

Why the Highest Price Isn't the Best Price

How to practice value-based pricing that boosts profits and promotes better relationships with customers.

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"CHARGE WHAT THE MARKET WILL BEAR" pretty well summarizes the pricing strategy of many suppliers serving business markets. They believe that practicing value-based pricing means finding out what the value of their offering is relative to alternatives for their customers and then charging as high a price as they can. If they think their offering is superior, they include in their pricing the full premium that they think the superiority earns.

But pursuing value-based pricing in that way is usually shortsighted in two respects. First, it neglects other potential means of profiting from delivering superior value that may result in greater overall profitability to a supplier. Second, it weakens customer relations rather than strengthening them, which a more progressive and comprehensive approach to value-based pricing can accomplish. We'll propose a framework for practicing value-based pricing in this more nuanced, strategic way. But consider first a recent case that demonstrates how the shortsighted pursuit of value-based pricing can go wrong.

Electron Instruments (a fictionalized name) manufactures and markets scanning electron microscopes. It has focused on the upper end of the market for SEMs, which ranges from \$500,000 to \$1.5 million per microscope. Even the low end of electron microscopes ranges from \$100,000 to \$250,000. In 2007, as a new initiative, Electron Instruments developed and introduced a desktop SEM that was intended to compete in

When customers' expectations of a fair price are met, their relationships with suppliers are strengthened, often leading to broader and deeper commitments.

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THE LEADING QUESTION

If charging the highest price isn't the best strategy, what is?

FINDINGS

- ▶ Customers give suppliers they feel good about doing business with a bigger share and mix of their business.
- ▶ Best practice suppliers use pricing tactics that motivate the customer to take action that benefits the supplier.
- ▶ Suppliers that practice value-based pricing increase short- and long-term profits.



the low end of the market and even attract some sales from customers that would upgrade from optical microscopes.

Electron Instruments believed that its desktop SEM was vastly superior to the next best alternative, a desktop SEM from a Japanese competitor. Electron Instruments did not, however, conduct any formal customer value research to validate that belief. Instead, it relied on its engineers' assessments and marketing's judgment based on qualitative feedback it received from a few beta test customers. Critically, though, these beta test customers were familiar with SEM technology, and most were users of the company's top-end, expensive SEMs.

Electron Instruments' management and marketing concluded that its desktop SEM was easier to use and had technical superiority to the Japanese desktop SEM. Convinced of superior value, management asked marketing what price the market would bear. Management and marketing's intent was to get maximum revenue without limiting Electron Instruments' ability to sell the desktop SEMs. They decided to price the desktop SEM at a 25% premium to the next best alternative.

Sales for its desktop SEM were not as good as Electron Instruments had expected, with certain target customers much slower to purchase the tool than forecasted. In one target country, for example, Electron Instruments' distributor was unable to sell *any* of the desktop SEMs.

Reacting to these unexpectedly poor market results, Electron Instruments began to investigate the cause. Marketing discovered that even though Electron wasn't wrong from *its* perspective about the ease of use and technical superiority of its desktop SEM (relative to the next best alternative), its prospective customers didn't evaluate the product the same way. Electron's beta test customers' experiences did not transfer to the actual target customers - especially those potential customers that had not previously experienced an SEM. Further, marketing discovered that the closed-system design of its desktop SEM was a substantial negative point of difference for customers that were experienced desktop SEM users. These prospective customers were attracted to the Japanese competitor's more traditional SEM design, which allowed for upgrades, such as adding a key analytical system.

Prospective customers upgrading from optical instruments did not find Electron Instruments' desktop SEM easy to use. The image produced by Electron Instruments' SEM *was* technically superior, but the new customers and prospects were so unaccustomed to the difference that they didn't value it as highly as Electron had predicted. Given that an SEM cost more than they were used to paying, they judged the image of the competing offering to be "good enough," especially considering the substantial price difference.

Based upon what it had learned, Electron Instruments decided to test its pricing with selected customers that were having trouble deciding. Reducing its premium to only 5% over its competitor's price, Electron found, accelerated the purchase decisions of these customers. Electron Instruments was now left with the challenging task of relaunching its offering at a lower, yet to be determined price.

Over the last three years, we have been conducting management practice research with businesses that routinely practice value-based pricing. (See "About the Research") We draw on their collective experience to provide a six-question framework for accomplishing value-based pricing that boosts profits as well as customer relations. (See "How to Practice Value-Based Pricing: A Framework," p. 72.) Here we'll discuss each of the six considerations in greater detail. Notably, we have found that the first and last questions — about market strategy and customer expectations of a fair price — are often neglected, leading to poor results.

