How pricing can drive branding and profitability

Nick Wreden, FusionBrand, shows how pricing strategy can provide the key to market success and enhanced profits

EVERY BRANDING book restates the cliche: 'Branding supports higher prices.' That's absolutely true. But the across-the-board statement leaves out a lot. How much higher pricing? 5%? 10%? More? What can companies do to their brands to support higher pricing? And what about worldwide brands like Tesco, Wal-Mart and others that compete on being the lowest-cost provider?

The issue of pricing becomes even more difficult during brand development. Should you go for premium pricing, and risk losing customers and market share, while opening a low-price door to competitors? Should you try to win market share with the lowest price possible? Or should you charge about what your competitors are charging and hope to win customers through word-of-mouth, and keep them through service?

No easy answers

Pricing is the most difficult of all branding decisions, so those questions have no easy answers. Perhaps that is why the topic is ignored so frequently in pop branding books. It is so much easier to talk about 'appealing to the senses', 'buzz marketing' or any other brand fad du jour than to figure out pricing that will optimise the brand.

But pricing is too vital to branding to be treated solely as a financial matter. Pricing affects image, marketing, finance, sales channels, perceived value, competitive advantage and distribution. Most impor tantly it affects profitability. Although profitability is also routinely ignored in run-of-the-mill branding books, it must be remembered that without profitability, ultimately, there is no brand.

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In general, an effective pricing strategy must be driven by the right corporate strategy. Poor pricing often results from a misdirected over-emphasis on sales or market-share growth. When companies pursue sales or market share growth as a primary strategy, then the temptation to reduce prices to achieve target sales or market-share goals is great. However, price reductions almost always affect profitability and often do little to achieve sales or market-share goals. The most effective pricing strategy is based on a corporate strategy to achieve profitability growth.

So how should companies use pricing to increase profitability, boost branding power and still fight off competitors? The answer depends on four steps: avoid common pricing mistakes; price based on market position; price based on customer value; and segment customers based on relative profitability.

Avoid common pricing mistakes

The most common pricing formula is well known: calculate all direct and indirect costs, add on a percentage for profit, and the total represents the price. Unfortunately, that total will not only be wrong, but will cost you money.

That's because companies rarely cost accurately. Accounting systems (with the exception of activity-based costing (ABC)) are dedicated to capturing traditional inputs such as land, labour and capital. But such traditional costs can represent as little as ro°/o of a product's final cost. Today, the majority of costs result from processes, which cannot be easily captured by traditional accounting systems. As a result, any pricing based on traditional systems will likely generate a price that is too low because it does not include process based costs.

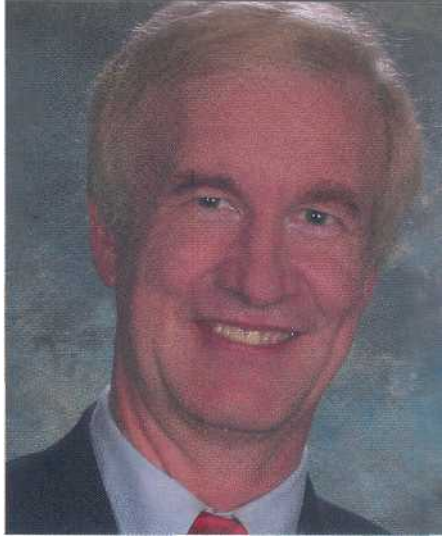
Companies also price according to market position - premium, mid-market or budget. Premium products typically command premium pricing. Consumers typically associate a higher price with higher quality. Additionally, a higher price can communicate status, thus delivering emotional value. All handbags essentially have the same utility, but a Louis Vuitton handbag is often prized, partly because of its premium pricing.

Mid-market items typically distinguish themselves from competitors based on merchandising, packaging or various value-added services/capabilities. Low-priced items are targeted at budget seekers.

Market pricing carries risks. Premium priced items typically demand much greater promotional and channel support. The mid-market is typically most crowded, making differentiation difficult. A low-price strategy requires intense focus on supply-chain excellence and other operational issues. As many have pointed out, a low-price strategy is difficult to maintain over time. It also attracts price-conscious buyers, who are notoriously disloyal.

Another common mistake is using competitive pricing as a benchmark. While certainly easy, this has several disadvantages. First, the competitive price

Louis Vuitton: price driving status?



