Pricing: technique alone is not enough

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Pricing optimisation has the potential to considerably improve profits and is often easier to implement than reducing internal costs. Pricing techniques have been significantly improved over the past few years, logics limited to “cost plus” and to competitive alignment have been challenged by numerous companies ; they have optimised their margins based on price/volume elasticity and have embedded these techniques into their commercial policies through simulation and control tools. This has given results … but their extent and their durability have often been far lower than the anticipated EBIT improvement of 200 to 400 basis points.

In our experience, such differences between theory and practice are due to two dynamics that sheer optimisation techniques neglect: the competitive dynamics on one side and the price-image dynamic on the other. If, for example, you cut your prices but your competitors quickly follow suit, how can customers really set you apart, and reallocate their purchases in your favour (in this instance, price/volume elasticity is actually reduced to zero)? If you have a mediocre price image (i.e. the perception your customers have of how price competitive and aggressive you are) and your main competitor has a favourable one, how long will it take for you to change these beliefs, and how large is the associated risk of your competitor counter-attacking in the meantime?

In order to permanently capture the considerable gains from better pricing, optimisation initiatives must take into account the reality of competitive and price-image dynamics.

Factoring in the competitive dynamics

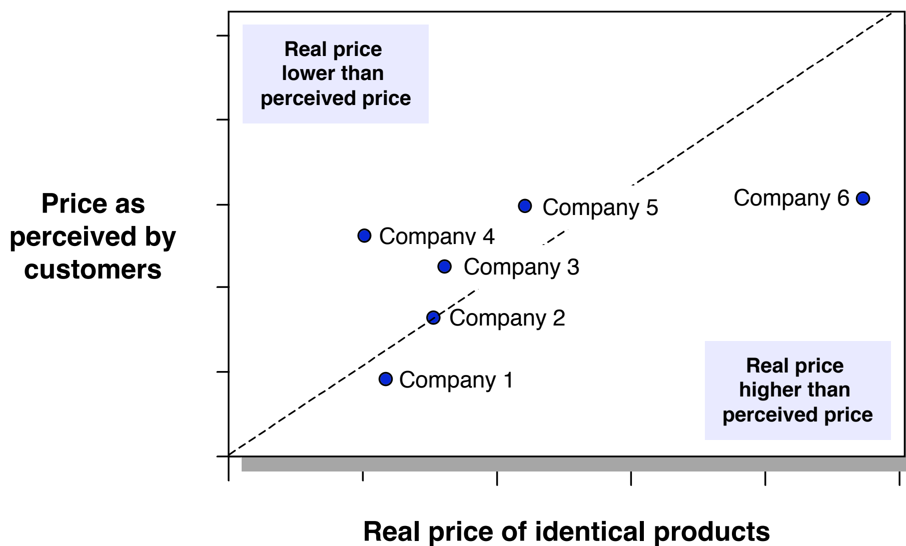
Two "fundamentals" must be considered: the structural characteristics of the industry in which the company operates and the position of the company in this industry.

Most industries display structural reductions in prices, due to technological innovations and gains in productivity. However, depending on the business sector, these reductions do not have the same impact on the profitability of the various operators. Some industries (automobile, telecommunications, most consumer goods and retail sectors, etc.) have sizeable scale effects and price reductions combined with volume increases lead to significant unit cost reductions. Other industries (steel, electricity production, etc.) have much more modest scale effects and the operators cannot "trade off" price reductions against structural cost reductions.

The company's position determines its “vulnerability” or its “appetite” for reduced prices. A leader in an industry with strong scale effects usually has lower costs and will benefit from a drop in prices far more than some of its competitors, particularly marginal competitors that will have to deal with prices that have dropped below their production costs.

Knowing your price image and your ability to quickly act on it

Enjoying the aforementioned long-term price reductions, customers do not view all industry players in the same way: some companies are perceived as aggressive and price-oriented suppliers, others are considered to be service- or quality-oriented, who basically follow the price reductions initiated by the competition. The lower the customer's involvement in a purchase, the less aware they will be of actual prices and the greater the disparity between price reality and price image. The diagram below illustrates these disparities, for mass retailers in general merchandising.