1 What is the market strategy for the segment? By market strategy, we mean what does the supplier want to accomplish in this segment? What would the supplier like to have happen? Unfortunately, when stripped of jargon and wordspeak, the "market strategy" for many businesses is simply "Sell more!" We contend that that is not a sufficiently well-articulated strategy. In such cases, pricing begins to substitute for actual market strategy, with price concessions and "special" pricing frequently being used to gain business.

Although it is natural for supplier managers to think first of price premiums as a way to profit from superior value, that is just one of several ways for suppliers to have value-based pricing that supports

the market strategy. Obtaining a larger share of the customer's purchase requirements or a more profitable mix of the customer's business may be alternative ways for a supplier to exploit superior value without necessarily pursuing a price premium.¹

At Electron Instruments, the market strategy was neglected in determining the price. Targeting customers in the desktop SEM market — a segment that Electron Instruments previously had not served — the company should have expected that it would have to give these prospective customers a greater portion of the value as an incentive to do business with a new supplier.

Furthermore, the product design went against the requirements and preferences of experienced desktop SEM users. And when targeting present optical microscope users, Electron Instruments should have expected that it also would have to give these prospective customers a larger inducement to convert to the new technology. In each case, more thought about market strategy, which aimed to enter and secure a profitable position in two new customer segments, would have led to a lower price premium and a more flexible product that would have enabled later sales of value-adding (and profitable) upgrades to customers in both segments.

In contrast, consider the recent experience of Bayer MaterialScience AG of Germany in entering the coatings market for high-end residential garage floors. Bayer's materials enable a coating system to deliver superior value through faster curing and lower costs for the applicator and through quicker turnaround, less nuisance and improved durability for the garage owner. When Bayer pursues market entry, an explicit part of its market strategy is greater openness to sharing a larger portion of its offerings' superior value with its prospective customers. To secure its position in a new market, it asks for a lower price premium in return for a commitment from the customer to purchase its materials for a period of years.

The recent experience of EnviroSystems (a disguised name) in working with a European-based truck manufacturer in North America nicely illustrates market strategy considerations in value-based pricing. EnviroSystems worked with this customer to develop a superior emissions control system to reduce greenhouse gases. The customer had set a

ABOUT THE RESEARCH

We began our research by seeking businesses from a variety of industries that were progressively practicing value-based pricing. We learned of these businesses from several sources. First, at the end of his keynote presentation on his book, *Value Merchants*, at the 14th Winter Conference of the Institute for the Study of Business Markets, James Anderson invited the approximately 150 managers from member and guest companies attending the conference to participate in the research on value-based pricing. Second, managers participating in the Business Marketing Strategy program held at the Kellogg School of Management at Northwestern University three times each year shared practices from their companies and indicated their interest in participating in the research. Third, we looked for European-based businesses that developed new technologies as the base of their market offerings and that analyzed the cost and value of market offerings either as suppliers or purchasers. We contacted businesses that were identified by university experts on innovation and asked these businesses to identify suppliers that they believed were progressively practicing value-based pricing.

These efforts led 24 companies to participate in our management practice research. These companies, based in the United States, Europe and Asia, are in a broad range of industries, including agricultural products, bearings, cutting tools, digital printing, drug discovery, electron microscopes, emissions control systems, health care, lithographic equipment, process engineering, specialty chemicals and steel.

We conducted telephone interviews and, most often, field interviews with key managers at each of these 24 companies. We also frequently conducted follow-up interviews to learn of the progress that they were making in their value-based pricing initiatives. As is often the case with inductive management practice research, we found few businesses that excelled in all of the considerations in practicing value-based pricing. Instead, we collectively drew on the best practices of these 24 companies to put together the framework and managerial guidance that we offer in this article.

target price for the base system that was 30% lower than the price EnviroSystems initially proposed. Working cooperatively, though, EnviroSystems successively proposed design changes and additional components that went beyond the base system, to provide an enhanced system that lowered the customer's installation costs, eliminated certain components and made end-of-line validation unnecessary.

