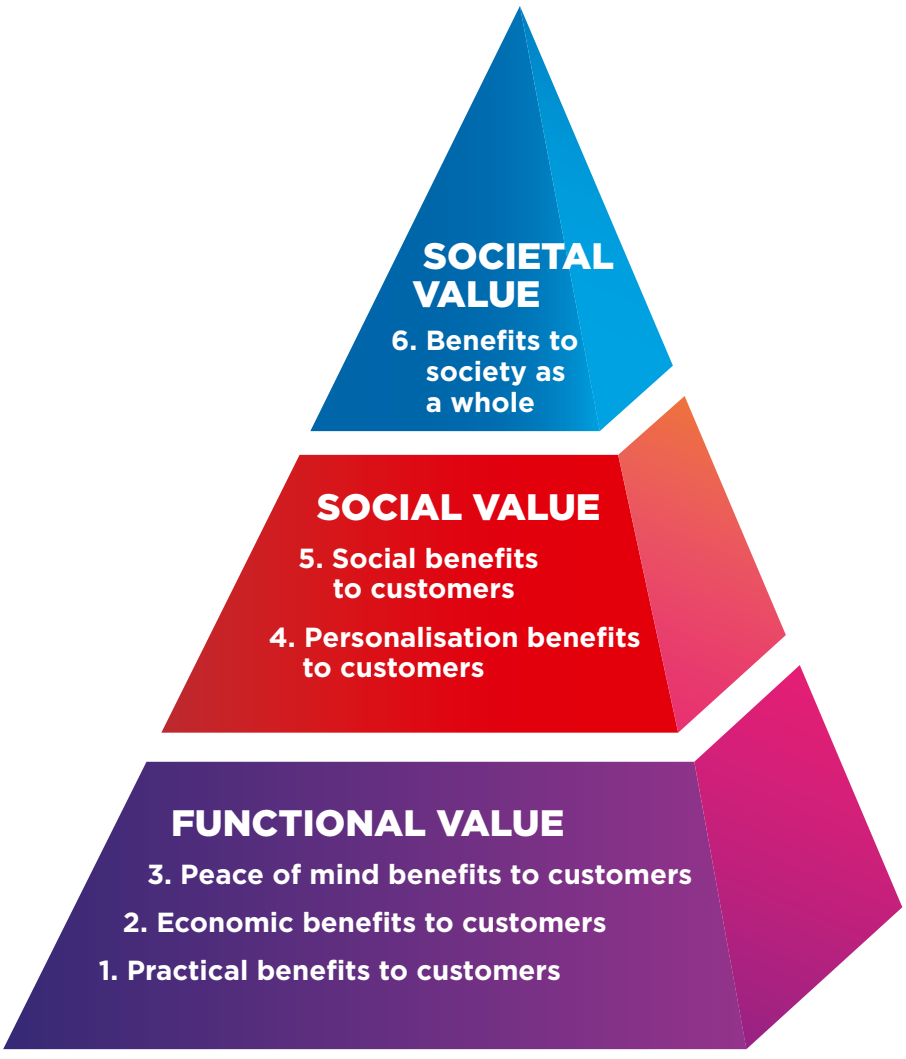
SIX PATHS TO SUCCESSFULLY INCREASING PRICES

Some companies are able to charge more than their (initial) competitors with products that are not necessarily technically superior or even fundamentally different. The key to their success is that they deliver *superior value* to their customers. To define customer value that can be monetised, look at this Value Pricing Pyramid. This pyramid is made up of three layers that represent three key areas of *value creation* for your customer:

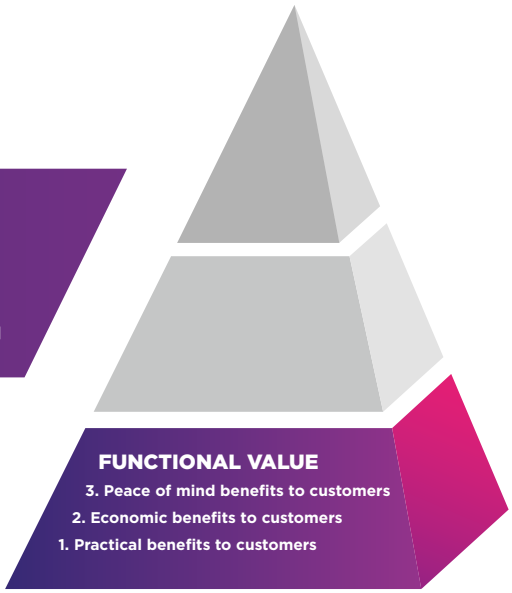
1. **FUNCTIONAL VALUE**
2. **SOCIAL VALUE**
3. **SOCIETAL VALUE**

Within each of these three layers, you will find specific pathways to value creation. These, in turn, will enable you to increase prices while gaining customers.

