

Product Pricing

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President



With thanks to:

**Professor Dick Harmer
Pradeep Mady**

Agenda

1. Overview of Pricing
2. History of Pricing
3. Value Pricing

Product Pricing

- ❑ One of the very foundations of business:

$$\text{Profit} = \text{Sales} - \text{Costs}$$

$$\text{Sales} = \text{Units sold} \times \text{Price}$$

- ❑ Much more focus in business schools on marketing, manufacturing, financing, R&D, etc. than on pricing theory and practice

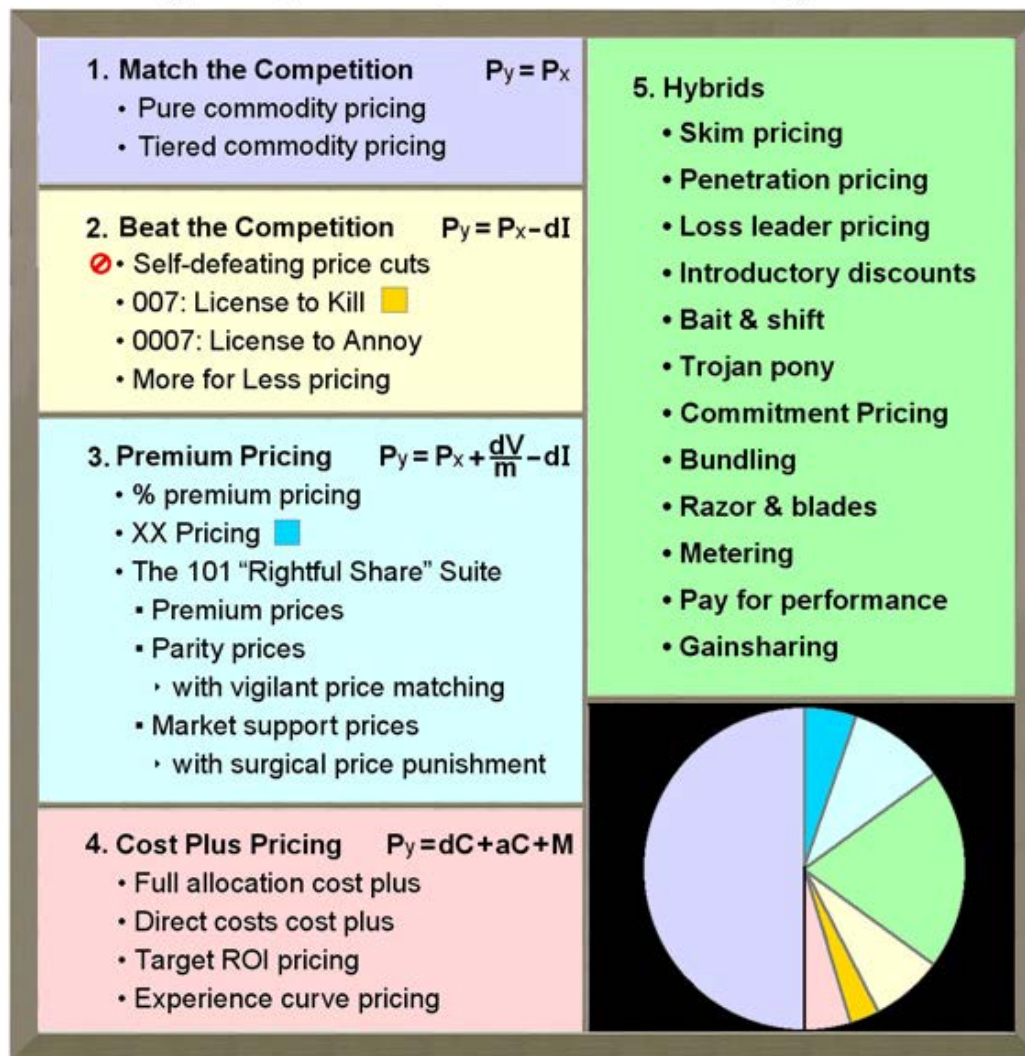
Key Sources of Complexity for Pricing Strategy