The customer accepted a price for this enhanced system that was twice the price that EnviroSystems had initially proposed because the demonstrable cost savings to the customer rose disproportionately. Nevertheless, EnviroSystems did not price this enhanced system as highly as it might have for three market strategy reasons. First, through its provision of more parts in the enhanced system, EnviroSystems was able to achieve a gross margin 33% higher than the standard gross margin for its participation in the initial base system. Second, EnviroSystems knew that the customer's adoption of the system in North America would enable it to

expand its business geographically to Europe, where the potential business for this system was several times greater. Finally, EnviroSystems wanted to be the first company that the customer would call for its next project.

2 **What is the differential value that is transparent to target customers?** By "transparent" we mean that target customers easily understand how the supplier is calculating the differential value (between its offering and the next best alternative) and that the differential value can be verified with the customer's own data. Each of these factors makes the estimate of differential value persuasive to the customer. Suppliers cannot expect a fair return on their superior value if they cannot persuasively prove it to the customer's own satisfaction.²

HOW TO PRACTICE VALUE-BASED PRICING: A FRAMEWORK

Setting the price of a market offering based on its value to a target customer requires more than simply knowing its value to that customer. Rather, there are six considerations to determine value-based pricing:

- What is the market strategy for the segment? (What does the supplier want to accomplish? What would the supplier like to have happen?)
- What is the differential value that is transparent to target customers? ("Transparent" means that target customers easily understand how the supplier calculates the differential value between its offering and the next best alternative, and that the differential value can be verified with the customer's own data.)
- What is the price of the next best alternative offering?
- What is the cost of the supplier's market offering?
- What pricing tactics will be used initially or eventually? ("Pricing tactics" are changes from the price that a supplier has set for its market offering — such as discounts — that motivate customers to take actions that benefit the supplier.)
- What is the customer's expectation of a "fair" price?

Valent BioSciences Corp. is a leading supplier of plant growth regulators for agricultural and horticultural markets based in Libertyville, Illinois. These PGRs modify plant growth, enabling growers to lower production costs significantly (e.g., harvest costs) and improve fruit quality, grade and size, leading to higher marketable yields. VBC makes the superior value of its offerings transparent to growers. In South Africa, for example, VBC worked with the agricultural economist from the largest apple cooperative to develop a customer value model for its ReTain PGR for apples. That

model enables growers to plug in their own historic orchard data to calculate potential returns from using ReTain in different scenarios. Further, VBC makes ReTain's superior value transparent by sponsoring studies in the major global apple growing regions, conducted by agricultural specialists who are recognized within the region as being unbiased, reputable researchers.

3 **What is the price of the next best alternative offering?** When pressed for details, it turns out that most suppliers' understanding of the pricing of their competitors' offerings is more sketchy and anecdotal than it is portrayed initially. While some industries supplying raw and processed materials, such as steel, have widely used industry sources that track and report prices for standard products by market, that is rare in business markets. Moreover, such "commodity" pricing knowledge provides little guidance in making decisions about value-based pricing, because it neglects other ways in which specific competitors add value to their offerings, such as supplementary services. Best practice suppliers make a more methodical, systematic effort to understand the pricing of the next best alternative offering.³

As part of its process for developing new offerings, bearings manufacturer AB SKF of Goteborg, Sweden, has a team of applications engineers and sales engineers engage pilot customers to gain a clear understanding of the next best alternative competitor's performance and pricing. When SKF recently developed its new Agri Hub, a rotating bearing unit mounted on an independent disc for plowing/tilling the soil, its team engaged five tillage machine manufacturers as pilot customers. Each pilot customer produced several prototype machines, which it first tested "in lab" on farmland that it owns, and then with some of its own customers, with whom it has close relationships. Through this pilot program, SKF demonstrated the superior performance of Agri Hub and learned what it would be worth in monetary terms to customers. It also learned from the pilot customers that the price of the next best alternative offering was about €7. Although SKF could have asked for a higher price premium based on its superior value, it decided to introduce its new Agri Hub at about €3 instead,

because its market strategy was to gain the business rapidly and not leave an opening for its competitor. SKF's market introduction of Agri Hub has been a success, with sales on a pace that is one year ahead of what was forecast.

4 What is the cost of the supplier's market offering? Supplier managers must strive to understand the cost of the market offering, not simply the cost of the core product or service. That will entail understanding the costs of services, programs and systems that the supplier will need to offer initially and eventually. Even when suppliers practice value-based pricing, there is often a cost-plus constraint. To that understanding of cost, managers add senior management's margin expectation to establish the price threshold for value sharing. The product manager is given considerable latitude in deciding what price to set, as long as it passes this threshold.