In total there are six pathways to creating benefits: practical, economic, peace of mind, personalised, social and societal.



CREATING FUNCTIONAL VALUE



PATHWAY 1
PRACTICAL BENEFITS FOR YOUR CUSTOMERS

When your product functions better than the competition, customers reap the kinds of benefits that may make them prepared to pay more.

Take Google's AdWords. AdWords is not the cheapest method of advertising online. For words like "lawyer" or "casino," companies are reported to be willing to pay more than $50 per click[4]. Why are people prepared to pay so much? Because advertisers want to reach their audience as efficiently and effectively as possible. And they want to do it fast. AdWords provides greater functional benefits to customers looking to promote their products and services because they target end users more effectively than many of traditional advertising.

A more generic example is that ubiquitous supermarket staple: the salad in a bag.

Think about it. Is a salad in a bag any better than a fresh lettuce? Probably not. But the end customer gets the convenience of not having to go through the process of washing and drying the salad, and cleaning the utensils used to do so. As such, salad in a bag can retail for more than 10 times the price of ordinary lettuce. The key here is to think carefully about what your customer does just before and just after they buy your product: what need does it answer and how does it function effectively to meet that need?

If your product provides twice, 100 or 1000 times the practical convenience of your competition, you are in a position to adjust price accordingly. The monetisation principle often changes completely. In the case of the salad, the services of washing and drying that customers might find cumbersome are literally included in the price of the bag. The Google offering also focusses more on the end result than traditional advertising, and applies a continuous "auction" technique to optimise pricing.

PATHWAY 2
ECONOMIC BENEFITS FOR YOUR CUSTOMERS

If your customers stand to make economic savings using your product, they are more likely to be prepared to make a greater initial outlay when purchasing it.

LED lights use only a fraction of the electricity of traditional light bulbs and last much longer, but are considerably more expensive to buy. The trade-off to customers? Sometimes an impressive reduction in electricity costs for lighting a room[5]. Electric vehicles are currently also more expensive to buy but outperform conventional cars in day-to-day running costs and maintenance.

The takeaway here? If your product represents an opportunity for your customer to save money after purchase, you have a clear rationale for charging more. In essence, you are creating a kind of third-party revenue stream in which you absorb the profit of someone else in the value chain. In the case of LED lighting, this is the energy provider. To put this in practice, you might facilitate the calculation of the "total cost of ownership" or even better, develop a "business case calculator" where the latter not also demonstrates costs, but also the gain potential. A critical condition is often that a longer term thinking is applied by the customer.

PATHWAY 3

PEACE OF MIND BENEFITS FOR YOUR CUSTOMERS

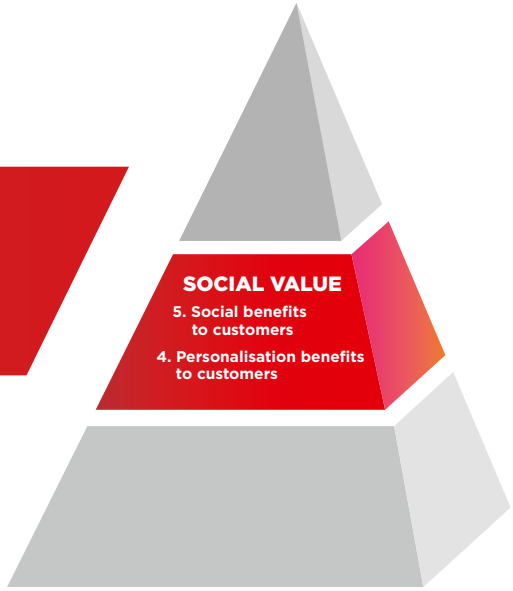
In the US, a new service is emerging on the parking lot. Companies like Filld.com fill up your car with petrol while you are at home or at work. Sure, you pay for the service (and the gasoline), but you don't have to worry about filling your car at an inconvenient moment.