Situational Factors



Different strategies for different contexts

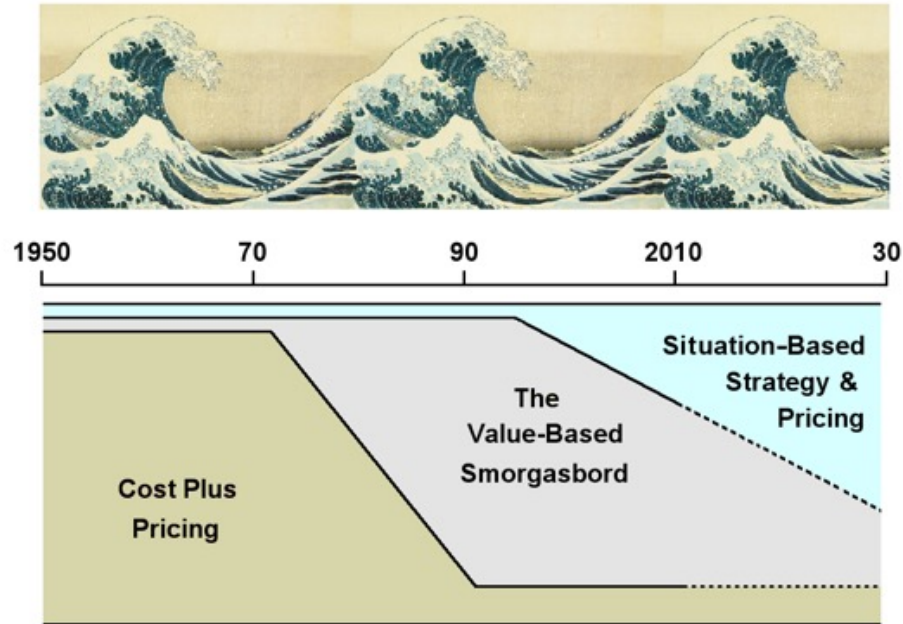
Pricing strategy is not some kind of generic “ball.” It’s different balls – baseball, football, basketball, etc. – each matched to different contexts.



Pricing at BU School of Management

- ❑ My students expressed surprise that I didn't cover pricing
- ❑ I found BU School of Management didn't have a full time faculty member specializing in pricing till 6 years ago
 - ❑ Previous pricing professor, Dr. Richard Harmer, left to found his own pricing consultancy in mid 1987
 - ❑ Strategic Pricing Group
 - ❑ Bought by Michael Porter's Monitor Group in 2005
 - ❑ Continued to teach one summer course
 - ❑ I contacted him and we became friends
 - ❑ Pradeep May is his disciple and successor
 - ❑ Founded Customer Value Center in early 1990's
 - ❑ www.CustomerValueCenter.org
 - ❑ Captures his wisdom and findings in a series of "Cards"

Pricing's 3 Great Waves



<u>1st Wave</u>	<u>2nd Wave</u>	<u>3rd Wave</u>
<ul style="list-style-type: none"> • Full Allocation Cost Plus • Direct Costs Cost Plus • Target ROI Pricing • Experience Curve Pricing 	<ul style="list-style-type: none"> • Demand Curves • Price Elasticity • Price Sensitivity Meter • Proportional Models of Purchase Choice • Importance/Performance Analyses • Proportional Value Maps • Multiple Tradeoff Analysis • Economic Value Analysis 	<ul style="list-style-type: none"> • Different Games in Different Contexts • Customer Economics Done Right • Purchase-Level Data Decks & Simulations

The Key Question

- ❑ If your product is 20% better than your competitor's, what should you price the product for?
 - ❑ 10% higher?
 - ❑ 20% higher?
 - ❑ 50% higher?
 - ❑ 100% higher?
 - ❑ 500% higher?
- ❑ The answer is:
 - ❑ *"It depends!"*
 - ❑ Consumers and businesses approach pricing and value very differently

**Consumers generally spend \$\$\$
to satisfy needs, wants, and desires**

Inputs:

- Products
- Services

**Consumption
Processes**

Outputs:

- Satisfaction of
- Needs
 - Wants
 - Desires



Purchases



**The *Very* Different Worlds of
Value Consumption & Value Creation**

**Business customers generally
spend \$\$\$ to make \$\$\$**

Inputs:

- Materials
- Labor
- Capital

**Transformation
Processes**

Outputs:

- Products
- Services



Purchases



Sales



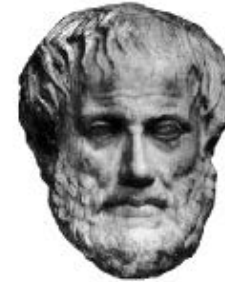
Aristotle's Two Big Steps on the Road to Value: Price Reality

...one very much in the right direction, one very much in the wrong.

▲ Use Value & Exchange Value

Use Value: the benefit or goodness its user gets from a product or service

Exchange Value: what that user should be willing to exchange for that product or service



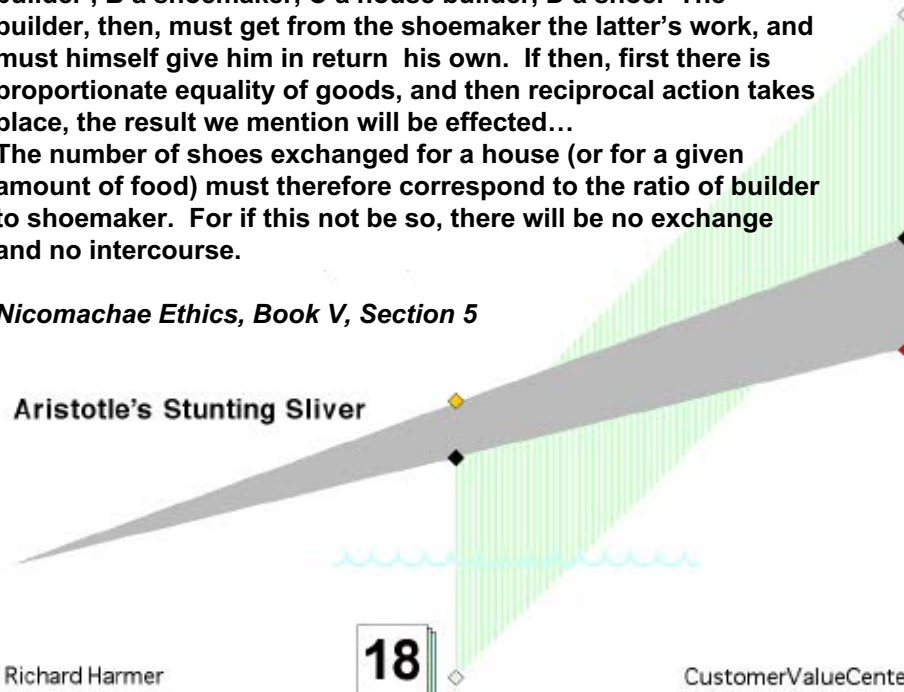
▼ Exchange Values should be, at their heart, proportional.

Proportionate return is secured by cross-conjunction. Let A be a builder, B a shoemaker, C a house builder, D a shoe. The builder, then, must get from the shoemaker the latter's work, and must himself give him in return his own. If then, first there is proportionate equality of goods, and then reciprocal action takes place, the result we mention will be effected...

The number of shoes exchanged for a house (or for a given amount of food) must therefore correspond to the ratio of builder to shoemaker. For if this not be so, there will be no exchange and no intercourse.





Nicomachae Ethics, Book V, Section 5

Aristotle's Stunting Sliver



Social Exchange vs. Market Exchange

One of the 3rd Wave's most important conceptual advances

	Social Exchange	Market Exchange
Proportionality $\frac{B}{C} = \frac{B}{C}$		
Profitability $\frac{B}{-C} = \frac{B}{-C}$		

*Profitability logics in the realm of social exchange
make you a jerk.*

*Proportionality logics in the realm of market exchange
make you a dunce.*

Key Questions

- ❑ Is there a correlation between goodness received and price paid?
- ❑ What is the conversion process between use value and exchange value?