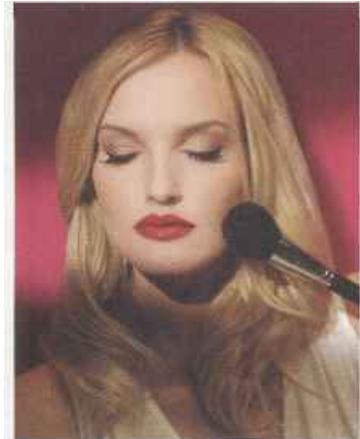
The digital printing business demonstrates that understanding costs, and not just value, is critical in practicing value-based pricing. To differentiate themselves from competitors and improve profitability, progressive printing companies increasingly offer value-added services to their customers, such as creative design, personalized printing and project management. The work flows for delivering these new services are more complicated and variable than traditional printing and require special investments in software, servers and staff training. To learn how to build out cost sheets accurately for these services, many printing companies rely on research, guides and tools developed by their equipment supplier, Xerox Corp., that also provide benchmarks for the average time and cost needed to complete each step in a work flow. These resources for more accurately understanding and managing costs complement guidance for value pricing, which helps printers understand how customers perceive the value of these services. As a result, printers think about, for example, what other kinds of suppliers (an advertising agency) would charge for performing a similar service, and the incremental revenues and profits that customers could earn from the value-added services (greater response dueto personalized mailing).⁴

5 What pricing tactics will be used initially or eventually? Pricing tactics are changes from the price that a supplier has set for its market offering. Although pricing tactics sometimes result in price increases, as in surcharges, they more often result in price decreases, as in discounts. Best practice suppliers use pricing tactics in ways that motivate customers to take actions that benefit the supplier. Volume discounts, for example, are frequently used to motivate customers to purchase in cost-advantageous quantities, such as pallet, truck or rail car loads. Best practice suppliers give price discounts only when they will benefit them in some demonstrable way, not simply to win the same business at a lower price.⁵

EnviroSystems finds that the customer's response to whatever price it initially quotes is "It's too high." EnviroSystems responds by specifying a few reductions that it could make in the proposed offering to lower the price, but it makes clear what the adverse consequences on performance and functionality would be. EnviroSystems' engineers also have been taught to respond to customer pressure by asking, "How can we work with you on this?" It does not grant a price concession without some reduction in its offering or getting some additional business.

Pilot customer discounts encourage customers to test early versions of new offerings and provide feedback on their use to suppliers. When Quaker Chemical Corp. of Conshohocken, Pennsylvania, was developing its RapidShield ultraviolet curing floor coating system, it engaged a General Motors Co. plant as a pilot customer. In return for a Quaker promise to discount the price, the GM plant allowed Quaker to put down a 200-square-foot floor "test bed," and plant personnel worked with Quaker to gather performance data. Following its initial success RapidShield was applied in other areas of the plant. Not only has this GM plant helped Quaker develop the RapidShield offering, but its staff has taken time to give testimonials to visiting prospects, which Quaker finds extraordinarily helpful in securing business from those prospects.

After market introduction of an offering, a supplier may suggest an initial use discount to stimulate customers to try the offering. Initial use discounts are implemented as invoice line reductions, so that the market price is set as the reference point. The



Bayer Materials, whose products include a line of environmentally friendly polyurethanes specifically designed for the cosmetics industry, often conducts pilot tests to determine fair prices for its products.

notation on this line would indicate the event or limited time period for which the discount applies. That kind of pricing tactic provides a temporary inducement to overcome customer reluctance to try an offering or to compensate for costs that the customer will incur only initially in its use of the offering.

Finally, suppliers should consider the kinds of pricing tactics that they likely will use eventually. When an offering's sales are at their zenith, the customers that are purchasing extraordinarily large quantities may expect the supplier to offer additional levels of volume discounts that reward this relatively large usage. When competitors' offerings eventually begin to close the gap in value delivered by a supplier's offering, that supplier may offer price discounts to customers willing to make a

Customers are always happier to pay a lower price Best practice suppliers actively manage customer expectations of what is a "fair" price.

commitment to continue purchasing a certain percentage of their requirements from the supplier. To anticipate what will be needed eventually, supplier managers can review what has happened in the past with similar offerings.

