The PRICING ADVISOR

A Professional Pricing Society Publication

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In this article, the author explains why he recommends Exchange Value to Customer calculations according to economic factors, rather than weighted average benefits, when pricing in industrial markets. This industrial markets specific example provides valuable pricing questions and insights that can be utilized by pricers in multiple industries. Tim J. Smith, PhD is the founder and CEO of Wiglaf Pricing, adjunct professor at DePaul University, and Academic Advisor for the Certified Pricing Professional designation. His most recent book is Pricing Done Right: The Pricing Framework Proven Successful by the World's Most Profitable Companies *(Bloomberg Financial, 2016). He can be reached at tsmith@wiglafpricing.com.*

Valuing Benefits: Weighted Average or Economic Impact?

I was recently asked the following question: "Why calculate exchange value to the customer by economic factors when we can do a weighted average benefit analysis?" And I knew I was being pulled into a best-practice discussion regarding an established standard operation procedure within that particular industrial goods firm.

I had a contrasting opinion. So why do I (and many others) like Exchange Value to Customer calculations according to economic factors, rather than weighted average benefits, when pricing in industrial markets?

What follows is my experience (see figure 1 on next page). Am I crazy or uninformed? Do you have a better argument?

Weighted-Average Analysis

The type of weighted average benefit analysis under consideration used a grid. The top horizontal axis listed the benefits and their weighted importance where the weights added up to 100%. The vertical left axis listed the competitors. Each competitor was scored on a 1 to 10 rating scale according to how well they delivered on individual benefits. Then, the scores were multiplied by the weights to calculate the weighted average benefits of the competing products along with the focal product.

All seems logical enough. But there were challenges.

First: who chooses the benefits, the weights, and the scores? While one could imagine a voice of customer exercise followed by a survey to define these factors, in practice they used an internal management consensus. While imperfect,

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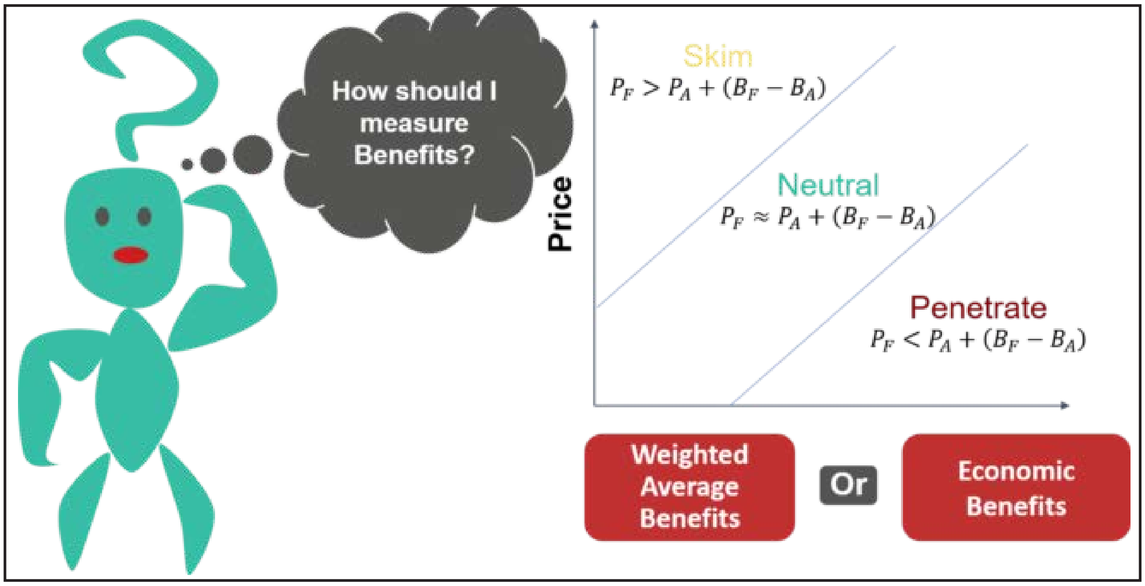
this approach should be directionally correct.