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may not accurately reflect your situation. The competitor's costs could be different, or you may offer value-added services not provided by the competitor. The competitor may also be pricing his products poorly. Finally, competitive pricing represents the slippery slope of a price war, an outcome that could be damaging for everyone. (However, always remain aware of competitive pricing.)

Too often, pricing results from internal compromises. Sales wants the lowest price possible to fuel sales. Finance wants the highest price possible to recover costs and boost profits. Marketing wants pricing based on competitive or customer input. The final price often is a compromise between all positions and may deliver the worst of all worlds.

The final mistake is using pricing as a sales tool. In this common scenario, prices are lowered until the customer buys. Such 'customer-driven' pricing presents pitfalls. By 'training' customers to buy on price, the chances are higher that they will defect to a lower price elsewhere. It also blinds them to the value that you offer. Finally, and most important, discounting may win a sale, but can have a disastrous effect on your bottom line. Lowering prices by just 10% means you have to sell 33% more to achieve the same profitability. A 20% discount means selling twice as much. (Seasonal, volume and other profit-based reasons to discount represent acceptable business strategy.)

Companies have various strategies to deal with these pricing inadequacies. In some cases, extra 'profit' is added to account for 'hidden' costs. Or unique packages/services are offered. Or they lower prices only when there is a concomitant reduction in the services or capabilities offered.

However, those are defensive measures. They can help avoid losing too much money on a sale, but they don't tell you what the customer is willing to pay. In other words, they don't tell you the maximum price you can get for your brand. That requires pricing on customer value.

Price based on customer value

Management books have their own blind spot concerning pricing. They generally suggest to 'price according to customer value'. Excellent advice, but it begs the question 'How do you determine customer value? What exactly is a brand worth to a customer?'

The process of understanding customer value starts by understanding what a brand is. Although there are many definitions of branding that cover legal or creative issues, few address brands in terms of customer value. That's a critical failing. Unless a brand delivers value, it will inevitably sink beneath the waves. The branding definition that best incorporates value is:

> *'A brand is a long-term relationship between an offering and a customer based on delivering economic, experiential or emotional value, backed by everyday operational excellence and consistently measured for accountability.'*

To determine what customers value and what the benchmarks are for that value, find out where they hold you accountable'

Many companies use 'customer satisfaction' as a stand-in for customer value. However, customer satisfaction is a poor metric for measuring value. Customer satisfaction cannot indicate the type (economic, experiential or emotional) of value received, nor the depth of that relationship. Customer satisfaction surveys have other failings too, including extreme variability in how 'satisfaction' is denned, and a lack of cause-and-effect (what exactly caused customers to be satisfied?). More tellingly, satisfaction surveys almost never question customers who have defected.

To determine what customers value and what the benchmarks are for that value, find out where they hold you accountable. This requires asking customers three questions.

1. On a scale of 1-10 (1 = lowest), what are the areas where you hold us accountable (for example, shipping, quality, innovation, and so on)?
2. In those areas, what are your quantifiable benchmarks for performance (for example, three days or under for delivery, less than 1 defect per 10,000, and so on)?
3. On a scale of 1-10, how are we doing against those benchmarks?

The answers can be plotted on an X-Y diagram, with the X-axis representing 'importance' and the Y-axis representing 'performance'.

Plotting the answers often delivers remarkable insights about how your brand is doing through customers' eyes. In general, the areas where customers hold you accountable (ranked 7-10), and where your performance meets or exceeds their benchmarks (ranked 7-10), are areas where you can charge a premium price.

Pricing according to what customers value may require unbundling or bundling as part of your brand strategy. In other words, it may be necessary to separate (or combine) services or other offerings from your core offering.

Segment based on profitability

The most important rule to remember in branding and pricing is that customers are not created equal. Customers differ not only in terms of demographics, psychographics and other traditional branding differentiators, but also in terms of profitability and service requirements. Everyone knows that 20% of customers generate 80% of profits (a belief backed by numerous studies), but many don't realise that, according to global management consultancy Bain & Co., 15% of your •

customers are unprofitable.

Customers are unprofitable because they require support or other services greater than the profits their purchases generate, or don't generate enough revenue to .cover acquisition costs. For example, one US brokerage found that i % of its customers were making 30% of calls to the service desk. Worse, 75% of those customers were unprofitable.

Servicing unprofitable customers creates several problems. First, it represents an ongoing - although often hidden - profitability leak. Another issue is the diversion of resources away from profitable customers. Believing that 'one size fits all customers' results in such mistakes as having profitable customers wait in the service-desk call queue behind unprofitable customers ...

