

HAMILTON CONSULTANTS

NEWSLETTER

Providing Marketing and Strategy Insights to Managers • 4th Edition, Updated • Pricing Strategy

Dear Friends,

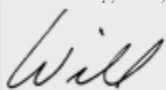
Pricing is one of the most powerful levers for increasing revenue and profit, yet rarely do we find it receives the management attention it deserves.

Senior management may happily devote months of their own and consultants' time to "strategic planning" or "reengineering," but give pricing policy and its relationship to other aspects of strategy only cursory consideration. As a result, millions of dollars of achievable profit can be "left on the table."

At Hamilton, we are focusing more of our resources on pricing strategy consulting. Our set of unique analytical and strategic tools often offer the fastest, most direct way to improve a client's bottom line.

This newsletter shares some of our insights from recent pricing work. We describe just how a strategic approach to pricing improved the bottom line for several clients, and how it can do the same for you.

With best regards,



William H. Rodgers
President

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The C-C-C's of Good Pricing

The A-B-C's of pricing involve understanding fully the three C's—Customers, Competition and Costs—and then developing a pricing structure and price levels for optimum long-term profit.

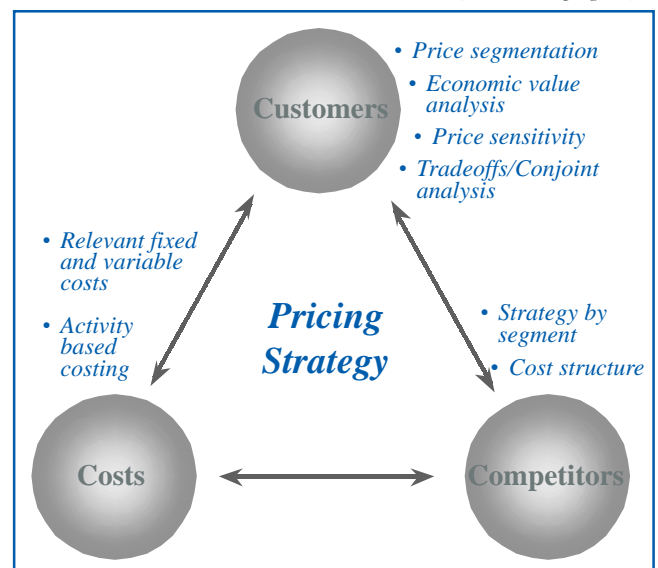
Pricing for profit has both a managerial component and an analytical component. There is no substitute for the leadership of an executive with the nerve, ambition and resolve to set a pricing policy and stick with it. Setting prices always involves a gamble with the unknown. Cool-headed general managers are needed to play the pricing game effectively.

Recognizing management's gamble, we see our role as consultants as providing the analytical underpinnings. Any bet against future

customer and competitor reaction should be bolstered with the best understanding and analysis possible.

Our investigations sometimes focus on just one area, such as cost, and in other cases on all the three C's. While we cannot describe all our techniques in this short article, we can outline the key questions which frame a typical Hamilton pricing strategy engagement.

(cont'd on page 4)



Pricing: Capture Profit By Capturing Value

Following is a precis of an article by William H. Rodgers and Dr. Jay Klompmaker of the Kenan-Flagler Business School, University of North Carolina at Chapel Hill. Dr. Klompmaker has worked closely with Hamilton Consultants in numerous engagements focusing on strategic pricing issues.

"All else being equal, segmented pricing, based on the value of the product to different customer segments, is always more profitable than flat pricing."

How should a marketer think about pricing? Don't begin with your costs. Begin with your customers. Pricing is a marketing tool, not a financial activity. Costs help you decide which customers are at most risk, which products to offer or eliminate, and what kind of product, customer, or volume mix will maximize profit. Costs have nothing to do with pricing. Customers care about value, not your costs. A World Series ticket may cost \$100, but a business person may pay scalpers' prices of \$500 if it means a

(cont'd on page 3)

Raising Prices Without Losing Business

A major manufacturer supplying the consumer goods industry was barely operating at breakeven despite a dominant market share. Management had recently asked for a 5% price increase, but backed down when the sales force reported customer complaints.

