OLIVER WYMAN

Retail and Consumer Products

Putting an End to Ad Hoc Pricing

Start by understanding what customers actually value

Pricing may well be the weakest link in the value chain. It has such potential to accelerate revenue and profit growth, yet it is so clearly under-managed at consumer and business-to-business companies alike. There are opportunities for fact-based modeling techniques to improve five areas of pricing strategy: price cuts, product portfolios, new products, market segmentation, and the pricing of packages or bundles. This sharp focus on customers' perspectives is the biggest lever for profitable pricing.

Let's put it bluntly: Pricing is the sick man of sales and marketing. That's not how most business leaders see it, but it's how it should be viewed. The problems were all too apparent in the frenzy of "employee price" discounts offered by several auto makers during 2005—a tactical approach that market researcher AMR Research expects will cost U.S. car makers up to $5 billion in profits.

The pricing predicament has many parents. Decisions about list prices and promotions are made by different, sometimes competing constituents: CFOs with earnings objectives want to raise prices; brand managers with market-share objectives try to keep list prices low; sales staff, spurred to meet quarterly revenue targets, are quick to discount; other channels offer other deals, from "this week only" coupons to long-term loyalty cards. The more that companies expand—in terms of products and corporate alliances as well as geographies—the greater the pricing complexity.

So it's not surprising that prices for many products and services are set in ad hoc ways that create wide price bands—the ranges of prices that customers pay in practice. A few companies manage to tightly control price bands: Microsoft's strategic position on the desktop helps it keep Office software prices buoyant while Apple's brand strength and product innovation ensure that iPods aren't easily discounted. But they are exceptions. The difficulty of poorly managed price bands is not limited to consumer markets; in many business-to-business (B2B) settings, pricing variations tied to factors such as volume rebates or freight charges often mean that even the providers' managers are unsure of precise price levels.

A certain amount of variation in prices is desirable, to be sure. But widening price bands simply train customers to constantly look for the lowest-price deal, eroding profitability as well as brand perceptions and value. Companies cannot capture the full profit potential of their products and services until their managers understand the ideal width of the price band for each product or brand given its position in the marketplace.

The pricing problem is not new, and many of its dimensions are well understood. But it takes on fresh urgency when shareholders are clamoring for growth and companies are increasingly selling their wares abroad. It is important when customers regularly turn to the Web to gather intelligence on a product, its price, and the accompanying services before actively considering a purchase. At the same time, solutions become more pressing because consumers are proving more resistant to automatic "pass-along" price increases. The situation is even more volatile in the retail sector, where more affluent buyers now shop at Wal-Mart and, in Europe, at discounters such as Lidl.

There is evidence to show that more companies are trying to find new ways out of the pricing predicament. They are certainly looking at software to help do the job. According to AMR Research, the market for price management software and services is growing steadily and will start to gather momentum in 2006. And those responsible for pricing are gaining clout. When the Professional Pricing Society surveyed its members recently, it found nearly one in five price managers saying they report to senior management—almost double the level in 2002.

However, there is a fundamental flaw in the pricing approach taken by most companies—and it is not solved by using price optimization software alone. The issue is that what marketers think their customers value is often different from what the customers really do value.

In our experience, the core questions about what customers value most—what they will *actually* pay for as opposed to what they *say* they'll pay for—are answered with rigorous econometric techniques collectively called discrete choice modeling. (See sidebar, "A primer on discrete choice modeling.") In the past year or so, we have conducted 26 discrete choice modeling studies (our version of the modeling is called Strategic Choice Analysis® or SCA) with over 15,000 customers in a wide swath of industries across the U.S., Canada, Germany, and China.

Our studies show that price (17% out of a possible 100%) is nowhere near as important a selection factor as product features (65%); service features (11%), and other features (7%) account for the rest of decision-making.

Econometric techniques transcend less precise and less useful methods such as market research that capture only consumers' stated interests. They help bring concrete answers to executives who want to be able to tell investors that the product will indeed be chosen with a predictable frequency by customers. We see opportunities for fact-based modeling techniques to improve five areas of pricing strategy. Let's look at each in more detail.

1. Price cuts: learning what customers really care about

Cutting prices and making it up in volume rarely works for long. The tactic certainly cannot fix other product or marketing problems. Starting in 2003, weight-loss food maker Slim-Fast lost market share to low-carbohydrate products such as the Atkins line. Slim-Fast responded by increasing its in-store price promotions and discount coupons. By the time Slim-Fast launched its own low-carb products in 2004, annual sales had dropped by 21%; parent Unilever ended up taking a charge of €650 million for the impairment of goodwill for Slim-Fast in the fourth quarter of 2004.