Such strong disparities between actual prices as measured at instant "t" and price perception can be explained by three factors:

- The long-term history of actual prices, in particular for products with high purchase frequency, as those have the greatest impact on price image; this history may be very different from the prices charged at "t", particularly for companies which favour the "yoyo" method (i.e. matching the competition when asked to do so by the sales force and raising prices again towards the end of the financial year or quarter);
- The elements of the marketing mix, above and beyond price, and the "low cost" perception that they promote: degree of aggressiveness of promotions; balance in the product ranges between entry level, mid-range and premium; price image of the distribution channels used;
- Major price signals sent in the recent past to customers and competitors: aggressiveness during the latest industry low cycle, price reaction when facing a new entrant, communication on “price” vs. "value adding" communication, etc.

These three factors create considerable inertia in the price image: in particular, the more erratic the pricing policy applied by a company over a long period (first factor) and the more its marketing mix communicates an image of high cost (second factor), the longer it will take to change its price image. Such a company will have to take into consideration this inertia into its policy.

Working on prices and on price image

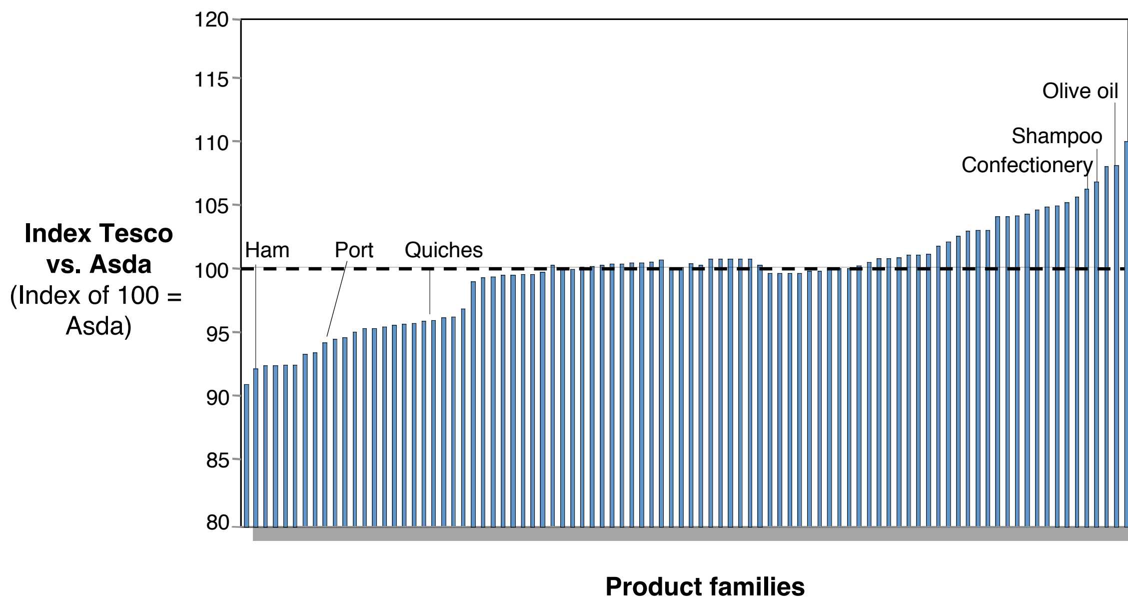
The actions to be taken depend on whether you are:

- A leader (the number one company in a sector) operating on a market with considerable scale effects;
- A leader operating on a market with more modest scale effects;
- A follower, i.e. a competitor with a market share which is significantly smaller than that of the leader.

A leader operating on a market with significant scale effects must pursue a policy of reducing prices in order to concentrate the industry for its own benefit. It positions the market's average price based on the costs of competitors which can be marginalised, thereby improving its position in the market and on the scale effect curve while slowly but surely suffocating rivals. Its aim is to have the best price image on the market; to achieve this it will strive to have the

lowest actual prices on the market over a long period of time. If a "discount" follower attacks, the leader reacts by using an entry level range for which it accepts reduced margins; it limits the risks of cannibalising the rest of its product and customer portfolio by clearly "impoverishing" the other marketing attributes of this entry level range. It finances the associated investments by moderately repricing upwards the parts of its business which have the least effect on price image and which are the least price sensitive.