We calculated that in order to generate adequate ROI, a 19% average

price increase, with no erosion in order volume, would be necessary—a daunting goal.

By applying a “3 C’s” analysis (Competitors, Customers, and Costs), we and management gained confidence that prices could be raised substantially—and would stick.

Understanding Competitors and Customers

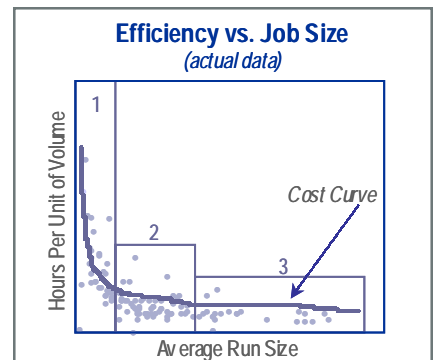
We initially focused on the market situation—the first two C’s. Our customer research indicated that the client’s strong market position supported a move to higher prices:

- 1 The competition was either geared to smaller volumes, had poorer quality, or was higher priced.
- 2 Customers had few alternatives or reasonable substitutes for our client’s products, despite their grumbling about price increases.
- 3 The cost of our client’s product was an extremely small portion of the customer’s finished goods cost.
- 4 Our client’s products were used by its customers to gain a competitive edge or to meet a competitive initiative.

Furthermore, sales records showed that customers were ordering small batches, partly because our client’s pricing structure did not penalize them for doing so.

Know Your Costs by Customer

Analysis of our client’s job costs showed that variable manufacturing costs per unit varied substantially across run volumes. Changeover time and slow start-ups had a bigger impact on short-run costs than the client realized.



We recommended our client offer customers three price levels to reflect the variation in costs by run size (see chart).

The good news for customers was that they could avoid price increases altogether by increasing the size of their orders which shifted their run volumes closer to our client’s manufacturing “sweet spot.”

Management announced the new pricing structure with a brief letter—then held their breath. A few customers asked for delays, but the prices stuck because the underlying logic was clear and perceived as fair. Profits have since tripled with no significant volume loss due to repricing.

Use Value-Based Pricing to Open New Markets

A wireless communications client had just built and deployed a new network technology which greatly increased their traffic capacity. They needed a pricing structure that would both attract customers from their competition and take advantage of the cost structure of their new network.

Existing Pricing Is Often Dictated by Historical Cost Constraints

On their old network, customers paid a fixed monthly fee for network access, which included a fixed number of text characters, plus a per-character fee for additional usage. This approach was designed to attract customers who only needed to send short messages—appropriate since the system was capacity-constrained for message traffic and the cost of adding additional capacity was very high.

The new network had much greater traffic capacity. There was now the opportunity to align pricing structure more closely with the economic value customers derived from the service in order to attract more types of customers.

The Value Delivered to the Customer Rarely Parallels Cost

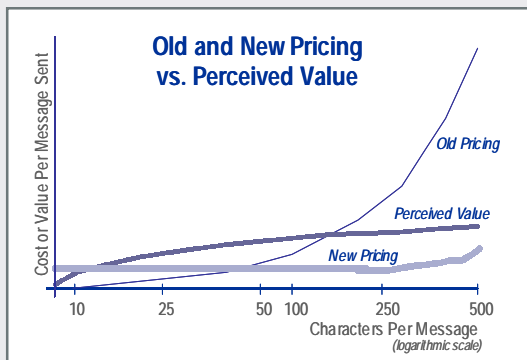
Not surprisingly, our customer research indicated that the relationship between message length and the value the customer derived was *not* linear. While customers felt receiving a 50-word message was more valuable than a 10-word message, it was not nearly five times as valuable.

Value-Based Pricing Can Help in Reaching New Markets

Therefore, we recommended pricing that was primarily message-based (see chart). There would be a fixed charge per message received, regardless of length, up to a length limit that encompassed the majority of messages typically sent. Very long messages would be charged a small per-word surcharge that was high enough to

capture value but low enough to encourage entirely new uses for the technology such as wireless E-mail.