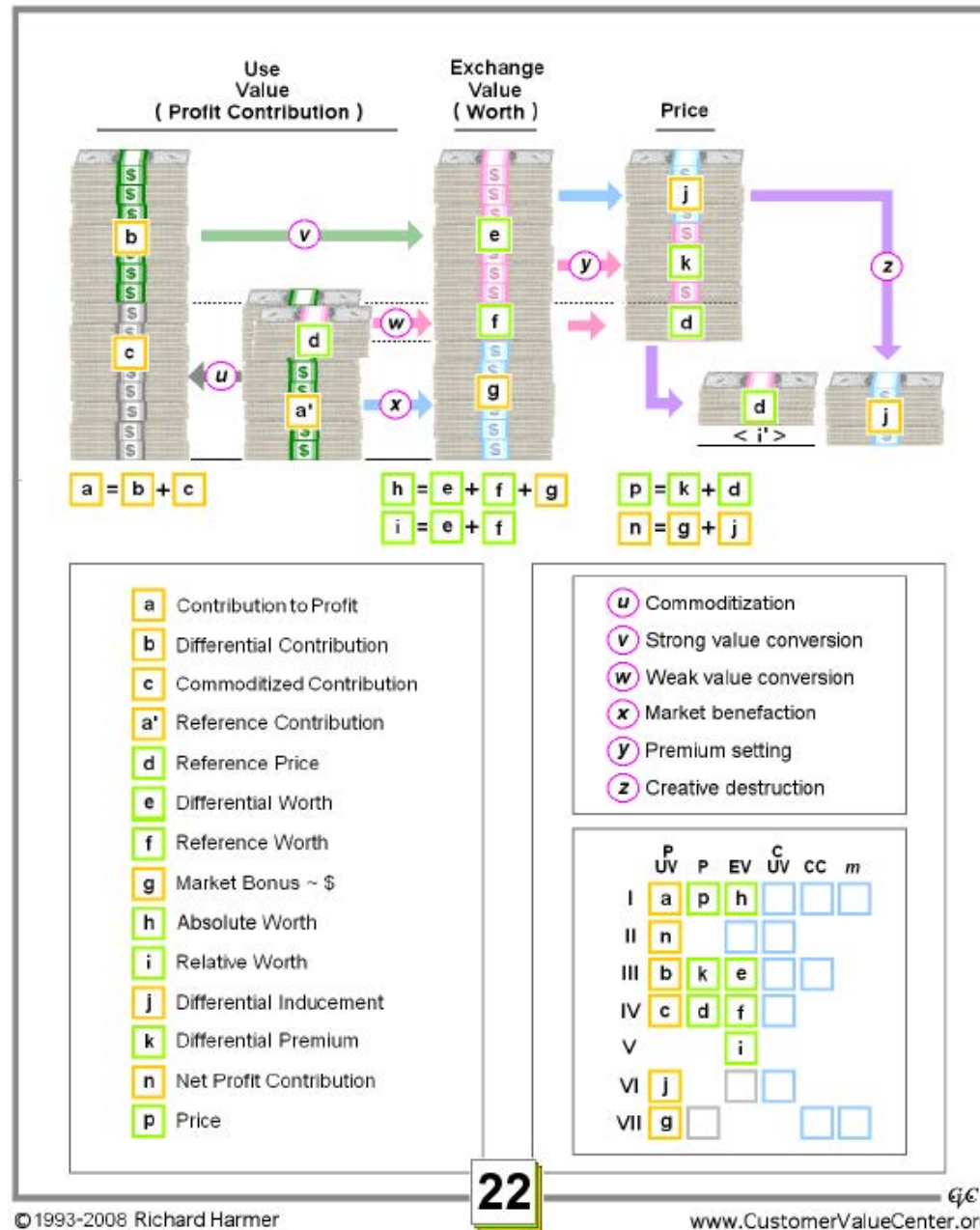
Commoditization

- ❑ Competition drives down prices
- ❑ State of the art (Reference) products are said to be “commoditized”
 - ❑ Tremendous value delivered at low price