Many sales and marketing managers continue to have faith that price cuts can "fix" problems such as undifferentiated products or an obscure brand image. Their faith is misplaced. Price decreases are easy to implement––especially compared to changes in product attributes or customer service, for instance—but extremely difficult to reverse. It often takes years, to bring a price back to its

A Primer on Discrete Choice Modeling

Discrete choice modeling is a "science of demand" that can be applied prior to product launch or product redesign and which has relevance to many different industries. Although it has been one of the most vibrant fields in the social sciences for more than 30 years, many business leaders are only now learning about it. And it is only in recent years that applications have begun to make an impact in the world of marketing.

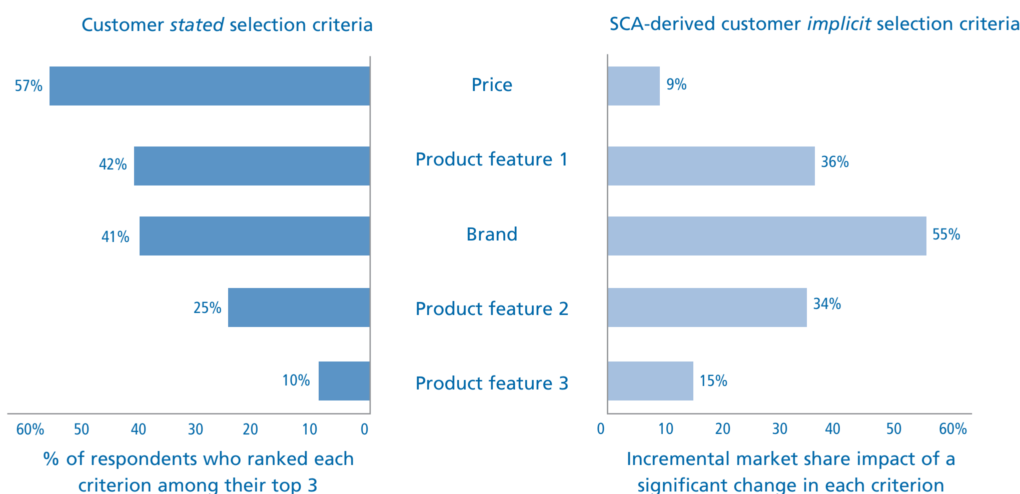
In the 1960s, economist Daniel McFadden was one of a few people to see economic applications for what was then crystallizing as a psychological theory to understand how people decide among several defined choices. McFadden's early and best-known application was to help the California Bay Area Rapid Transit Authority (BART) understand the potential demand for a mass-transit system. He helped BART analyze the way people make transportation decisions when assessing cars, buses, and trains with different prices, convenience levels, and trip times. His model was quite accurate, predicting a 6.4% share of commuter travel for BART, close to the actual 6.2% share achieved by the system.

What started in psychology and transportation economics soon evolved into one of marketing's most important tools. Oliver Wyman was one of the first firms to apply the technique; our adaptation is called Strategic Choice Analysis (SCA)®. The markets for SCA have evolved from simple demand estimations of existing products to forecasting demand for new products, brand strategy, real-time market experimentation, and other new applications.

In a typical SCA study, we begin by understanding the attributes that may be important to customers' decisions and then the levels of those attributes. We map the combinations of attributes and levels, usually surveying thousands of customers to ask them to choose among a range of market scenarios that include competitors' offerings. The multiple possibilities can be statistically simulated without having to test all combinations.

The survey data is analyzed using econometrics to uncover the patterns of choices made and to pinpoint what's driving the choices. The SCA model allows us to model the effects of, say, changing price plans or price levels. We can examine which competitors gain or lose share as each company changes product or service prices or features. And we can play competitive "war games," attacking or counterattacking in "what if" scenarios.

Exhibit 1 **Price matters less than you think**



Source: Oliver Wyman study with customers in China

original level. What's most regrettable is that price often isn't the driver that instinct or history or a manager's whim might say it is.

We find that when asked directly, customers regularly overstate the importance of price. But when they are asked, using a series of choice matrices, to trade off product and service features against price, their ranking of price drops steeply. For instance, in a recent survey of 1,200 customers in China, 57% named price as one of the top three criteria in choosing a home-technology product. However, after the Chinese customers participated in an SCA exercise, price was the least important attribute compared to the vendor's brand and the product's technical characteristics (Exhibit 1).