Second: how sensitive is the resulting metric of benefits to the input parameters? While the overall measurement of benefits was directionally sound, the specific relative measurements were highly sensitive to input parameters and weightings. Thus, the benefit differential, which is a key issue in pricing and price positioning, was suspect.

Figure 1



While these challenges could be addressed and perhaps reduced through customer surveys, one should back up and ask the following: Why conduct a survey for pricing based on a weighted-average when academic research and industry best practices both point to conjoint analysis as a far superior survey-based tool for measuring perceived differences between products? As well as the relative importance of these differences and the price tradeoffs people are willing to make for those differences?

We know we have a superior customer survey based approach. The attractiveness of the above weighted average approach was that it could be done internally with managerial insight, thus quickly and at a low cost. And while not specifically perfect, it is directionally decent.

So why do the academic literature and best practices both suggest calculating the exchange value to customer when a simple weighted-average approach might work?

Economic Impact

Exchange Value to Customer is calculated by:

1. Identifying the nearest competing alternative and the differential benefits.

2. Calculating the value of the differential benefits from the customer's perspective.

3. Pricing near but slightly below that of price of the competing alternative after adjusting for the value of the differential benefits.

This too seems logical enough, but has its challenges.

Like the above weighted average approach, this exchange value approach too is improved through direct customer research but is usually chosen as an approach that, with reasonable management insight alone, can produce a relatively accurate price. And, like the weighted-average approach, the financial impact of a benefit is highly dependent on the input parameters to that model.

Then, it has an additional challenge: How do you calculate benefit differentials? Some benefits can be modeled financially, such as labor savings, time savings, risk reduction, disposal cost, output improvements, other benefits cannot. For instance, the benefit of "brand trustworthiness" might have a large value but it is very difficult to model. Plug values often get used for psychological factors. And plugs are little more than guesses, to be honest.

Given the large challenge of actually modeling the financial impact of benefits and the fact that calculating exchange value to customers internally suffers from the same challenges as using a weighted average benefit metric for price positioning, why bother with the extra work?

A Sample Comparison

The answer came from examining the results of the two approaches on the same product in the same market, and seeing the nature of the difference in world-views and resulting usefulness.

The weighted average benefit metric indicated that the product should be priced high and would be nearly identical in benefits with a product that had a very large market share.

When I asked if the two products were really similar, and if so, why are they projecting such a small market share, the product management team quickly stated that the two products did very different things. Yes, they are both used by the same customers and were in the same product category, but the two products solved different problems for those customers and weren't really comparable. Thus, the weighted average approach led to a distorted picture of the pricing opportunity.

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The weighted-average approach examines all products at once. Hence, it creates a generalized picture of the market. Not bad for getting an overall picture, but it can be misleading and is insufficient for pricing.

The exchange value approach indicated that the product should be priced low for a large segment and very high for another small segment. It clarified that some customers would highly value the offering in certain situations, while those same and some other customers would have little value for the offering in other, more common, situations.

The original product that was considered similar in position according to a weighted-average benefit metric was clearly identified as not a real competitor. Rather, a different, inferior product was found to be the nearest competing alternative. I say inferior yet in some situations the two products were relatively comparable, while in others the inferiority was blatantly obvious. Because the exchange value approach examines the focal product against its next nearest competitor from the viewpoint of a specific market segment, it creates a focused picture of how an offering is likely to be evaluated by that specific segment. If more segments and competitors are to be considered, more models of the Exchange Value to Customer are needed. This leads to better and more accurate pricing on a segment-by-segment basis.

> Value-based pricing drives the firm to approach the right customers with the right value proposition to drive their purchases profitably.

Specificity

Recall the adage: markets don't buy products, customers do. Value-based pricing drives the firm to approach the right customers with the right value proposition to drive their purchases profitably. The more price segmentation a company can do, the more profitable it generally is.