This pricing structure captures the full economic value of both short and long messages, encourages increased message traffic at very low variable cost and opens the door to entirely new classes of customers.



chance to sit with a \$10 million customer for three hours.

Pricing works well as a marketing tool for two reasons. First, the marketer's job is to capture as much of the value customers see in the product as possible. Some customers see more value than

"Strategic pricing involves communicating with [all] customers and competitors.... Pricing tactics are often used to effect change with [specific] customers."

others depending on their use of your product, and the urgency of that use. Second, a customer's price sensitivity can be man-

aged. Advertising, service and quality levels, packaging, salesmanship, and even the way a price is communicated ("for just \$1 a day you can reduce defects by 50%") can all raise perceived value and reduce price sensitivity.

Price Bands

A useful notion is the price band, which is the range of prices for which some quantity of a single product will sell to a single market segment. At any point in time, a product will always sell over a range of prices. The narrowest price band we have ever seen showed a price variation of about 20%. Even commodity products have price bands, some as high as 600%.

Price bands can be both supplier- and customer-driven. Price band analysis often reveals some customers are receiving very low prices, often after a series of promotional discounts, and are no longer profitable. The key is to move those customers into higher price bands, or drop them as unprofitable.

Segmented Pricing

All else being equal, segmented pricing, based on the value of the product to different customer segments, is always more profitable than flat pricing. There may be some costs in terms of customer confusion and price management, but as a general rule of thumb, the more prices the better.

Two people in the same row on an airplane, for example, may have paid very different prices for their tickets. The business person wants convenience and flexibility and is willing to pay for it. The vacationer wants lower prices, and

Reducing Your Customer's Risk Through Pricing Structure

A software and technical services client was having trouble closing sales for a new product. The proposed \$500,000 flat price for the product, a highly specialized development "tool kit" with supporting consulting services, was perceived as too high by most prospects. At the same time, for the largest and best prospects, this price left money on the table.

The software promised prospects a short-term benefit of significant cost savings by streamlining development processes. However, the potentially larger benefit, incremental sales from offering their customers drastically more flexible and powerful solutions, would not be realized for two years or more.

Price Structure Should Reflect Both Near- and Long-Term Value

To broaden the market and increase margins, we recommended that the pricing structure reflect two different value components:

Fixed minimum component—a base fixed price to capture a share of the upfront cost savings.

Variable component—based on the customer business unit's revenue, to reflect the longer-term revenue-boosting benefits of our client's tools. This component would be low for small customers, but could be substantially larger than the fixed component for the largest customers.

Structure Pricing to Deliver a Powerful Service Guarantee

We recommended that the customer pay for the software in installments reflecting when value components would actually be delivered. Their only upfront commitment would be for the fixed component. Once their development effort is successfully implemented, they pay the revenue-driven component of the license fee.

This pricing structure provides our client with a powerful sales tool—the ability to share the long-term risk and reward of the customer's system development effort, while covering its own variable costs upfront.



will sacrifice flexibility for that. To succeed in charging different prices for different buyers, the seller needs to identify which buyers are likely to fall into which price segments, and find ways to charge higher prices to buyers in less sensitive segments. There are a variety of tactics available for implementing segmented pricing, including pricing by type of buyer, time of purchase, purchase location, size of order, product design, product bundling, tie-ins, and metering.

Pricing Strategies vs. Pricing Tactics

Pricing strategies are transparent and involve trying to move industry price levels up or down. Strategic pricing involves communicating with customers and competitors—you want everyone to know what you are up to. Pricing tactics, on the other hand, are used to raise product prices relative to your price band or the industry price band. Pricing

"...as a general rule of thumb, the more prices the better."

tactics are often used to effect change with some customers, but not others. For example, using prices to replace less profitable customers with more profitable ones is a tactical move. The key is to increase profitability, while maintaining market share and strong customer relationships.