Working with a major high-technology product manufacturer, we applied SCA techniques to gauge customers' reactions to various pricing and product moves. The research proved that far from pushing lower prices from the high-tech supplier, customers would not balk if prices were raised. Our analysis revealed that the company could charge more and even gain market share if it focused primarily on the product features that the customers valued. We identified several defensive and offensive moves to retain and gain market share. The firm refocused its market strategy to stress the solutions and the value of the product to the customer's business rather than all the technical features that had been the core of the previous strategy.

The outcome: This high-tech supplier saw annual revenue growth shoot up into double digits—a performance level that had not been seen for many quarters. And the revenue growth came predominantly at the expense of competitors.

2. Product portfolios: ensuring profits without cannibalization

Brand managers within the same marketing group often compete not only for the same resources, but also for the same set of customers. But this "may the best brand win" approach can lead to internal price wars that undercut the pricing strength of the product portfolio as a whole.

A leading food manufacturer faced that challenge. Each of its six brands came in several flavors; the company was offering more than 15 choices on the supermarket shelf. Discrete choice modeling helped the food maker gauge the price elasticity of each brand and sub-brand, comparing the company's products with each other and with competitors' offerings. The approach included market share simulations that showed that if a brand overlapped with other brands in the portfolio, a price change didn't hurt the cumulative

market share of the product portfolio; losses in one brand or brand flavor were recouped by gains of other portfolio products and gains at the expense of competitors. The analysis allowed the company to identify overlap and cannibalization among its brands, and its consequent pricing decisions led to significant lift in overall portfolio revenue and margin.

In some purchases, the buyer has little or no opportunity for customization of the product; the decision is to buy the whole thing or buy something else. But more and more companies are offering products and services that the buyer can customize. When the buyer can make *a la carte* choices—selecting from different baskets of attributes and features— another price modeling technique works best: menu choice modeling (Exhibit 2). This is an extension of traditional choice models. Control of "product design" shifts to the buyer; the seller decides which "components" to offer, sets the price of each one, and the buyer then selects the components.

The menu model is a powerful and increasingly popular tool that accurately reflects the decision-making process in a mass customized world. It lets buyers optimize prices for individual products and service components that are purchased a la carte or in bundles; allows for measurement of the effectiveness of bundle discounts and incentives; and can provide insight into the value of the attributes and features of different components. Indeed, simply granting customers the option of tailoring their desired packages increases the likelihood of purchase, even if the purchasing flexibility is used only to justify a buying decision.

3. New products: pricing correctly from the start

It's common for marketers to overestimate the worth of their new products. This means they are likely to make pricing decisions that compromise their companies' growth prospects for some time—conceivably for the lifetime of the product.

Exhibit 2 **Simulating purchase of a luxury car through a menu choice exercise**

1. Menu choice baseline

What brand style would you like?

Choose one of these options: Lexus / BMW / Cadillac / Mercedes-Benz

AND

Choose one of these options: 2-Door Coupe / 4-Door Full-size

What is your choice of …?

Interior Options
Choose one of these options
Front & Side Airbags / Front Side & Head Airbags / Front & Side Airbags, Electronic Stability System / Front, Side & Head Airbags, Electronic Stability System

AND

Single zone temperature control / Dual zone temperature control

OR

Exterior Options
Choose one of these options
My color preference is:
Silver Metallic / Mystic Blue / Gray Metallic / Mica Blue

How likely would you be to purchase this package?

Total Package price **$35,000**

Choose one of these options: Very unlikely / Unlikely / Neutral / Likely / Very likely

A. Respondents assemble their ideal luxury vehicle (brand, style, safety, climate settings, color)

B. Impact of choices on overall price was immediately transparent

C. Respondents stated how likely they would be to purchase such a vehicle in the next couple of years

Given the lifetime revenue and profit potential of new products and services, it is doubly important to understand what customers will actually pay for. Choice modeling analysis helped one leading telecommunications company avoid a marketing minefield by assessing whether the services that the company wanted to add would make any difference to its customers' selection of telecom providers.

The firm's original marketing plan called for pricing the additional services at the prevailing market prices. However, our modeling studies indicated that customers did not ascribe value to most of the additional services at the tested prices. In fact, the analyses signaled that the company would lose market share by pricing its new services at the tested levels. Had the company gone to market with its original assumptions, it would have suffered from huge marketing and sales investment losses, a bungled go-to-market strategy, and potential long-term fallout for the brand. In fact, the research showed that if the value-added services were offered for free, they would help to drive up market share.

