

Ten Ways Not to Price New Products and Services

By

**Dennis E. Brown
Per Sjöfors
Atenga, Inc.**

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Abstract: Profits are lost when new products are priced incorrectly. Strategic pricing techniques, adapted to the special requirements of new products and services, will spell the difference between success and failure. As more than half of new product introductions fail, nothing could be more important.

Value Optimized Pricing is a business process that acquires and uses hard data to pinpoint messages, services, product attributes, competitive intelligence, and market segmentation data that actually correlate to customers' willingness to buy, and influence the levels they are willing to pay. It is particularly productive when applied to new product introductions.

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1. Introduction

New product introductions are the most important and risky activity of any growing business. Blockbusters such as RIM's Blackberry and Apple's iPod have redefined markets and companies for years to come. The first company to recognize a unmet need, a new marketplace, a new value proposition, and able to successfully fill it can earn outsized profits and build substantial competitive advantages, which can last for years. This is not only valid for consumer goods companies. The first company to recognize the need for Internet security filtering has grown to a \$200 million company with gross margins in excess of 92%, selling its products to corporations all over the world. In high tech companies, new products introduced in the prior 18 months often contribute more than half of current revenues. At Gillette, every year 50% of revenues are derived from products less than 5 years old.

Given the importance of new products to companies' success, and the fact that most new products fail, or tread along earning disappointing profits, the lack of attention paid to pricing them is shocking. In fact, in many cases, pricing is more of a detriment to new product success. Most companies focus on product design, cost control or sales volume and pay minimal attention to pricing, forgetting that pricing, especially for new products, is just as important as the other three variables. Even when they focus on pricing, many companies fail to optimize it. They fail to do the research and capture the relevant data that enables optimized new product pricing. They fail to use this data, and the price of the product, to formulate and strengthen their value propositions, drive product options, policies, messages and prices. In this failure, they forego funds that could be used to educate new customers, improve the product, or provide incentives for dealer channels. According to the research company AMR, 23% of new product failures involved failures in pricing.

2. Value Optimized Pricing

Managers rarely discuss pricing with enthusiasm. Pricing is often the center of strained relations with good customers. Competitors use pricing to steal market share. Within the company, product managers, financial managers and customer-contact managers clash over the structures and levels of prices. These clashes arise from the lack of hard data from the marketplace on their customers' willingness to pay. They are driven by the opinions, interests, perceptions and preferences of the individuals.

This lack of hard data leads many companies to give up. Managers declare that "*We know our costs, and we take our industry's traditional margins.*" Or, they say, "*We know our customers and we know what they will pay,*" believing that biased information from sales negotiations are the same as hard data, skipping the all-important data collection step altogether. One expert has

called this approach “winging it.” These managers may talk to a few salespeople and a few customers and get some feedback to justify their decisions. This input may make the managers feel good, and may raise their confidence in their decisions, but it cannot replace properly executed statistically significant research results. Thus, they fail to research adequately the market's perception of their various new value propositions or their product's features and attributes, messages, policies or options.

Some companies think about pricing differently. They have discovered the highly leveraged effect of pricing on their business success, and they have built the capacity to practice pricing in a way that transforms the bottom line.

A process called Value Optimized Pricing turns price strategy into a formidable instrument for growth and competition. Companies using this process perform extensive, focused market research of a particular kind before setting their pricing strategy. They manage their price structure aggressively. The price structure is the focus of their ongoing activity to grow their business profitably. Value Optimized Pricing enables companies to define service levels and bundles of products and services targeted to specific, well-defined markets. Value Optimized Pricing provides ongoing efficiencies in product development, marketing, sales and operations. Value Optimized Pricing aligns your company's offerings with the perceptions of value of your prospects and customers. Value Optimized Pricing is also a framework for managing your relations with customers and with competitors.

Right pricing the products from just about any company is perceived a big problem. In a recent study, 186 managers around the world (57 from the United States) responded to a survey in which they rated the severity of their various problems. As can be seen in Figure 1, below, pricing decisively topped the list, and pricing in the business-to-business sector was even more problematic.