The British supermarket chain Tesco pre-empted Walmart's entry into the UK (when it acquired Asda), by cutting prices. It has since maintained a moderate premium on prices versus Walmart/Asda. It does this in a de-averaging manner: Tesco is up to 10% less expensive on some product categories and up to 10% more expensive on others (see diagram below).



For a leader in *a market with modest scale effects,* there is no objective advantage in reducing prices more quickly than required by technological progress and overall productivity gains. It must optimise its margins and use pricing to regulate the industry's supply-demand cycle: in the event of undercapacity, it must make targeted price reductions in order to weaken marginal competitors; in the event of overcapacity, it must reduce its own capacities, abandoning unprofitable volumes if necessary to ensure that the industry does not enter a destructive downward spiral. Consequently, the main aim of its work on price perception is to send signals to competitors: deciding not to underbid competition on unprofitable customers; if attacked on customers in its core profit zone, striking back by cutting prices or, even better, by increasing its value proposition to those very customers.

Unlike the leader, the *follower's* generic strategies do not depend on the type of business. Whether or not the market share has value, the follower cannot directly engage the leader in a global price war. If it has higher costs than the leader, such a strategy is too costly and cannot be sustained in the medium term. If its costs are identical because there are no scale effects, a strategy of reducing prices is by definition worthless.

The follower's weapon will be to have a more targeted approach than that of the leader, either through costs or through "value". Either it calculates better the real landed costs for each customer depending on the product range (different levels of complexity, different stock turns, small production runs vs. long production runs) and depending on the levels of service offered (commercial support, logistical services, after-sales service, etc.); this enables it to identify a segment for which the leader is overestimating the landed costs and therefore is "overpriced"; it takes advantage of this price umbrella to sell at a lower price than the leader, and in a manner which it is able to maintain. Or it has a better understanding than the leader

of the specific needs of certain niche markets and decides to increase the value it brings, i.e. to invest in services or in a quality that the leader is neglecting due to its "average" approach to the market.

The follower has two objectives/actions in terms of price image:

- To avoid discrediting itself by being perceived as too expensive. It must remain credible, avoiding exceeding certain ceilings and following some downward movements (even if it means de-averaging them tactically, just as the leader Tesco does with the discount follower Walmart/Asda). It is not easy to strike the right balance and a frequent mistake is to match prices on products with high turnover while paying less attention to prices for products with low turnover: in the long run, such a strategy creates distortions in price ranges and can prompt customers to trade down to a cheaper product in the range, which would severely harm the margin generated by the company; in addition, the low turnover in question may hide a high purchase frequency for some customers, customers who may not forgive what they view as “insult” prices;
- To support the cost- and value-targeted approach in a non-aggressive manner: to do so establishes its best supplier status on the selected segment by specifically communicating a price commitment to those customers; preventing a reaction from the leader by avoiding global and permanent approaches and by favouring targeted approaches: specific offers, focused promotions, etc.

How to get started

By applying the principles mentioned above you can steer the competitive dynamics to your advantage and intelligently play upon the inertia of customers' price perceptions. As a result, these principles make it possible to construct a robust pricing policy and a price image that is best suited to your specific market position. There are significant long-term gains at stake: the "famous" 200 to 400 basis points of EBIT, which can be reinvested to fund the company's development, are achievable.

So the game is worth playing… but you must have the relevant information and approaches needed to start the process:

- A relevant strategic segmentation of your business, and a robust assessment of your position and of the scale effects you are subjected to (or which you benefit from);
- For each strategic segment and each business line, an accurate and exhaustive photo of your price positioning, not limited to the standard vision given by industry panels; a price-image barometer including the specific drivers of your price image; an ABC costing which fits with the economic reality, at the required level of detail;
- A thorough understanding of the dynamics: the competitive dynamics (who will follow which price movement? For how long, given the structural competitive dynamics?) and the price image and elasticity dynamics (how will consumers react to a change in prices given the characteristics of the market and of my price image? Within which time frame?).

There is often a great deal of work involved, and it requires more than just a purely technical or software-based approach. As a result, pricing is repositionned in its true context: a strategic issue, to be dealt with by top management.

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Estin & Co is an international strategy consultancy based in Paris, London, Geneva and Shanghai. The firm assists the boards of major European, North American and Asian groups in their growth strategies, and private equity funds in analysing and improving the value of their investments.