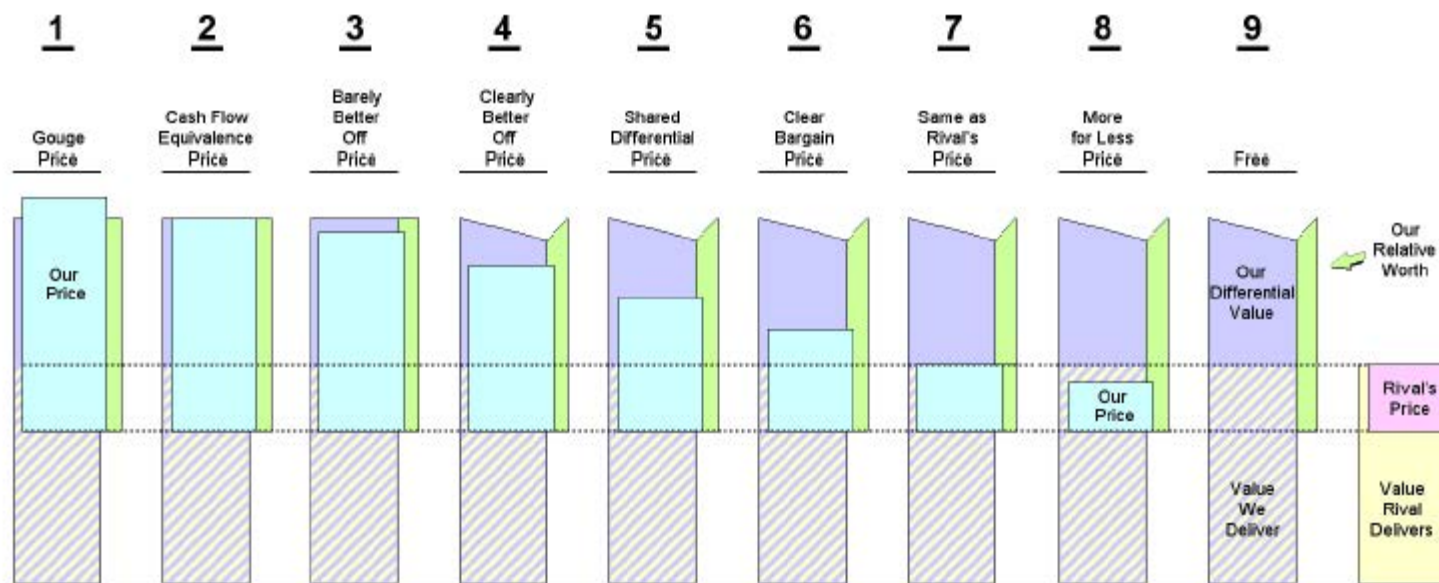
Customer Value (Premium) Pricing

- ❑ Intellectual property protection lets us charge a premium price for a product with superior properties
 - ❑ Don't have to worry about competition
- ❑ Charge for “goodness” (value) delivered to customer
 - ❑ Customer's goodness comes from:
 - ❑ Increased sales
 - ❑ Decreased costs
- ❑ Calculate the value of our product versus the current alternative
 - ❑ Reference price, reflects commoditized “goodness”
- ❑ Decide how much to capture for us
 - ❑ 80%?
 - ❑ Leaves 20% for customer as incentive to switch – the Differential Incentive
- ❑ Results in “XX Pricing”
 - ❑ XXX would be obscene