That was what happened. The telecom provider went to market offering these services at the optimal pricing to get a foothold in the market, and later increased prices once the market became familiar with the business value and benefits of its services.

4. Market segmentation: matching the price to the customer set

It is a fundamental marketing truism that different customer segments place different values on brands, products, and price points. The trouble is, this rule is often forgotten in practice. Many marketers choose to apply uniform pricing across all customer groupings, effectively leaving money on the table.

At first glance, the uniform pricing may appear to be right. The supplier of a high-tech product had priced the product at a suitable level for the market as a whole. However, a closer examination of customer preferences,

2. Menu choice tradeoffs

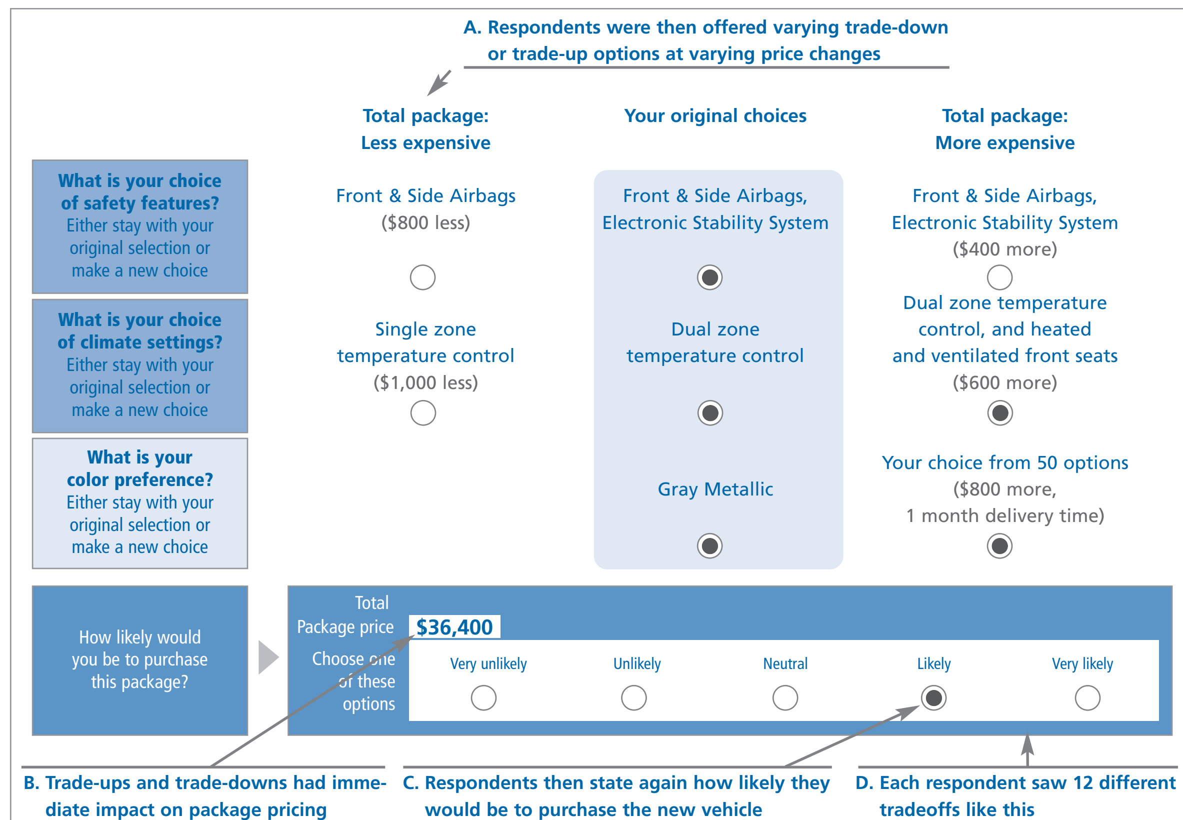
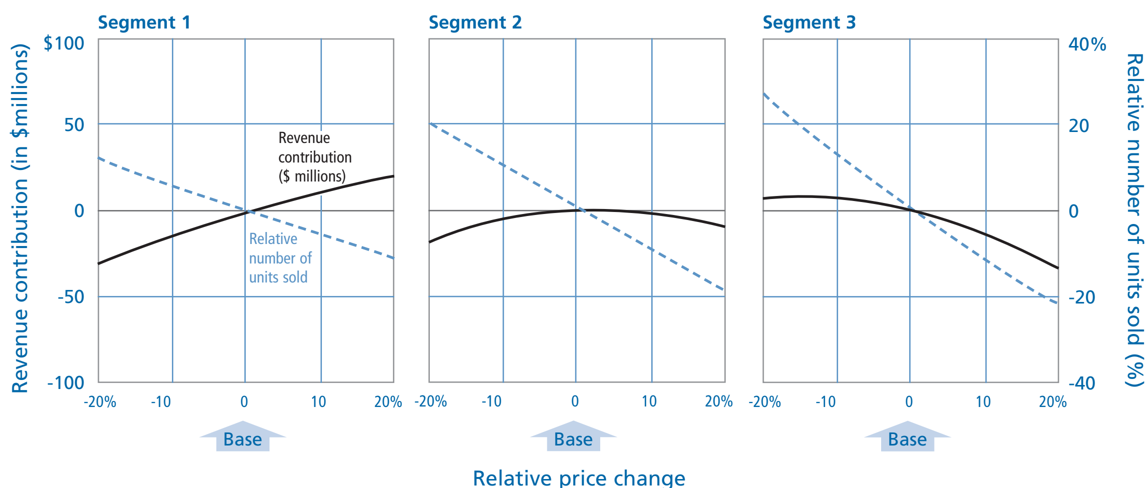