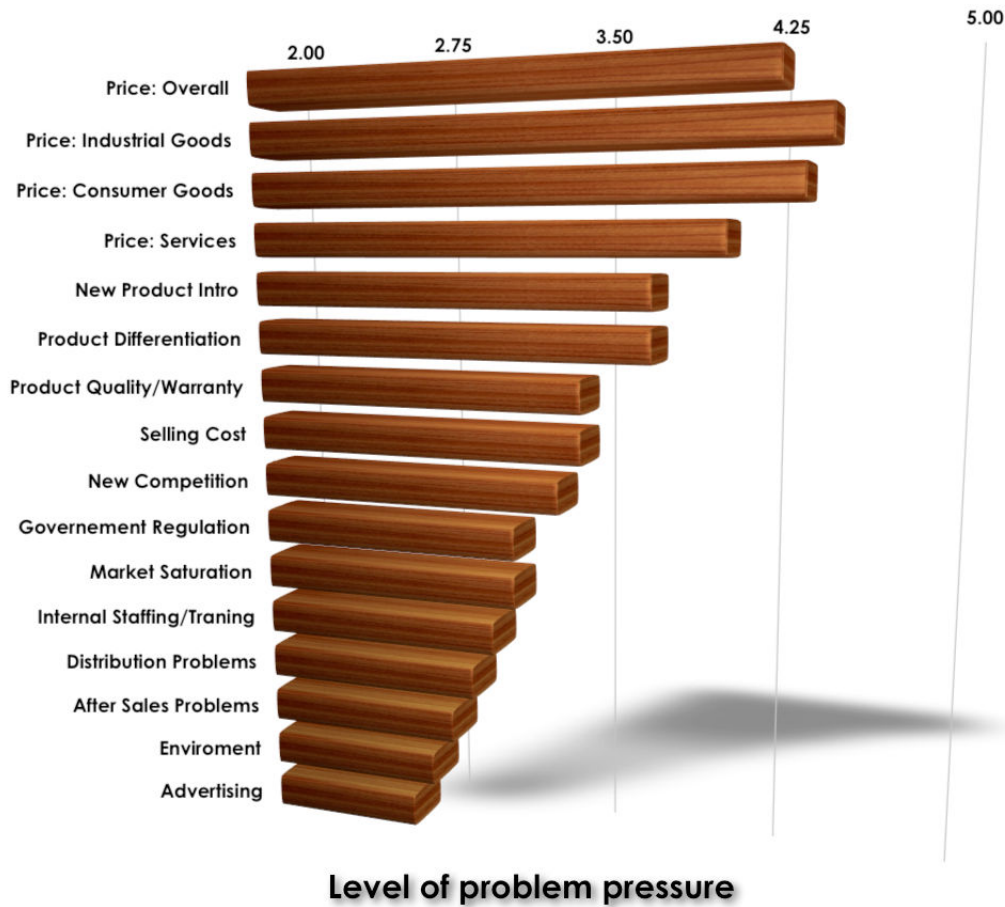


Figure 1
Managers' Rating of Marketing Issues

3. Pricing Successes

Consider the following three scenarios:

A manufacturer of specialized wiring harnesses priced a new model at \$150. This was a replacement product, designed to obsolete its predecessor. It substantially simplifies the connection of a particular broadcast camera to a particular video capture device. Instead of using a rat's nest of wires and confusing plugs, the new harness was a simple bundle with a diagram of the camera's socket configuration printed on its jacket. It clearly labeled which plugs went into which sockets. The company's normal cost-plus formula would have priced it only \$137.50. Raising the price to \$150.00 created a mirror for the attributes of simplicity and usability that the company wanted to communicate. Surveys showed that the \$150.00 price

would be well-accepted by the users. At 10,000 units projected for the first year, the results are shown in the table below:

	Priced at 137.50	Priced at \$150.00	Difference
Units	10,000	9,500	
Revenue	1,375,000	1,425,000	
Cost	1,100,000	1,045,000	
Profit	275,000	380,000	\$105,000

The simple 9% difference in price realization drove 38% higher profits (\$105,000/\$275,000), in spite of slightly lower sales volume!

A drug manufacturer introduced a new ulcer medication after the market incumbent was already established. This was an enhancement product. Conventional wisdom said that as a late entrant, the drug should be priced at least 10% below the incumbent's price. But market research showed that doctors were concerned about drug interactions and side effects, and the dosing of the new product was more convenient. So knowing the attributes of the product that buyers valued, the company was able to charge more for it, and the product was released at a premium price over that of the incumbent. The pricing became a way to communicate the product's superior attributes in the marketplace, an active part of the marketing mix. The product became the volume leader in its category.