6 **What is the customer's expectation of a "fair" price?** Customers are always happier to pay a lower price. Best practice suppliers, though, actively manage customer expectations of what is a "fair" price. One manager in our research astutely captured what the intent of a supplier ought to be: "You want the customer to absolutely feel good about the price." What she meant is that her counterparts at the customer must be able to justify to themselves and to others in their businesses why they are paying the price they are when it is higher than that of the next best alternative. Her business routinely seeks to make the customer engineers it works with heroes in their own companies. As evidence of this, one of Ford Motor Co.'s engineers recently received the prestigious Henry Ford II Distinguished Award for Excellence in Automotive Engineering for his work on a project with her business.

Consider the strategic alliances between Belgium-based Galapagos and pharmaceutical companies such as Merck and Johnson & Johnson. Galapagos's comparative strength is in drug discovery and early clinical trials, while its partners are better at conducting later clinical trials, obtaining regulatory approval and marketing new drugs. Considerable uncertainty in this process makes estimating value and setting Galapagos's price impractical. Instead, Galapagos and its partners specify performance milestones and procedures for determining their fulfillment, triggering fixed and/or variable payments. Through these value-pricing mechanisms, Galapagos is eligible to receive in excess of €2 billion in success-dependent milestone payments and up to double-digit royalties on sales of new medicines.

Managing customer expectations of a fair price begins by demonstrating to customers in a way they can easily understand how the supplier is calculating the differential value (between its offering and the next best alternative) and then helping them to verify the differential using their own data. Suppliers can still innovatively practice value-based pricing in situations where the value will become known only later by reaching agreement with customers on a value pricing *mechanism*.⁶

Managing customer expectations of a fair price also requires gaining an understanding of the range of potential prices that customers would regard as "fair." Bayer MaterialScience gains this understanding by first reaching agreement with pilot customers on the differential value and assumptions, and then asking them: "Based on this, we think a fair price would be x to y. Do you agree?"

Health Informatics (a disguised name) recently conducted market research with its target customers to study their price expectations systematically for an innovative inpatient disease management offering. They asked target customers questions including:

- At what price do you perceive the system to be a bargain — a great buy for the money?
- At what price do you perceive the system as beginning to get expensive, so that it is not out of the question, but you would have to give some thought to it?

- At what price do you begin to perceive the system as so expensive that you would not consider buying it?

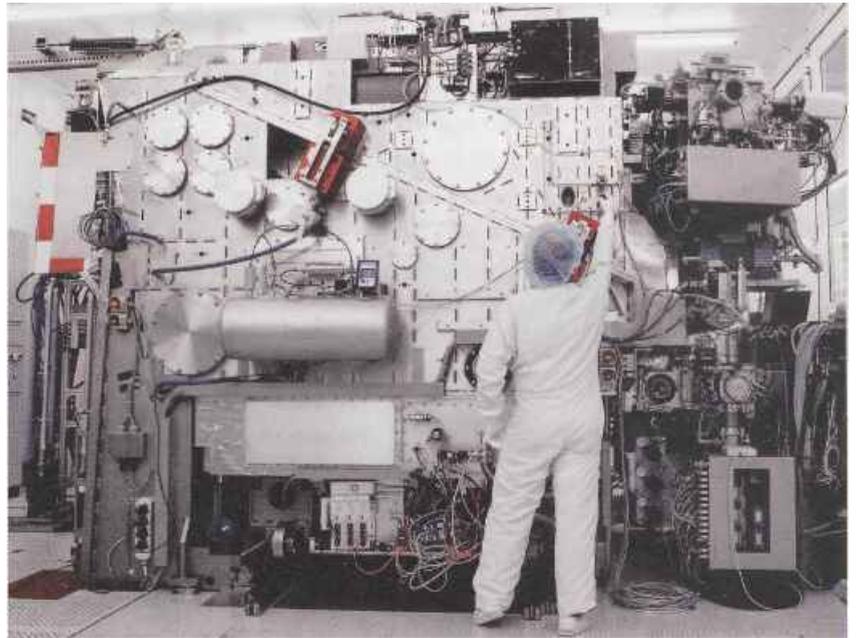
The results from that market research enabled Health Informatics to decide on a price for its offering that target customers would find fair, even though it was priced at a premium over that of the next best alternative.