Exhibit 3 **Price elasticity: variation by segment**

There is substantial opportunity to gain revenue in Segment 1 by raising prices and in Segment 3 by lowering prices, but limited opportunity to gain revenue in Segment 2 by changing prices only.



Source: Oliver Wyman research with 1,220 consumers for an electronics product

applying discrete choice modeling techniques, quickly uncovered three distinct segments with quite different price elasticities. It turned out that the price was already optimal for one customer segment; in another, there was room to increase margins by raising the price; in the third, it made more sense to cut prices (Exhibit 3).

The high-tech supplier implemented segment-specific price changes, and the changes were soon reflected in stronger revenues and profitability for that product. The lesson? One market may in fact be several mini-markets, each deserving its own pricing approach. That nuance may not be obvious without a fact-based analysis generated by econometric methods.

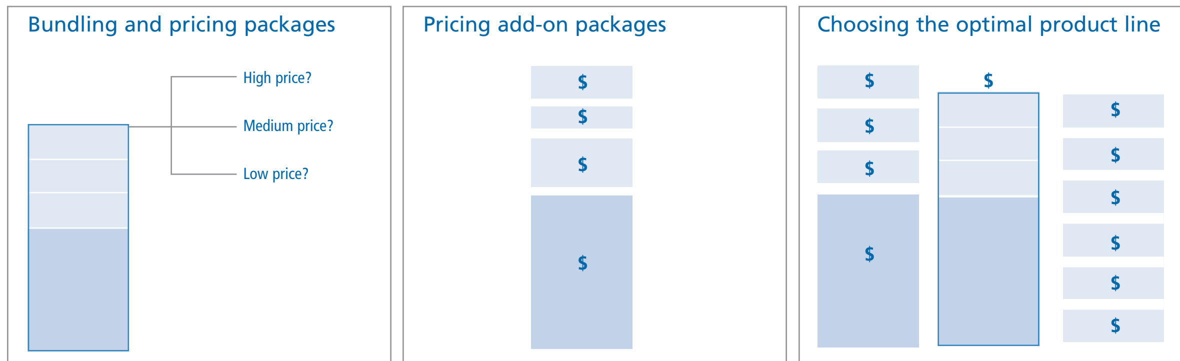
5. *Package pricing: making the most of add-ons*
Many consumer products are sold as standalones, but many more are sold with add-ons such as a warranty, delivery charges, installation charges, off-site or on-site maintenance fees, and so on. Most B2B products are bundled with add-ons, and the package options greatly increase the complexity of the pricing decisions; a customer might choose the three-year warranty, for example, but pick ground shipping instead of express delivery. As a consequence, marketers often default to creating package prices based on current industry practices, an approach that often leads to lower prices than customers will pay (Exhibit 4).

A good case in point is a telecommunications company that was seeking market share growth and leadership in a B2B applications market. Using choice modeling to gather and interpret insights into end-user requirements, perceptions, and demand drivers such as price sensitivity, we helped the firm better understand its customers' views on warranties. As a result, instead of giving away its warranty free as it had planned, the company was able to increase revenue by appropriately pricing its warranties. Specifically, the telecom provider could gain another two points of market share on its 12% base share despite charging as much as 15% of the equipment price for a five-year parts and labor warranty (Exhibit 5).