A commodity business services company felt strong competitive pressure and decided to do something about it, by introducing a new premium service. The company's introduction of this new service was so successful that it is now the company's only offering, and it is marketed at a price *fully ten times* that of competitive services in its marketplace. By surveying the market, they were able to identify a market segment that is not price sensitive. The service of this company was a breakthrough, offering a value proposition never before available. They guaranteed elimination (not just control) of a particular business problem. They focused all their marketing and sales efforts on this particularly quality-sensitive segment of the market and promised them what they really needed. Recognizing the superior value provided to this chosen segment, the company let that guide their price. This enabled the firm to train and compensate their staff in a way that allowed them to deliver on the promised level of service. Thus the customer's value perception drove the price, which in turn funded the activities necessary to provide the value.

These success stories have several elements in common. First, the companies went beyond mere cost-plus and competitive analysis. They used their cost data only to establish a *floor* for their prices. Then, through careful, in-depth market research they looked beyond their cost data, and segmented their markets based on each market segment's resonant value proposition and willingness to pay. Furthermore, the first company used price to communicate a very distinct message: that simplicity is a premium. The firm reinforced the price with other renditions of the same message in their product descriptions and marketing, and in the guidance they gave their sales force. The result was a business success, as they went on to dominate their marketplace. The second company used qualitative market research to understand at a profound level what was the value they delivered to their customers and what they would pay for it. Again, they went on to dominate their market. The third company was able to define and isolate the most profitable portion of their marketplace. Once they had done so, they configured the entire company to serve only that portion, and they were able to dominate it. They denied the richest profits to their competitors and captured them for themselves.

4. 10 Ways Not to Price

4.1 Mistake #1: Ask your salespeople

Companies tend to rely on their salespeople for market intelligence. The rationale is straightforward; salespeople are out talking to customers every day, so they understand what the market is demanding.

There are a number of problems with this approach. First, salespeople are generally motivated to "get a deal" at any price. Customers are generally motivated to drive down your prices. So asking the salespeople for price guidance creates a downward bias in your pricing, a force to lower the prices. Second, salespeople are not trained or skilled at understanding buyers' needs in an actionable fashion, with the precision necessary to support price actions. The skill of extracting from buyers a clear, actionable basis for understanding needs is not usually taught in sales training classes, and salespeople usually come back with superficial statements around desirable traits expressed in adjectives. Third, buyers are often reluctant to share with salespeople what they truly value about your product or service, as well as competitive and alternative solutions to their problem, so what emerges is a distorted view of their needs.

The gold standard for market information is anonymously conducted market research by a skilled, trained independent third party. Buyers describe their perceptions, values, needs and wants, and rate alternatives on a number of relevant attributes. Research of this type enables companies to better understand and leverage the perceived value their products bring to their customers, and how to address, influence, control and leverage those perceptions. These perceptions and values

drive their customers' decision-making: whether they will buy at all, and what levels they are willing to pay.

4.2 Mistake #2: Leave pricing to the end

When prices are decided after the product design is complete, they rarely reflect the value perceptions of the buyers. When new products are proposed, the essential first step is to identify and qualify the buyer's problem that it will solve, the outcome or results buyer are looking for, and what they are willing to pay for that outcome. "Mr. Buyer, if we could <state the problem> what would that do for you? What savings would it generate? What additional revenues would it enable? What processes would it impact and streamline?" Answers to these questions, other elements of the willingness-to-pay issue, and trade-off analysis, taken, of course, to much greater detail, will enable you to establish the actual value for your solution. This value, then, becomes the basis of the product design, development, and pricing. Products should be designed to deliver a particular value for selected buyers, and to deliver a profit at the prices those buyers are willing to pay.

4.3 Mistake #3: Base prices on costs

Basing prices on costs is a time-tested, effective and proven way to drive profits away from new products. Costs have little or nothing to do with buyers' perceptions of value, and willingness to pay, so using your cost as the basis for prices guarantees that the price will be too high for some customers and too low for others.

Basing the price on cost also means you fail to segment the market, and sell a "one size fits all" product or service. Some segments will look at your product and say "too cheap, cannot be any good", while other segments will say "too expensive".

4.4 Mistake #4: Make price decisions based on "gut feel"

Decisions based on hard data and sound analysis are more likely to be correct than those based on gut feel, intuition and casual conversations. Setting prices is not an area where data and analysis should be ignored. Prices must reflect the value perceptions of the buyers, and the only way to know these is to ask them in a systematic, unbiased anonymous process. When companies base their prices on an imprecise abstraction like "the market", they invariably fail to capture the value they are delivering to customers. Basing prices on "gut feel" provides no resistance to premature commoditization.