What sharing of the demonstrated superior value of an offering seems fair? While our research reveals varying answers, a "50/50" sharing rule was mentioned more than any other split. Yet in probing that, we found that when the "50/50" rule was expressed, the sharing most often was applied only to the demonstrated "hard" cost savings, with any "soft" cost savings going to the customers. Even though soft savings typically require assumptions to express them as monetary estimates, they are nonetheless substantial, with the result that in practice the customer receives more than 50% of the total savings in a "50/50" sharing.

A related issue is whether or when to specify the superior performance of an offering as cost savings or incremental profit from additional revenue. ASML Netherlands BV is a Netherlands-based supplier of lithographic equipment to the semiconductor industry. Because lithographic equipment is the most expensive equipment in a wafer fab, the production processes are designed around them to optimize their productivity. ASML sells enhancement packages (software and hardware improvements) that enable customers to increase the output of its lithographic equipment, which leads to more output of the entire waferfab. Furthermore, some enhancement packages also allow the customer to reduce the size of chips and to improve their functionality.

The improved output is measured after installation of the upgrade under standardized test conditions. ASML then conservatively calculates the value of its enhancement packages as a percentage of the equipment price. For example, a 10% increase in output is valued at 10% of the investment in that equipment. Typically, that is shared "50/50" with the customer. So if the investment was \$ 12 million, the price of this enhancement package would be \$600,000.

Although it would be tempting for ASML to claim the incremental revenue and profit that its customers can earn from turning out more wafers, more chips per wafer and/or higher prices for chips having better



functionality, it resists doing that. It recognizes that its customers would not find price premiums calculated in that way to be fair. After all, it is not simply its enhancement packages but the customer's product design, brand and marketing and sales efforts that together cause the incremental revenue and profit.

When the superior performance of a supplier's offering does enable customers to earn greater revenue and profit for its offerings, the supplier must be able to demonstrate that persuasively. Further, suppliers accomplishing that still often provide the customers with a greater proportion so that customers find it fair. VBC's offerings make good fruit great. So while they do provide significant harvest cost savings, the greater proportion of the superior value they provide comes from enabling growers to earn incremental profits through superior fruit quality, grade and size. To meet or exceed grower expectations of what is fair, VBC has established an internal benchmark, where it looks for potential offerings to provide growers with a 3:1 or greater return. That is, if a VBC offering has a price premium of \$100 per acre relative to the price of the next best alternative, the grower would earn a \$300 or more incremental profit per acre from its use. Finally, to manage grower expectations, VBC encourages growers to think of its offering not as part of their total spray program, where it would be a relatively large percentage, but instead as an investment in lowering operating costs and improving the price their customers paid for the fruit.

ASML calculates the value of its enhancement packages as a conservative percentage of the increase in output its customers achieve.

A final aspect of managing the customer's expectation of a fair price is to have price transparency. By "transparent" we mean that the customers understand how the pricing systematically varies across different ways of doing business with the supplier and that they know that every customer doing business with the supplier in the same way pays the same price. As we discussed earlier with pricing tactics, suppliers need to vary their prices to motivate various customer actions, but it must be *managed* variation, not ad hoc.

Health Informatics practices transparent pricing for its market offerings. It uses a pricing schedule that details the pricing for various usage situations. Thus, although different group purchasing organizations for hospitals may receive different pricing based on different volume and compliance levels, everyone sees the same pricing schedule, and if different GPOs decide to do business in the same way with Health Informatics, they get the same pricing. IV Therapy, Nutrition Baxter Healthcare is another noteworthy supplier that strives to practice transparent pricing. Health Informatics and IV Therapy managers stress that to achieve transparent pricing, the pricing schedule must be explainable to customers and implemented consistently. Supplier managers might believe that they are being responsive or "customer oriented" when they give ad hoc price concessions, but they are clouding customer expectations of what price is "fair" for the value their offering provides.

Conclusion

Getting a price premium for providing superior value is fine so long as customers feel that it is fair. As a senior manager in our research sagely concluded: "Value-based pricing is not about squeezing as much money out of customers as you can, but building customer relationships." Customers that feel good about doing business with a supplier are more willing to give that supplier a larger share and a more profitable mix of their business. They are more willing to collaborate with the supplier, to generate and share data on the performance of its offerings relative to the alternatives and what that is worth in monetary terms. They are more willing to work together to "tweak" present offerings to enhance their value and to develop new

offerings that will deliver superior value. Suppliers that practice the kind of value-based pricing we have discussed not only boost profits in the present quarter, but they also set themselves up to profit over the long term.

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