Exchange Value to Customer clarifies which segment of the market is likely to purchase at a given price, thus enables the company to pick the segment to serve when management decides on a price. By providing greater clarity than a weighted-average approach, exchange value to customer enables better pricing and decision-making.

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Six Best Practices for Pricing Research

Businesses in all markets should constantly be looking for ways to increase profits and better optimize every aspect of their operation. One proven way to do so is by evaluating pricing strategies and utilizing solid pricing research to make sure they maximize profits. In this article, the author presents six best practices pricers should employ when conducting pricing research. Author Paul Hunt is the president of Pricing Solutions and a frequent PPS presenter, instructor, and contributor. He can be reached at phunt@pricingsolutions.com.

Companies are increasingly turning to pricing research to maximize their profit and with good reason. Given its scientific accuracy, it is a reliable way to optimize your pricing strategy. When used correctly, pricing research is a tool that companies cannot afford to ignore. Having a firm understanding of how prices are being perceived by your customers is now more important than ever. Sound pricing research can be the difference between a successful product or service or a flop.

Re-analyzing core pricing strategies can help both lulling businesses as well as businesses pursuing growth. One such consumer products company was stuck with this issue. The business kept prices at 99 cents, a key pricing threshold, but was not meeting their profit objectives. Management was concerned that customers were too accustomed to the price that pushing through the 99-cent threshold would dramatically reduce volume, ultimately hurting their bottom line. The company needed information from their customers in order to make this critical pricing decision.

Vigorous research showed that in order to mitigate profit losses, the price increase should be set at $1.29 and volume would fall after the 99 cent threshold. However, volume remained relatively similar at prices between $1.00 and $1.29. With this information, the company could now confidently set new prices at $1.29, improving their overall profitability. Pricing research can go a long way in helping you discover and create new opportunities for your business. Here are 6 ways you can successfully conduct research and get the most from your results.

1. Start Pricing Research Early

When conducting pricing research for a new product or service, the earlier in the development phase you can start, the better. This way you can “design-to-price,” a philosophy where you deliver the most value to a customer by first setting a price point and then building products around those thresholds. Pricing research will allow you to understand what your customers are willing to pay, and make sure you don’t over or under deliver on your product or service at price points. By realizing these pricing objectives you can make more profitable design decisions.

2. Choose the Right way to Research

Pricing research methods are based on two very different categories, business-to-business (B2B) and business-to-consumer (B2C). For B2B companies qualitative (discussion-based) research seems to be most effective. Since B2Bs have considerably smaller customer bases, conducting interviews and product tests are the best methods for effective pricing research. For B2C companies, quantitative (survey-based) research will provide the most useful data because the consumer base is much larger and diverse.

3. Indirectly Conduct your Research

Never directly ask customers what they would be willing to pay. Customers often underestimate or overestimate their willingness to pay and are susceptible to bias. When conducting pricing research, it is best to gather information on price indirectly. Do this by having consumers answer tangent questions on related issues and value drivers.

4. Use Pricing Research to Build Meaningful Segmentation

The main objectives of pricing research are to help you segment the market and help you decide the niche you want to target. More importantly, it can help you understand which markets you are not going to pursue. Pricing research can give you valuable insight into a consumer’s willingness to pay to make sure your product or service has an adequate market.

5. Pass the Data to the Sales Team

Once you have developed your pricing strategy the results should be passed on to the sales force. By giving them access to this data your sales force can more efficiently target and sell to customers. Many companies provide their sales force with product education, but that seldom relates to what customers are willing to pay. In providing them with relevant pricing data they can better articulate sale pitches and reduce confusion when negotiating prices with customers.

6. Set Definable Goals

Consider long-term growth when conducting pricing research. Don’t simply research how to price a single new product. Try to gather data from competitors, pricing history, and other sources to help you make ongoing decisions for your business. Set definable goals of what you want to accomplish through pricing research and squeeze as much value out of your research investment.