4.5 Mistake #5: Base your price on internal perceptions of value

The classic example of Mistake #5 is to bring out new technology from the labs based on the attractiveness of the technology, rather than the needs of the buyers. But there are other cases

too, new products marketed based on sound recognition of buyers' needs, priced to capture the maximum portion of their willingness to pay.

Even where products have emerged from the laboratories rather than from the needs of consumers, their marketing and pricing must still be based on buyers' value perceptions. There are numerous successes where breakthrough products were developed by insightful individuals who were lucky enough or intuitive enough to discern needs unmet in the marketplace and move quickly to solve them. But the critical pricing step is too important to be done by intuition. It must reflect the value perceptions of the buyers, and the company must seize control of those perceptions and move over time to improve them.

4.6 Mistake #6: Ignore connection of value to customer economics

Buyers may *like* a new product, process or service, but they will only buy it if it produces one of four general outcomes:

1. It saves them money.
2. It generates revenues.
3. It enables them to do something they could not do before (and desperately need to do), or to do something faster and more conveniently.
4. It helps them to better meet personal goals or objectives

These outcomes are expressed here in very general terms, but they are the only reason business buyers open their wallets. Their generality means that a large number of companies can use them to describe their new products, and buyers have become jaded, tuning out these messages. This means you must know, better than your competitors:

1. How your products save them money (and how much!)
2. How they generate revenues (and how much!)
3. What are their perceptions of value around your problem area today (which drives your customers' willingness to pay)
4. What very explicit messages will cut through the clutter and express clear statements of value.

Hard savings are shown by reducing consumption of materials, reducing labor, or reducing risk. It is not enough to merely say "this will save you time." You must show which business processes will be affected, and which steps will be removed or reduced. Risk reduction must be similarly explicit; you must assess the value of the bad thing to be avoided, calculate its current risk, and show how you reduce it.

Faster, easier, more convenience are all examples of soft savings. It is much more difficult for a buyer to justify a purchase on soft savings, and most companies discount them in their buying decisions. If at all possible, do the hard work of turning soft savings into hard savings for your buyers.

Personal objectives are almost as important in business-to-business scenarios as they are in consumer goods. In the corporation, people will make purchase decisions they will enhance their standing in the company. The opposite is also true people will NOT make a decision if there is any risk that the decision may reduce their standing in the company. In the computer business, one of the most powerful messages ever written was "nobody gets fired for buying IBM".

4.7 Mistake #7: Win the deal at any price.

When the variable costs are a relatively high percentage of the total cost of producing a unit for sale, setting the price, and determining the profit of any transaction is straightforward. When the variable costs are a low percentage of the total cost, or when fixed costs must be allocated among multiple products, the definition of "profit" for any given transaction is much murkier. In this context, it is far more tempting to discount heavily to win the business. An attitude of "any dollar is a good dollar; any customer is a good customer" takes hold, and getting your price becomes much more difficult. The difficulty is made even worse because customers know this, and they may bargain even harder for low prices.

The counterbalance to this attitude is a clear recognition of the value that your solution delivers. An economic value analysis (EVA) should be a rigorous part of any new product development; if the new product cannot deliver clear economic value to the customer, its release should be carefully scrutinized. Turn the EVA into a sales tool, so your salespeople know what questions to ask, what data to gather in order to demonstrate for any specific customer the economic value your solution delivers.

A second counterbalance is a salesperson compensation plan based on profit, not on volume. When salespeople are motivated to get the deal at any price, it is inevitable that they will work to drive prices down, depriving the company of revenues and profits they should have.

A third counterbalance is a careful review of discounting authority and practices. Careful restriction of discount authority can often improve price realization in and of itself.

4.8 Mistake #8: Use lower prices to win quick market share

This mistake is surprisingly common. Companies release a new product, and they are motivated to drive sales as rapidly as possible. They perceive price as an inhibitor of sales, and they work to remove as many inhibitors as possible. Hence, the impulse to lower price.

The problem with this line of reasoning is that it ignores the realities of customer perception. First, a low price often signals low quality. The lower price of StarOffice on the market today signals to buyers that the utility of the purchase will be less than "better" products such as Microsoft Word. This is a clear case of low pricing driving lowered perceptions of value. A better strategy for StarOffice would be to design, support, package and price it for a specific market (such as the scientific market) where it can provide exceptional value, concentrate its efforts, and earn higher prices.