Rolls Royce makes engines for planes and boats. But since 1962[6] they have operated a subscription model called Power by The Hour, providing engines to airlines. For a flat hourly rate per engine, Rolls handles a large variety of service, going from installation, check-ups, maintenance and decommissioning. For airlines and now also shipping companies, this translates into peace of mind. They might pay more for the service, but in exchange they enjoy the predictability of subscription payments without the hassle of engine purchase and the responsibility of overhauls. They can get on with their core business of flying or shipping customers or goods around the planet.

What have Rolls Royce and companies like Filld understood? If you offer a service that means your customer doesn't have to worry about something that is not core for them or their company, you can attach a price to that service that will impact your bottom line. This can be seen as an extension of the practical benefits of pathway 1 through time.

When pricing a "peace of mind" solution, it is key that you have a clear view on the expected costs and benefits of your solution as there is often a risk transfer from the customer to your side. Historical or real time data might help you to estimate what probabilities of events in the service provisioning are.

CREATING SOCIAL VALUE



PATHWAY 4
PERSONALISATION BENEFITS FOR CUSTOMERS

A personalised or individual product – a *one-off* that reflects one's own sense of self, control and individuality -- can incentivise people and businesses to pay more.

In the automobile industry, BMW-owned Mini cars are traditionally offered with a broad set of options giving future owners the possibility to have a car that is "different" from other Mini owners. In 2018, they went one step further with launching the Mini Yours Customised[7] proposition which includes a set of options to fully personalise your vehicle using digital and 3D printing techniques. Imagine your name printed on the door trims or a personalised welcome message projected on the ground while opening the door. MINI Yours Customised exhorts buyers to "make their mark on Mini" with a range of designs, patterns and colours which owners can change as often as they like … at a price.

Nike by you is an entire co-creation process offered to customers online who are looking for a unique pair of running shoes. Customers can "design" their own sneakers for an additional cost. In the high-end luxury goods sector, companies like Gucci give customers the option to personalise shoes and bags with their own initials – with a substantial hike in the original price of the goods.

There is an important psychological dynamic at play here. Not only do consumers end up with a bespoke product that speaks to their sense of individuality. The process itself is also *enriching as such*[8]. So, in a sense, Nike, Gucci, BMW and others are creating an additional layer of value to their customers – for which some are prepared to pay.

In B2B environments, offering features and services separately from the basic product and service solution might be appealing to expert customers that prefer to compose their solution themselves[9]. By selecting different options, tools and services, the end price may be higher than a so-called "integrated" solution. Putting this pricing technique into practice, transparency on the prices of individual choices could increase the customer ownership for what he or she is paying.

PATHWAY 5
SOCIAL BENEFITS FOR CUSTOMERS

Human beings have basic needs, among them the need to be heard by other people and the need to belong to a group[10].

Savvy business organisations can address these human needs, creating value and leveraging opportunities to increase prices, revenues and profits at the same time.

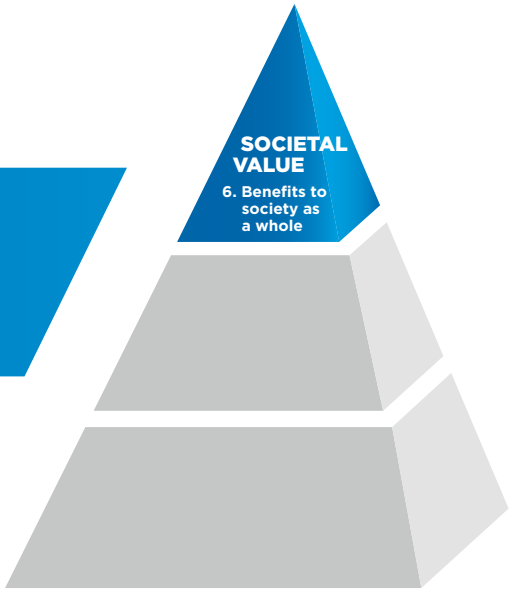
LinkedIn is the premier online professional network. Users can join for free, but additional benefits – the ability to send InMails to extend your networking reach, for instance, come at a price that many businesses and individual customers are willing to pay.

You might have heard of a new social networking app for sports enthusiasts called Strava. Strava connects to your wearable and/or smartphone and monitors and stores physical activity. The innovative element of the app is that it connects users who can then compare their performance, join challenges, feature on leader boards and monitor individual performance and progress. Users can also give "kudos" to encourage people they are following and comment activities.