Customer Value Conversion: \$ Use Value



The 9 basic price positions for a premium product



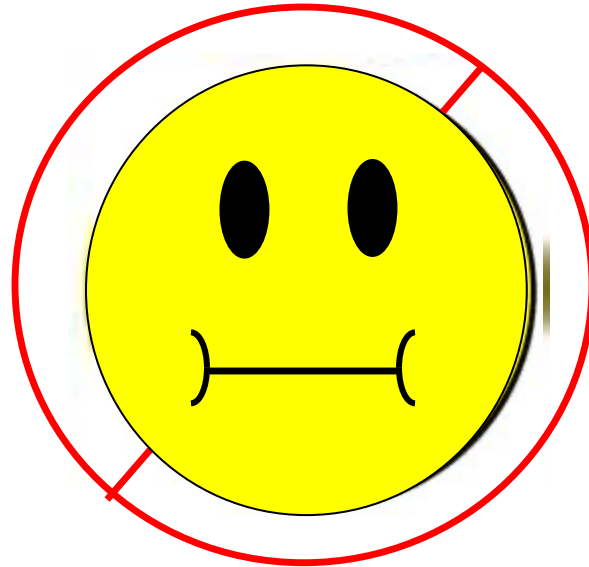
Which you ought to choose depends on which key contingencies kick in in the specific competitive context.

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The Customer Outcome of a Good Pricing Analysis



The Customer

- ❑ There's no such thing as "The Customer"
- ❑ There are many, many customers
 - ❑ All use the product differently
 - ❑ All get different goodness from the product
 - ❑ Therefore the product is worth different amounts to each customer
- ❑ We can't price it differently to each customer
 - ❑ Unless we can come up with different versions of the product
 - ❑ Barriers to stop lower priced versions "leaking" into higher priced markets
- ❑ Have to make trade-offs of pricing versus total profitability

Pharmaceuticals

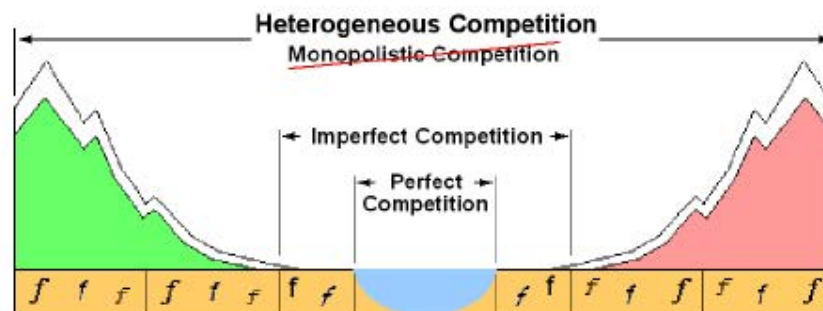
- ❑ Avastin vs. Lucentis
 - ❑ Wet form of AMD
 - ❑ Both made by Genentech
 - ❑ Avastin: \$150
 - ❑ Intended for colon cancer; much smaller dose for AMD
 - ❑ Lucentis: \$2,000
 - ❑ Derived from same parent mouse antibody
 - ❑ Lucentis smaller, and affinity-matured to provide stronger binding
 - ❑ NIH trial showed equivalent efficacy
 - ❑ Canadian study showed higher incidence of intraocular inflammation with Avastin
 - ❑ UK study showed no significant difference

Pharmaceuticals

- ❑ Campath vs. Lemtrada
 - ❑ Identical products
 - ❑ Campath approved for various B-cell leukemias and lymphomas
 - ❑ Sales ~\$100 million
 - ❑ Lemtrada under development for Multiple Sclerosis
 - ❑ Potential upto \$3.5 billion annual sales
 - ❑ Lemtrada subject to \$14 CVR (~\$3.5 billion) in Sanofi acquisition
 - ❑ Withdrew Campath from the market to prepare for launch of higher priced Lemtrada

Chamberlin Landscape & the 3 Arenas Framework

~ Different strategies for different positions within an overall market ~



Value Position	A	B	sC	cC	sC	D	E
1. Widgets		5%	15%	60%	15%	5%	
2. Gismos		20%	5%	20%	5%	20%	30%
3. Uxyls	40%	20%		30%		10%	
4. Fracters	10%	30%	5%	10%	5%	30%	10%
Share Aspirations	100%	90%	1/n		5%		0%
Price Positions	+XX	+ %	+0~	-0	-0	-0~	-0~
Game Postures	Keep Out! This is ours. W. K. W. Y. L.		Share High or Share Low: Your Choice.		We're watching ... Enjoy it while you can.		