If your product is truly innovative a higher price will signal this fact to the marketplace; a lower price is counter-productive. If your product is similar to an existing market leader and your cost structure is similar as well, a low price will generally not win great success. One Atenga client brought out a "me too" medical product at a price 20% lower than its competitors. After several years on the market, the company withdrew, having won a negligible share of the market. Subsequently, the company reformulated the product, targeted it at a specific market segment, offered it at a premium price and within 6 months was able to dominate its selected market niche.

In the software arena, the example of VMWare is representative:

A company called VMWare is leading the development of a marketplace for "virtual computing," a technology that enables a single physical computer to host many separate "virtual" computers, each with its own setup, applications, and peripherals. This turns out to be surprisingly useful. VMWare fees are \$5,570 plus \$1200 per month. Their competitor, Virtual Iron offers a similar, but slightly less functional product for a \$1,000 license. After several years, VMWare still commands 85% market share.

A radically lower price is a successful market entry strategy only under two conditions. First, it can succeed if it brings new buyers into the marketplace, buyers who were formerly shut out, who desire the new product's functionality but were unwilling to pay its price. Second, it can succeed if you determine that the existing marketplace is "overserved," that is, existing buyers do not value the features the existing products delivers, and will prefer something less costly and often less capable. This latter determination should be the basis for a new product development and release only if based on very solid market intelligence.

4.9 Mistake #9: Base your messaging on product features

Ask many marketers why buyers should purchase their products, and they may respond with a set of product features. "Buy our product because it is reliable," they may say. Or, "Our product is compatible with both Windows and Unix." Vendors routinely describe their new products in terms of their features, occasionally the benefits those features deliver, and only rarely do they address

the reasons one should purchase something like it at all. The result is predictable; salespeople hold numerous conversations with interested buyers, but sales results are disappointing.

It is useful to consider a new product in terms of the "job" that it is hired to do. A software-training product, for example, is hired to enable employees to be trained less expensively, more quickly, more conveniently, more thoroughly. Yet the "job" companies buy this product for is better employee relations; well trained employees are less likely to switch jobs, more loyal, are less absent, etc., saving companies substantial sums of money. Thus, the value-optimized price is **not only** related to the cost of traditional class-room training, but the cost of new hires. A computer-assisted surgery device is hired to enable surgeons to operate on knees minimizing the trauma of the surgery process itself. Yet the "job" is lowering the risk of complications; costly for the hospitals and surgeons in terms of reputation; costly for the insurance companies in terms of cost. Thus the value optimized price is **not only** related to the reduced cost of less trauma, but the much higher cost of complications, which, can be many times the cost of surgery in the first place. Only when the buyers agree that these outcomes are worth paying for do they become interested in the product's features (robust, scalable, reliable), its flexible licensing model, etc. These latter features speak to the levels they are willing to pay.

4.10 Mistake # 10: One Price Fits All

New products are released to the general marketplace without recognition of the Iron Law of Pricing. That law states that different customers will value your products differently, recognizing that buyers vary in their buying motives and the levels they are willing to pay. Even highly targeted products often fail to take into account the differences among buyers in these important attributes.

Companies often segment based on geography, size of company SIC code. All of these discriminators have the advantage of being relatively easy to apply, but they usually obscure the more important discriminators: What product attributes will the buyers respond to? What underlies their willingness to buy? What messages will attract their interest? How will they want to be approached and informed? What is their timeframe for solving the problem? These differentiators enable the company to find the segments most likely to purchase the new product, most likely to value it highly, least likely to resist fair prices.

5. Conclusion

New products and services present a unique challenge to the manager or executive responsible for taking them to market and setting their prices. The challenge lies in the nature of competition, the absence of historical data, and the importance of price as a token as well as a measure of the new product's value. Disciplined, careful research, however, can provide the data to support

sound judgments about the customer's perceptions of value and willingness to pay. The research must include internal as well as external perceptions, and it must collect enough metadata to enable judgments about which market segments are the most likely to adopt the new products quickly and profitably.

Atenga is a strategic pricing company, helping companies optimize their price levels and realization strategies. Atenga developed the Roadmap and provides the educational, research and analytical services that support Value Optimized Pricing. For more information, visit us at www.atenga.com, write us at info@atenga.com, or call us at 888-280-8251 ext 2.

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