Businesses should constantly be looking for ways to increase profits and better optimize every aspect of their operation. One proven way to do so is by evaluating pricing strategies and utilizing solid pricing research to make sure they maximize profits.

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Practical Analytics: Cutting Through the Garbage

There are hundreds of vendors, technologies and services that use analytics, but deciding on what the right solution is for your business can be difficult. In this article, the author presents 6 practical tips for selecting the right analytics solution. This article is specifically relevant to pricing with the continued growth of Big Data applications and the importance of consumer analytics in pricing decisions. Michael Stanisz is a Principal at Revenue Management Labs, where they help companies develop and execute practical solutions to maximize long-term revenue and profitability. Connect with Michael at mstanisz@revenueml.com.

The first piece of advice that I always give people looking to expand their analytical capability is this: "Don't trust anyone using the term **analytics.**" Now watch me be a hypocrite as I use the term ten times throughout this article.

The term "analytics" is ambiguous. Analogous to the claim: "I can help you do math." A third grader doing fractions has very different needs compared to a university student solving partial differential equations. Both activities constitute math. Specificity matters. The term has been used to describe a wide array of topics from aggregating databases, data visualization and reporting to cutting edge advanced statistical modeling.

The world can be a confusing place for those of you out there looking for help to solve business problems using analytics. There are hundreds of vendors, technologies and services that use analytics, but deciding on what the right solution is for your business can be difficult. Over several years, I have seen companies implement hundreds of analytical solutions with varying degrees of success and frustration. To reduce risk and enhance success, I have developed 6 practical tips when hunting for the right solution.

1. Don't Be Fooled by Attractive Words

Terminology in the analytics space is constantly evolving. It's hard to read through a business magazine without hearing about machine learning, deep learning, AI, VR or analytics.

These concepts may be at the forefront of solution providers' marketing, but most of these concepts have existed and been utilized for years without the preponderance of fancy lingo. **People often find themselves enamored with "buzz words" and miss focusing on the business problems they are trying to solve.**

Algorithms and back-end technologies are simply tools that are comparable to a hammer or saw. Do not lose sight of the overall goal or business problem you have to deliver on.

2. You Don't Need a Ferrari

A client once described to me a situation that occurred when implementing an analytical solution: "Picture a cave man who is trying to light a fire with two sticks. I drive up to him in a brand-new Ferrari, throw him the keys and expect him to drive." This is all but too common within many organizations.

They finance large, complex, expensive solutions to drive an analytical culture without truly understanding the infrastructure (e.g. people, structure, targets, etc.) that need to be in place for success. This often leads to a brand-new Ferrari (tool) collecting dust in the garage. Before buying a Ferrari, test drive cheaper alternatives and train the organization to drive slowly and approach methodically.

Pilot programs or home-grown solutions are often a good alternative to test an organization's capability of successfully transitioning to a data lead organization.

3. Don't Get Too Hung Up on the Data Acquisition

This is often a point of contention with many people spouting the adage "garbage in, garbage out." Let me preface by saying that I agree with this notion whole-heartedly, but there is a vast difference between perfect data and incomplete data.

I have seen managers and directors so focused on gathering the perfect data set that they go months without being able to make a business decision. A good strategy is to utilize the information available, even if it only gets you eighty percent of the way there. This not only allows businesses to make actionable decisions but also creates an environment to learn about quirks in the data that require future adjustment. That being said, the incomplete data needs to be verified for quality and should constantly be updated.

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4. The Plain English Rule

Put simply, make sure you understand the process and are able to describe what you are doing in plain English (one to three sentences). For example, a tool that segments customers using hierarchical Bayesian k-means clustering methods can be simplified to "grouping likewise things based on attributes."

Possibly the most important thing to remember when embarking on new analytics initiatives is to remember the wise words of Jerry Maguire: "Show me the money."

Technical jargon is endless and is often used to portray the illusion of complexity and sophistication. I often hear vendors respond with "it's complicated" followed by a slew of technical jargon that I can barely comprehend. Swallowing pride and admitting a lack of understanding of the technical jargon can force the conversation back to plain language. Make sure never to commit to a tool or project which you do not fully understand in plain language!