At the end of 2018 Strava announced they had more than 36 million users worldwide who had uploaded more than 624 million sports activities over the preceding year[11]. Why? Besides the practical value of keeping track of activities, Strava generates multiple personalisation and social benefits: a "proof" of an individual's personal sporting accomplishment, sharing and comparing those with groups of people of choice; receiving positive feedback and the ability to give positive feedback on the achievements of others.

These types of social benefits can be monetised in different ways. The most evident is segmented tier pricing, often starting with a free "step-in" price: the so-called freemium model. Paid subscriptions often include more analysis and/or communication possibilities. Third party payers (e.g. advertisers) are also introduced especially when the existing base of users is substantial. Building on the rich data which becomes available, a premium price compared to traditional advertising techniques can be charged.

CREATING SOCIETAL VALUE



PATHWAY 6
BENEFITS TO SOCIETY AS A WHOLE

THE BRAND OF THE CUSTOMER MARQUE DU CONSOMMATEUR [12]

An initiative launched in France in 2016 is gaining international traction. Consumers themselves decide on the amount to pay for milk, weighing factors such as farm labour, the time each animal must spend feeding outside and which type of food they receive. Prices are substantially higher than for competitors' milk, but in 2019 the number of consumers had grown to 11.2 million, with 124 million litres of milk sold since launch.

The example above demonstrates of how people are willing to pay more for products that are better for the planet, natural resources, animals and human beings involved in their value chain.

A recent US survey found that buyers want sustainable products and almost 47% are willing to pay more. This willingness to pay effect appears to be stronger amongst younger, generation Z customers[13].

More and more companies and organisations are applying an internal or external price for the use of natural resources that goes beyond the "material" cost. Carbon pricing is an example that the World Bank is also focussing on. Charging internally for carbon can lead to different investments but also product decisions[14]. Travel agency Uniglobe helped the University of Ghent to review its transportation means. In the case a flight is still needed, the CO2 is compensated[15].

Creating societal value through your product or service is a key pathway to the kind of value creation that can drive pricing strategy. Most customers are willing to pay more for an offer that respects the value chain from a societal point of view. Three conditions are key to gaining traction with customers apply: the impact on society should be **concrete** (e.g. like the brand of the consumer), the initiatives must be **credible** (e.g. through an audit) and purchasing this kind of offer should be **convenient** (e.g. by just ticking a box at the end of ordering a flight to compensate Co^2 emissions).

GOING ABOUT IT THE RIGHT WAY (AND AVOIDING THE PITFALLS)

As we have seen, there are **six key pathways** you can follow to increase prices and drive your bottom line and/or increase your societal relevancy. Those six pathways are contingent on creating functional, social or societal value for your customers. Getting it 100% right means focusing on how you create value. It also means making a commitment to being honest and open.

There are **three** core ethical considerations that should underscore your pricing strategy.

1. BE FAIR

Back in 1999 Coca Cola tried to hike vending machine prices when the weather was warmer. Enraged customers complained and the media stoked the controversy by securing this comment from rival firm, Pepsi: "*At Pepsi, we are focused on innovations that make it easier for consumers to buy a soft drink, not harder.*[16]"

The PR fallout for Coke was as swift as it was damaging.

2. BE TRANSPARENT

When Mondelez International increased the gaps between Toblerone's distinctive triangles, they assumed no one would notice. Consumers however were quick to point out that the iconic chocolate bar now resembled "Holland more than the Swiss Alps" and eventually, Toblerone reverted to its original shape[17].

3. BE CONSISTENT

In 2018 the cost of tickets issued by three airlines for flights between Brussels and JFK airport at a given day with a fixed return date was analysed. Pricing discrepancies revealed vast inconsistencies. While the cheapest tickets were being charged just over €250, others were offered at more than €3,000.

The airline industry is an example that differentiates prices on a large variety of different elements. Customers accept price differences when it is clear why they are paying more or less. Rules that are inconsistent or perceived inconsistency can alienate customers. How would you react if a work colleague was doing exactly the same job as you for a different salary?

"The nature of business is to create value for your customers and to capture part of that value for your shareholders and stakeholders. The two, twin parts of that equation should be balanced equitably, which means building a pricing strategy that aligns with your ethics and values as a business."

YOUR NEXT STEP

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