The Power of Brand in Pricing

Marketers know that stronger brands are less price-elastic than weaker brands (remember our Apple iPod example), yet many still tend to react to a competitor's pricing moves, forgetting the weight of the equity in their own brand. So any complete modeling initiative should com-

Exhibit 4 **Making sense of bundles and add-ons**



Bundling and pricing packages

- Which individual packages should be bundled with the core offer?
- What should the bundled package prices be?
- How do individual packages affect demand for the core offer and its price elasticity?

Pricing add-on packages

- Which packages or services should be offered as an add-on to the core offer?
- How should the individual packages be priced?
- What should the core price be to optimize overall demand?

Choosing the optimal product line

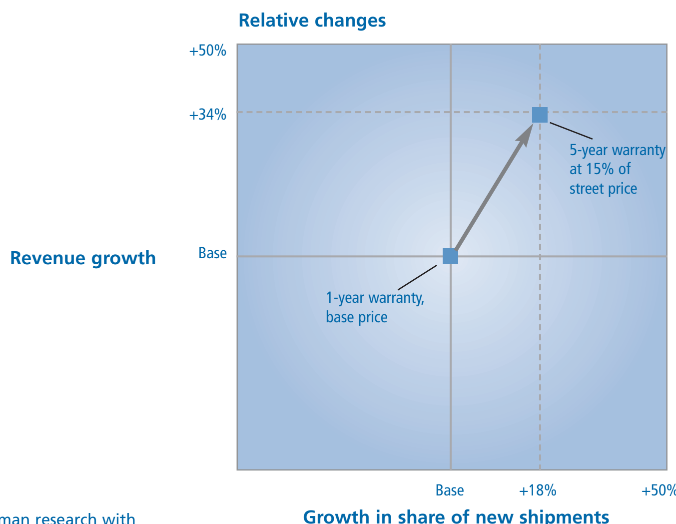
- What is the optimal mix of bundled packages, add-ons to the core offer, and a la carte offerings?
- What is the level of cannibalization across the different product configurations?
- What pricing across the configurations will maximize revenue and profit?

pare brand attributes of the company with those of its key competitors.

We designed such comparisons into a choice model for an Internet service provider and found that the customers of its proposed new product were willing to pay more for the same features when offered by the company compared to its competitors. The Internet provider's market share was driven not only by a superior product but also by a superior brand that commanded a price premium. Its price elasticity turned out to be much lower than competitors'—almost half that of the next two largest brands in the market, giving the company room to be firmer with its pricing practices.

In another example, a technology company's products sold in China were losing out to unbranded products made by local Chinese businesses. To combat the loss of sales, the company was keen to launch a low-end

Exhibit 5 **Add-on pricing: the impact of warranty offers**



Source: Oliver Wyman research with 600 customers in Canada

product line and wanted to gauge market response to such a concept. We tested two new concepts in the Chinese marketplace. The research models showed surprisingly high sensitivity to brand yet low sensitivity to price. The new concepts were well accepted and the early indications were that cannibalization with existing products, while significant, would not be large enough to erode margins. The company saw that its new concepts, priced and featured correctly, could generate up to 50% revenue gains in China.

Growing Certainty

At root, pricing is about capturing value. Yet most pricing mechanisms today focus primarily on information and process—sales force discounts, win-loss analyses, and so on—rather than on what customers value most. A sharp focus on customers' perspectives is the biggest lever for profitable pricing, and the tools and techniques such as discrete choice modeling are the best way to assess value.

Best-practice companies are already moving in those directions. They can point with growing certainty to the levers and organization designs that can best support a sharp focus on the customer.

It is vitally important for all businesses to follow the lead of the exemplars in aligning pricing to customer value. In effect, pricing approaches are one of the last links in the value chain. The product or service has been designed, sourced, staffed and created; many capable teams have already worked hard to build value into the product from the start. Now it is the turn of those who control the pricing levers to do their best work. ❖

Oliver Wyman
Oliver Wyman is building the leading global management consultancy, combining deep industry knowledge with specialized expertise in strategy, operations, risk management, organizational transformation, and leadership development. The firm works with clients across a range of industries to deliver sustained shareholder value growth. We help managers to anticipate changes in customer priorities and the competitive environment, and then design their businesses, improve their operations and risk profile, and accelerate their organizational performance to seize the most attractive opportunities.

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