5. Use the Sniff Test

The sniff test, a valuable tool to use in everyday business life, is just as germane and relevant to analytics. Most people would be familiar with the concept of doing a smell check or back of the napkin calculation to ensure the outcome is reasonable.

What is surprising is that I see professionals every day trusting the output of analytical tools blindly, without the sniff test. Recently, I worked with a company that was using elasticity outputs to quantify increasing prices. They were shocked to see a much larger volume impact when the price was adjusted. There was an obvious underlying error in the model not accounting for distribution gains, artificially lowering the elasticity on certain SKUs and costing the company millions. A simple sniff test would have identified the problem and saved millions.

6. Show me the Money

Possibly the most important thing to remember when embarking on new analytics initiatives is to remember the wise words of Jerry Maguire: "Show me the money."

It is easy to get lost in metrics like clicks, conversions, market share, etc. Without understanding the financial value of the metrics, they are useless. If a click on an advertisement does not lead to increased revenue or profitability, it does not make sense to invest in a solution to drive and monitor clicks. A narrow, one dimensional, blinded viewpoint can be costly. Before investing have a clear vision of the objectives and financial return.

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Mix and Match: Clever Customer Segmentation in the Middle East

In this article, the author explains how the changing market complexity and increasing customer diversity in the Middle East demands that pricers and marketers develop more dynamic consumer profiling methods for this region. Consumer profiles are evolving at a more rapid rate than that determined by traditional market segmentation methods such as mere geographical clustering, revealing that consumers are looking to purchase offers that go beyond their known price thresholds.

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The cultural diversity in the Middle East (the Gulf region in particular), along with the constant fluctuation of foreign residents coming and going every few years, create a type of market vitality that should encourage companies operating in the region to regularly revise their market segmentation techniques. **The traditional method of building static consumer profiles should be replaced to create a more dynamic mechanism.**

When it comes to market segmentation, many companies in the region tend to apply some sort of polarizing approach to society. However, the reality is more vibrant than these companies realize. **Middle East consumers today have become more unpredictable and markets are heavily affected by consumer behavior and lifestyle factors.** Consumer profiles are evolving at a more rapid rate than that determined by traditional market segmentation methods such as mere geographical clustering, revealing that consumers are looking to purchase offers that go beyond their known price thresholds.

Family income, for example, used to be a key determining factor of consumer purchasing behavior. However, the widespread application of credit card installment payment plans offered by banks (zero interest rate payment plans in particular) has motivated large numbers of consumers to surpass their predetermined purchasing profiles to acquire products that are beyond their normal financial means.

To deal with the challenging cultural diversity in the Gulf region, many companies begin their market segmentation process by dividing consumers geographically among three major regions (Arab, Asian and Western), and then proceed to the regular demographic sub-segment categorization that addresses each target group through its own particular medium.

Throughout this process, companies usually do not take into account the commonalities shared by all sub-segments living in a single society and under the influence of a specific cultural behavior pattern. Consequently, promotional campaigns play a crucial role in shaping overall consumer behavior.

While most Asian and European consumers begin their purchasing cycle by first assigning a given budget to their product needs and then looking for suitable products that fall within their allocated budgets, the purchasing cycle of Arab consumers starts with an emotional attachment to a specific product or service, and then proceeds to work around consumers' financial capacities. The preference of Arab consumers for a certain product is not explicitly admitted, although a purchase is often justified by discussing the qualities and benefits of the purchased product.

The telecommunications industry is a clear example of the phenomenon of duality among youth. Young people often switch from one operator to another in order to capitalize on the most profitable promotional offer. Yet, when it comes to purchasing mobile devices, they do not hesitate to raise their purchasing power substantially to procure the latest smart device. The same concept applies to the automotive industry. Arab consumers tend to place too much value on owning cars with many upscale features (this enhances their social image) and are willing to pay more for options and features that they will rarely use.

