



What is **value-based pricing**, and why should I care?

Most companies don't practice value-based pricing. That's a fact. Rather the majority would categorize themselves as either cost-based, market-based or competitor-based pricers. Yet I would bet if you asked any group of executives which orientation is best for business, value-based would win hands down. So why the gap? And why should you care?

Market-based (aka customer-based) pricing is characterized by an understanding of what customers are willing to pay for a service, with the primary objective of closing the sale. Market-based pricing typically emerges when businesses launch, as profitability takes a back seat to growth. After all, the primary goal of the business is survival, and simply gaining a customer is considered a success. Profitability is generally a function of sales, operating under the belief that if we sell more stuff, we make more money. If there is a pricing philosophy in the firm, it is price to "close the deal". It follows that the organizational locus of pricing power is in the sales organization. As a result, without pricing in the way of sales, the outcome is growth but low margins. For a new business this may not be a bad outcome. It is just not a very profitable outcome. Strategically, market-based pricing tends to increase price competition.

The mantra of cost-based pricing is "make your margin". The good news is that it does encourage profitability. The bad news is that it annoys your sales people and customers because your costs have nothing to do with why customers choose your company and offerings. In sum, with cost based pricing profitability is achieved at the expense of growth, with the director of pricing commonly referred to as the "VP of No". Cost-based pricers often have price policies that are misaligned with the marketing strategy of the firm. The locus of pricing authority tends to be finance, who has a thorough appreciation for the power of price, but in many cases not the market sensitivity to align price policies with marketing strategies. Information for setting prices tends to be financially oriented.

Competitor-based pricing often emerges as organizations strive to become more strategic. As they should, organizations look to the marketplace and profile competitors. The mantra becomes "Watch the Competition". In the evolution of pricing capability, this is an important step because it is a move toward a strategic view of pricing where competitor behavior and the role of pricing in creating competitive advantage are considered in decision making. Paradoxically, despite the more strategic orientation, a focus on the competition may increase price competition if firms are inclined to match one another's prices. In sum, competitor based pricing can lead to reduced differentiation among competitors and increased price competition. Unfortunately, if you are watching the competition you are not watching the customer. That's the problem with competitor oriented pricing.

Value-driven pricing is unique because of the primacy of value, where price is determined by the relative value of your offering versus the competition. For example, sales people with a value orientation will be very comfortable saying "our prices are 20% higher than those of the competition, and here is why that



is good news for you”. Offering differentiation and price points are maintained because the focus is to improve the performance of your customer’s business, not on covering your costs. Professor Jim Anderson at Northwestern, a leading authority on value, defines value as “the worth in monetary terms of the technical, economic, service and social benefits a customer firm receives in exchange for the price it pays”. Value based pricers ask 3 questions

1. As a result of working with us rather than the competition, how will the customer be better off, measured in monetary terms?
2. What costs must we incur to deliver that value?
3. What price level and structure will allow us to maximize long term profitability of the service/customer/business?

Note a value based price may be higher, lower or the same as the market average. Price is set strategically, dependent on the market strategy of the business. The objective is to maximize profitable growth.

The challenge of value pricing is doing the work. Value pricing requires information, structure, training, controls and incentives to be effective. The payback is usually substantial. One study found that value oriented pricing resulted in more satisfied customers, happier employees and higher profitability. When price and volume are no longer at odds, profitable growth is the result.

The following real life example illustrates how prices might vary across the four models, and how value-based pricing won the day.

A new advertising agency believed that a segment of the attorney market, trial attorneys, was underserved by existing competitors. Trial attorneys often have incomes several times as high as other members of the legal profession and are highly concerned with the image they project. The new competitor believed these firms would have an appetite for premium offerings at a premium price.

Their primary competitor was an established agency with a national clientele that specialized in the development of syndicated advertising programs for physicians and attorneys. If you tune into daytime television on a sick day, you have seen their work. Over 20 years they built a brand and standardized set of offerings. Good value at a good price.

Let’s say for example that an annual syndication license from the established competitor cost \$25,000. Then the competitor based price for the new entrant would be \$25,000. The market-based price might be less because of the desire to close the deal in a head to head competition, or say \$22,000. The cost based price, because it was a startup with high fixed costs might be \$30,000. In fact, the new entrant chose to price their offering on value, which they determined to be 5X the level of the existing competitor, or \$125,000. Because of their targeting and unique offering they succeeded at market entry, creating a very profitable market segment in the process. Obviously, if the new entrant had focused on the competition instead of value, they



likely would have ended up with a mediocre offering, weak financials and a small market position.

This example illustrates the mantra of the value driven pricer: “Create, Communicate and Capture Target Value”. The value orientation enables breakthrough offerings and strategies where price and volume are no longer at odds. One study found that value oriented pricing resulted in more satisfied customers, happier employees and higher profitability. When price and volume are no longer at odds, pricing processes can be configured to empower sales and shorten the sales cycle.

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