Knowing Where You Are

Whenever evaluating price changes for a product, it is a good idea to calculate its "profit break-even curve." This curve is calculated from a product's fixed and variable costs, and is the string of prices and volumes that keep profit constant. Its value is in asking "what if" questions: e.g., if the curve says a price increase of 10% and a volume drop of 20% provides the same level of profit as now, managers and sales people can speculate whether volume really would drop 20%. If not, there's probably a profit opportunity in increased prices.



This article appeared in The Coatings Agenda America 1999/2000.

Understanding Customers

- Are there market segments that will pay different prices? One price for all can prove to be the *wrong* price for just about *everyone*. A segmented pricing structure can allow you to capture both more customers and greater margin in virtually any industry. Our market research on price segmentation is designed to answer questions like:

- Which current customers value specific features and benefits highly enough to pay handsomely for enhancements?
- Which new customers could you attract profitably with a “stripped-down” version?

Car companies have used this approach for years, with their high-priced models sometimes priced three or four times higher than their least expensive model.

- How price-sensitive are customers and how do pricing concerns interact with other purchasing decision criteria? A clear understanding of the dynamics of price-sensitivity gives management the power to maximize margins. Some key price-sensitivity issues include: the proportion of total purchasing which this decision encompasses; degree to which reductions in quality or service can cause problems for the customer; and, most importantly, the realistic availability of alternatives.

Hamilton also uses sophisticated research techniques such as conjoint analysis to measure the tradeoffs that customers make between price and other product attributes.

- What economic value does the product have? Economic value analysis (EVA) is particularly helpful in pricing new products, or in developing new product-service bundles. EVA requires a calculation of the complete value of the product in use. EVA asks the question,

“What is the sum cost of alternative products and services needed to achieve the same customer benefit?”

Understanding Competitors

- Who is the price leader in our industry? Our clients with the largest market shares often worry about raising prices for fear of losing share. What they may miss is that while their competitors may not have the desire or ability to raise share, they would be happy to join in raising prices. Researching competitor’s ambitions and capacity utilization can often give clues to their likely reactions to your pricing moves.
- What are our competitors’ strategies and cost structures? Competitive analysis for pricing should address several key issues, such as: Which market segments are key competitors in the best position to serve? Which are they likely to avoid? Which product lines drive their profit margins? How are *their* costs likely to drive their strategic thinking? Does their cost structure allow them to deeply undercut our pricing initiatives and still make money?

Understanding Costs

- What is the relationship between price, volume and profit? One of

our first steps with a client is to build a simple economic model with relevant variable and fixed costs, and profit levels. Doing sensitivity analysis of price and volume shifts often shows that higher prices can easily be risked because expected reductions in volume still result in substantially more profit. This is especially true of high variable-cost businesses.

- What are marginal costs for an individual product or market segment? A firm may want to have lower prices for a certain segment of the market, a certain time of the day or year, or according to a certain size of order or bundling of services. In these instances, Hamilton undertakes detailed job costing analysis, often supplemented by “Activity-Based Costing” to allocate overheads.

Pricing is at the *core* of sound marketing strategy formulation—not an afterthought to the planning process. By focusing on pricing structure and its interplay with strategic goals, we help our clients build a sustainable competitive advantage through innovative pricing.



Hamilton Update

Moved again! With Harvard University ever expanding, Hamilton Consultants has moved yet again in Harvard Square to 104 Mt. Auburn Street, 4th Floor (same zip code). Please update your rolodexes and stop in for a visit.

New product: For the past year, we have been developing and utilizing an exciting new offering called Market Based Profit Improvement (MPI). We have worked with several clients over the past year applying the MPI principles with success. Please contact us for more information on how MPI can help your company improve profits and growth without major cost cutting or restructuring.

New Professional Associates: Recently, Hamilton added three professional associates who bring with them extensive expertise in the publishing, financial services and manufacturing industries.

Paul Stonich: Paul has over 20 years of consulting expertise and is the author of several books and articles on improving profitability and building winning strategies.

Bill Nichols: Bill also has over 20 years of consulting and management experience, with an expertise in the mutual funds industry.

Joel Baron: Joel was most recently Publisher of *The New England Journal of Medicine* and brings with him over 25 years of publishing experience.

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