Companies that operate in the Middle East should change how they apply market segmentation and contemplate the benefits of switching from an absolute "given data" method to a "functional tool" technique. When launching new products (or even when running a promotional campaign), instead of addressing each segment as an isolated pillar, marketing executives need to consider a mix and match method: bringing together a number of sub-segments with certain shared commonalities and using a single approach to address them. This method has led to higher sales revenues than originally anticipated.

> The telecommunications industry is a clear example of the phenomenon of duality among youth.

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Price Transparency is Knocking on Your Door – Are You Ready?

This medical industry specific article provides valuable insight on the impacts of price transparency on pricing strategies in all industries. Author Chris Provines is a 24-year veteran of the healthcare industry. He is the CEO of ValueVantage, and the author of Strategic Pricing for Medical Technologies *(2012), and his newest book* Healthcare Value Selling *(2014). He is on the PPS Board of Advisors and is an Adjunct Professor at Rutgers University where he teaches in the MBA program. He can be reached at chris@valuevantagepartners.com.*

Hospital supply price and cost transparency has been an issue for a long time. **A 2012 study** by the U.S. Government Accountability Office (GAO) reported that medical devices suffer from opaque pricing, which leads to lower hospital bargaining power and higher costs. In the past, the key users and influencers of supply choice, physicians, were often unaware of supply prices and procedure costs. Recent studies, though, show that transparency is beginning to shine a light on medical supply costs. This appears to help change purchasing and utilization behavior, and could be an issue for many suppliers.

Published studies across a variety of supply areas – from spine to sutures to joints – illustrate the impact of greater transparency. A study by researchers at Wharton showed that price transparency has the potential to improve hospital bargaining power and reduce supply costs.

Other recent research shows that combining price/cost visibility with physician incentives can bring additional savings. A study published this year in JAMA indicated that physician-level cost scorecards combined with a department-level incentive reduces costs. In this study, physicians who received individual procedure-cost scorecards saw an almost 10% decrease in surgical supply costs.

Other studies have confirmed that greater visibility to costs, combined with some mechanism to share savings, result in supply cost savings. **Greater price/cost transparency is being driven by: advances in data transparency, the growth of new supply chain service companies, and the maturing of hospital supply chains.**

Price and cost transparency helps providers to take advantage of three potential cost-reduction levers:

1. **Price savings:** Help hospitals identify price savings or improve negotiation leverage
2. **Utilization:** Lower cost by reducing over-utilization of supplies
3. **Specification management:** Lower cost by using best-value or most appropriate supplies

Supply Chain Ecosystem Improving Price Transparency

The U.S. annual spending on medical devices and diagnostics is approximately $200 Billion. It's not surprising, therefore, that supply chain service companies are moving quickly to take advantage of the opportunity to help providers reduce costs. There's now a large ecosystem of businesses focused on helping providers take costs out and bring value in. These include: Vizient, MDBuyline, ECRI, Curvo, BroadJump, ProcuredHealth and many others.

A number of these companies provide a proactive means for providers to identify and act on savings opportunities. For example, Curvo offers a free open price benchmarking App. The App allows providers to upload their data and receive price benchmark data from 300 hospitals. Vizient has a similar product that allows hospitals to do real-time price benchmarking. ProcuredHealth offers a number of services including device formularies. These supply chain service businesses will likely continue to innovate in order to reduce supply costs.

Suppliers Are Aware, But May Not Be Ready

Most suppliers know transparency is coming. Two years ago, I conducted a study – along with Model N – of trends in the medical technology industry. In the survey, almost 80% of medical technology executives polled believed that price transparency would be a significant issue within 10 years.

Many suppliers have wide, unexplainable supply item price variation across customers. This is usually the result of poor pricing practices or widespread individual account-level negotiations.

With the continued pressure on providers to reduce costs, and the evolution of supply chain service companies, we may be at a tipping point where unprepared MedTech companies begin to suffer the full force of price/cost/value transparency.