Market Segments

- Suppose three well defined market segments:

Reference product	\$10	
Segment 1	10% of total	\$100 extra value delivered
Segment 2	50% of total	\$50 extra value delivered
Segment 3	40% of total	\$10 extra value delivered

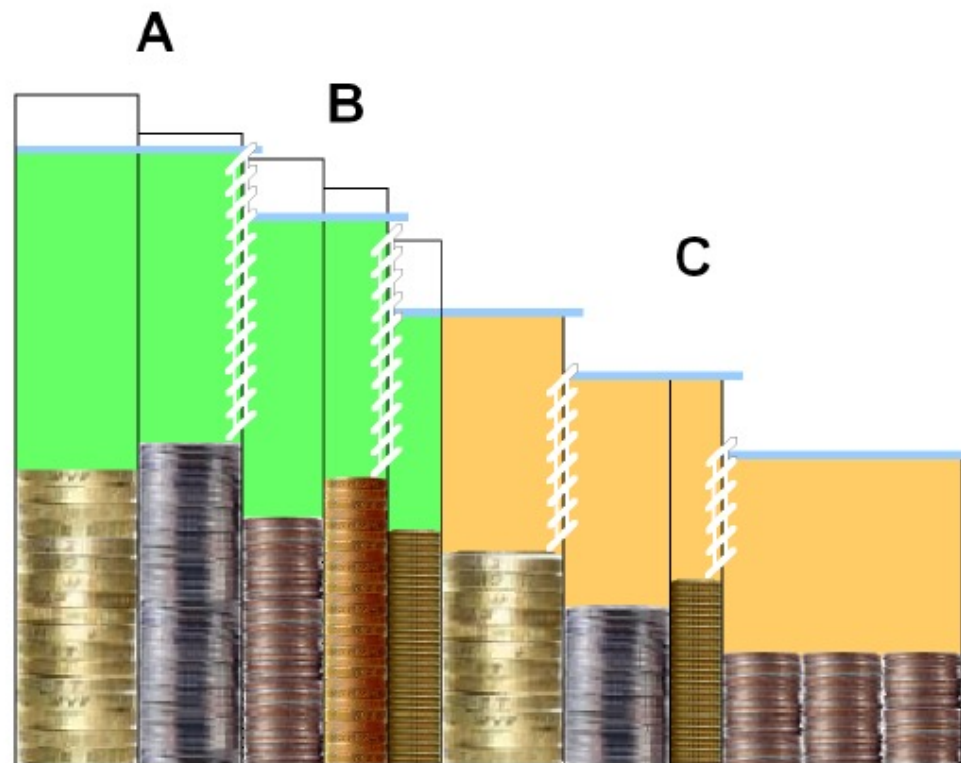


- Price to capture 80% of value

- Pricing options:

Price at \$90	Capture Segment 1	Revenues: \$9
Price at \$50	Capture Segments 1 & 2	Revenues: \$30
Price at \$18	Capture Segments 1, 2 & 3	Revenues: \$18

Corey Staircase



Ray Corey 1920-2004
Harvard Business School

Product Line Pricing Strategy

- ❑ Low base price
 - ❑ Upgraded models, where cost of upgrade much less than price differential
 - ❑ Price fences allow different prices for different features
- ❑ e.g., iPad:
 - ❑ Wifi only:
 - ❑ Wifi + 3G

 - ❑ \$100 (extra 20%) for 16GB or 32GB?
 - ❑ \$139 (extra 33%) for a 3G receiver?
- ❑ Selective uglification!

Product Line Pricing Strategy

- ❑ Low base price
 - ❑ Upgraded models, where cost of upgrade much less than price differential
 - ❑ Price fences allow different prices for different features
- ❑ e.g., Google Nexus Tablet (July 2012)

Model	Components	Price	Margin
8GB	\$151.75	\$199	\$47.25
16GB	\$159.25	\$249	\$89.75

Additional Resources

- ❑ *The Strategy and Tactics of Pricing*, 5th Edition by Thomas Nagle, John Hogan and Joseph Zale (Mar 12, 2010)
 - ❑ \$54 on Amazon