How do you distinguish the golden 20% from the unprofitable 15%? Customer profitability is based on customer lifetime value - essentially, the amount of profits generated by a customer as long as he or she continues to buy from you. There are various spreadsheet-driven formulas, which range in complexity and data required, used to calculate customer profitability.

Perhaps the easiest method is to use the rule-of-thumb developed by Sunil Gupta and Donald Lehmann in their book, *Managing Customers As Investments*. Generally, customer value is anywhere from 1 to 4.5 times annual profits. In other words, if a customer generates $100 of profits in a year, the lifetime value of that customer ranges from $100 to $450.

The primary driver of increased customer value is retention. The longer a customer stays with you, the more profitabl they become. In fact, studies by Bain & Co. have shown that even a 5% increase in retention can boost profits by more than 25%.

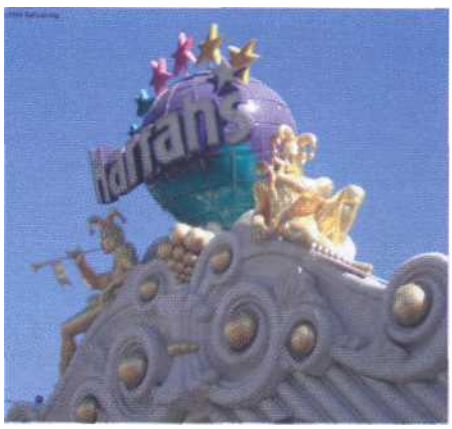
Once customer value is calculated, then it's easy to group customers by profitability. The golden segment includes the top 15-20% of customers who represent the greatest profitability. A middle segment includes customers who represent 50-65% of profitability. Another segment includes the least profitable. The bottom segment is reserved for unprofitable customers. (Generally, all new customers are unprofitable, because acquisition costs are higher than initial revenue. New customers should not be placed in any category until their purchasing track record provides information about relative profitability.)

'Segmentation by profitability ... changes enterprise focus from managing brands, regions or campaigns to managing customers, who, after all, are the ultimate source of profitability'

Such profitability-based segmentation offers numerous advantages. You can reserve the best services for your best customers, helping to improve their retention. Loyal customers are typically less price sensitive than lower-value customers, helping to maintain margins. You can work to improve the profitability of lower-ranked customers, either by improving their sales and/or profitability or by reducing costs. For unprofitable customers, the best strategies are to raise prices or to downshift them to lower grades of service.

Improved acquisition

Another advantage is improved acquisition. By studying the characteristics of profitable and unprofitable customers, you can target (or avoid) customers with similar characteristics. If, for example, most profitable customers live in south-western England and were acquired through public relations, then shift marketing resources towards a PR campaign focused on Bristol and surrounding cities.



Harrah's casinos: rewarding loyalty

For example, the gambling casino Harrah's has a Total Rewards programme that can link a customer's gaming activity to profitability-based segment profiles. If a customer's activity matches characteristics of other 'Diamond Level' players, Harrah's bestows all the privileges of its highest customer ranking for a limited time, helping to build loyalty. The key to making this strategy work, of course, is a lead and sales management system that can track prospects and their evolution into customers.

Finally, segmentation enables more profitable pricing. McKinsey & Co. has estimated that across-the-board pricing - charging all customers the same price - can reduce profits by 12-15%. With segmentation by profitability, low-profit/ unprofitable customers can be charged more, either to increase their profitability or drive them into the arms of competitors. Why does anyone want to keep an unprofitable customer? Even the most profitable customers can be charged more for the services and/or offering that they value most.

Many companies are fearful about raising prices. But price hikes have the advantage of positioning your brand as higher quality than competitive offerings, and enable you to provide additional services that deliver customer value. It can make unprofitable customers profitable, or drive them into the arms of competitors. In fact, if you are considering two prices, always choose the higher one. As a general rule, it is better to raise prices in small increments than in one or two large increases.

Segmentation by profitability offers several advantages over traditional marketing. It changes enterprise focus from managing brands, regions or campaigns to managing customers, who, after all, are the ultimate source of profitability. It also increases emphasis on retention, the main driver of customer profitability, and makes companies smarter about acquisition. Companies can no longer afford to indiscriminately acquire customers without looking at their long-term value. Finally, it improves pricing. Companies can charge higher prices to those that either value its services or cost it money, and maintain price discipline for mid-profit customers. •

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Fonte: ADMAP, v. 41, n. 4, p. 52-54, apr. 2006.